

1 August 2007

Recommendation

Buy*

Upside

33%

Target Price

US\$2.11

Current Price

US\$1.59**



Arafa Holding

Textile Industry | Egypt

"Shopping for larger sizes..."

Reuters Code

AIVC.CA

Bloomberg Code

AIVC EY

Market Cap

US\$377.6 million

Enterprise Value

US\$368.9 million

Number of Shares Outstanding

237,500,000

Average Daily Turnover

US\$744,512

12-months high/ low

US\$1.62/1.14

Shareholders' Structure

25.3% | Alaa Arafa

16.5% | Samaa Ragab

13.7% | Shereen Arafa

11.9% | Ashraf Arafa

32.6% | Free Float

From a textile manufacturer to a vertically integrated large retail group

Al Arafa for Investment and Consultancies (Arafa Holding) currently holds a group of companies that can be broadly classified under one of 3 segments: Textile, Apparel & Tailoring, and Retail. With US\$292.4 million of revenues in FY06/07, Arafa exports 90% of its products on a net basis, mainly to the UK and the US. BMB group, which was acquired by Arafa in 2004, currently accounts for 57% of the total group revenues. Generally, manufacturing and tailoring activities take place in Egypt, giving Arafa an important competitive advantage due to the low labor component, which reduces the "cut and make" costs. That is why Arafa's strategy will be based on 3 components, going forward: (a) Leveraging on the supply benefit from manufacturing in a low-cost market; (b) Keeping the supply chain inside one company, while serving a number of countries; and (c) Focusing on the synergies created between the different subsidiaries and distributors.

Acquisitions to result in major growth...

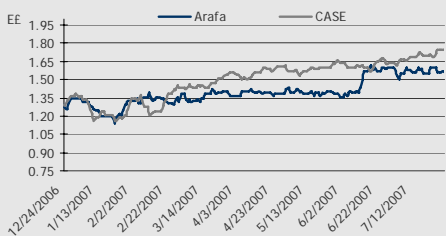
Arafa Holding is set to witness a complete turnaround in the next year or so. This is due to the fact that the company is aiming to acquire a number of companies that will grow its revenue base both non-organically (through acquisitions) and organically (through increased orders for the apparel & tailoring and textile segments). Acquisitions are to focus on already established brand names with a strong local management team, and are to be funded using a 70/30 debt to equity mix to acquire a stake that ensures a sufficient control. We believe that this task will be very challenging, as it will be increasing the size of the company significantly.

...while enhancing further integration and synergies between the main segments

The vertical integration between the 3 segments is one of the strongest features of Arafa Holding. The company intends to capitalize on the advantage created through the vertical integration of its business segments, which creates important synergies between the different companies under the umbrella of Arafa.

We value Arafa at US\$2.11 per share, 33% above current market price

Arafa Holding's consolidated performance has witnessed improvement, especially as the restructuring of its important holding BMB has come to an end. We expect margins to continue rising constantly, especially with more important inter-segment sales contributing positively to the bottom line, as subsidiaries leverage more on the supply advantage that they have in the Egyptian manufacturing facilities. Our DCF valuation of Arafa yielded a fair value of US\$2.11 per share, 33% above current market price, and accordingly, we assign Arafa a "Buy" recommendation.



* Refer to back cover for investment ratings
** Closing of 1 August 2007

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Selected Indicators

Year ended March 31 st	2005PF	2006PF	2007A	2008F	2009F	2010F	2011F
Revenues (US\$ mil.)	254	275	292	332	393	429	454
Gross Profit (US\$ mil.)	84	92	104	121	146	167	190
Gross Profit Margin (%)	33%	33%	36%	36%	37%	39%	42%
EBITDA (US\$ mil.)*	27	28	39	45	55	68	82
EBITDA Margin (%)	10%	10%	13%	13%	14%	16%	18%
Net Income (US\$ mil.)	13	19	24	31	38	48	59
EPS (US\$)	nm	nm	0.10	0.13	0.16	0.20	0.25
P/E (x)	nm	nm	15.4	12.2	9.7	7.7	6.4
P/B (x)	nm	nm	2.4	2.3	2.0	1.7	1.5
Total Debt/Equity (x)	2.2	1.4	0.4	0.5	0.5	0.5	0.5
EBITDA Int. Coverage (x)	5.1	4.8	5.8	7.7	8.1	9.1	9.9

Source: Arafa Holding Pro-forma figures, Beltone Financial estimates
nm not meaningful
* Excluding export rebates

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Arafa Holding – An Overview

Al Arafa for Investment and Consultancies (Arafa Holding) is a textile and garment manufacturer, exporter, and a global retailer, the latter being the main driving force of the company. Arafa's business model relies on using low-cost Egyptian production facilities, while exporting to European markets, mainly the UK. In late 2006, Arafa Holding underwent an Initial Public Offering (IPO), after almost half a decade of being a privately-owned family business. Having said that, and except for its current chairman and CEO, the Arafa business has almost always been mostly managed by non-family members.

Arafa is currently a large vertically integrated retail group

Strengths

- Vertical integration of the different segments, creating important synergies
- Low labour costs, which provides Arafa with a major competitive advantage
- Business relationship with diversified well-known fashion names
- Strong management team with international experience and clear strategy

Weaknesses

- Difficulty to fix lead times to deliver end products, due to local logistical problems
- Concentration of major customers, given that most of the sales of the apparel & tailoring segment are directed to a few customers
- Low margins of main provider of revenues, the retail segment, given the nature of the retail business as well as the dependence on the mature UK market for retail sales
- Aggressive expansion strategy with, currently, unknown outcomes, making it difficult to predict performance

Arafa Holding has evolved basically from being a small simple retailer and textile manufacturer, to a more sophisticated apparel and tailoring company, and progressively also to a supplier and retailer for well-known fashion houses. This last step is set to draft the future of Arafa, as the main growth strategy, going forward, is set to focus on acquiring quality distributors with established brands. These acquisitions would not only expand the business operations, but would also benefit other parts of the business, as the company will be looking to export local products to the acquired retailers, creating a synergy between its different segments. This will be helped by the competitive advantage that Arafa has from the textile and apparel & tailoring segments in the local market given the low labour costs in Egypt. The strong partnerships with renowned fashion houses and the experienced management team should continue to boost the company's performance in the future.

Major growth strategy to focus on acquisitions to increase synergies between different segments...

On the other hand, Arafa is still facing serious problems with fixing the delivery time of its end products to the export markets, because of logistical reasons that are mostly out of their control. The company is, however, working towards improving the general operational conditions. Aggregate sales related to the apparel & tailoring segment's 5 largest customers contribute more than 70% to total company sales, creating a high concentration risk, although this is a common practice by similar businesses, and is acceptable according to industry norms. Margins on retail revenues, the main contributor to sales, are naturally very slim; more so because of the dependence on the mature UK market. Despite that, Arafa aims to expand through the acquisition of European retailers and distributors, with established markets and experienced management, to further enhance its aim in being a dominating international retail group. Whether the company would succeed in doing that, while growing their business organically, will depend on the quality of the acquired entities, which we find very hard to judge at this stage, especially in an established market, like the European market. Arafa is, however, supported by a strong board of directors, among whom is its UK subsidiary BMB's majority owner, Mr. Peter Lucas. In his capacity as the chairman of Arafa's retail segment, Mr. Lucas is advising the company on future target acquisitions in Europe, given his long experience in managing retail operations in the region. Together with other members of the board who have different backgrounds, Arafa is currently considering a list of prospect acquisitions, of which management expects at least one to be materializing before the end of the year.

...while delivery problems, concentration of major customers, and uncertain outcome from acquisitions are the main weaknesses

Group Structure & Operations

In broad terms, Arafa Holding operates in 3 inter-related segments, that is, Textile, Apparel & Tailoring, and Retail. Although the general organizational structure involves a large number of companies, each company operates, directly or indirectly, in one or several segments. We believe that analyzing each entity on a standalone basis would be irrelevant, at this stage, and that it is more important to analyze the individual segments and the inter-segments relationships.

Arafa's business relies on 3 main segments...

Vertical Integration is the main highlight ...

The 3 segments are actually partially vertically integrated as, besides acting as suppliers to each other, they have strong business relationships with other groups that are not under the umbrella of Arafa. This is considered to be a good contributor to the standalone as well as to the overall diversification of Arafa.

...with an important vertical integration

Figure 1 | Segment Integration



54.4% of textile sales were directed to sister companies in Apparel & Tailoring, while 17.1% of Apparel & Tailoring sales were directed to sister companies in the Retail segment

Source: Arafa Holding, Beltone Financial

As we can see in Figure 1, the idea of the integration goes two ways in Arafa Holding, as expansion in the retail business creates additional proportionate orders for the Apparel & Tailoring segment, which in turn means the Textile segment would be providing some of the garments to be used in tailoring. So, the business, in this sense, is not only vertically integrated, but also quite inter-related: more business for one segment means more business for the others, as well. That is why, throughout this report, we argue that the company's expansion policy will not only affect the retail segment, where it will be directly making acquisitions (and thus "growth by acquisition" or non-organic growth), but will also be contributing to the other two segments revenues, organically. Having said that, it is important to stress that Arafa is not in any way trying to achieve a full vertical integration, as management believes that no single subsidiary should be made dependent on a single supplier, even if this supplier is a sister company. Moreover, standalone companies are continuously seeking better deals to improve their individual margins. That is why for the year ended March 31st, 2007, 54.4% of the textile segment revenues came directly from the apparel and tailoring segment, while the latter derived only 17.1% of its sales from the retail segment. This means that, for instance, the apparel and tailoring companies sold most of their products to foreign retailers that are not part of the company. However, the integration of the 3 segments remains important and will continue to be the main highlight for Arafa Holding and the main driver of profitability, as the company secures more business for its different segments.

Demand is initiated at the Retail segment level creating more business to all segments

Retail

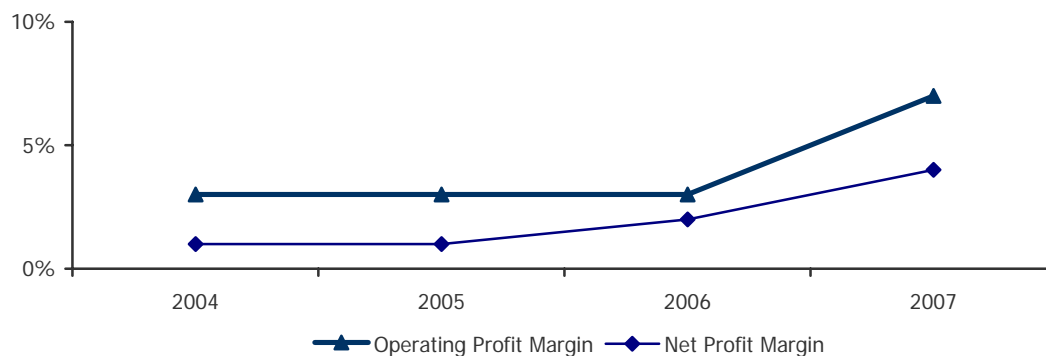
More than just the largest segment...

The Retail segment is the largest contributor to Arafa's revenues with 66% of total sales for the financial year ended March 31st, 2007 (FY06/07). Besides this, the importance of the retail segment to the company can be mainly referred to the overall demand-driven strategy of Arafa. The top-down approach that is basically created with demand for a finished product to be distributed by the retail segment, dictates certain apparel and tailoring inputs, which in turn means orders for the textile segment. So, by expanding its retail segment, Arafa Holding will not be just expanding one of its business segments, but will be further creating business for the other divisions. This vertical integration is one of the most important competitive advantages created for Arafa, as it allows better cost management and increased economies of scale. It also makes Arafa unique, in its local and regional market, as it ensures a timely response to market demand, and helps minimize operational risks by following the demand driven production approach.

... and despite the typically slim margins involved...

Although total retail sales grew by 23% from 2004 to 2007, the improvement in operating and net profit margins was not that significant, as is expected from typical retail operations. Margins were flat at 3% and 1% respectively from 2004-2006. The year ended March 31st, 2007 witnessed the best margins, as the results of restructuring the company's main provider of retail revenues, BMB, started to be seen in performance. Operating margins improved to 7% and net profit margins to 4%.

Figure 2 | Retail Segment Operational Performance



Source: Arafa Holding, Beltone Financial estimates

... Retail is definitely the segment that will define a new group

As we briefly explained earlier in the report, Arafa Holding has not always been largely dependent on owned retail and distribution in foreign markets. The company's experience is in general retail activities besides textile and garments manufacturing, which underpins the operational activities currently taking place. Although the earlier founder of the family business restarted the business (after the nationalization of its major manufacturing facilities) as a fabric retailer, the real garment retail segment has effectively been formed through 2 major acquisitions, one local and one foreign. The local market acquisition was of Concrete, which was a retailer of casual and smart-casual menswear. The foreign market acquisition took place in the UK and marked the real transformation of the retail segment, only 3 years ago, when Arafa acquired a 30% stake in BMB Group Limited. Arafa had historically good relationships with BMB, as it acted as a supplier of higher end formal men suits. The decision to venture with one of its suppliers was taken by BMB, as important synergies could be established between the distributor and the supplier, and since BMB was looking for a longer term source of finance, and a reliable partner.

BMB Group Limited

BMB group was formed through a management led buyout by its CEO Peter Lucas, who acquired it from the UK-based William Baird in 2000, following M&S' decision to cut down its suppliers, leaving William Baird in a relatively weaker position. BMB is basically a concessionaire, but also has its own stores. The group deals with over 750 active independent retailers in the UK, and is estimated to have the largest market share of the UK formal men suits market with around 22% in 2007 (M&S has around 18%). In 2004, Arafa acquired 30% in BMB, with an option to increase its portion to a controlling stake. BMB contributed, on average, 91% of total retail sales and 62% of consolidated Arafa sales, since its acquisition. Besides being Arafa's major contributor to revenues, the reason why we consider BMB as the main factor driving future performance of Arafa is that the company will be seeking to replicate the BMB model in future acquisitions. The importance of the relationship even extends beyond that, as Arafa entered into a garments supply agreement with BMB pursuant to which it will be supplying BMB with 300,000 suits (i.e. 30% of the total suits sold by BMB) and 250,000 linear meters of fabrics per year. BMB currently has concessions with high profile department stores such as Debenhams, House of Fraser, Selfridges and Burton. The group's long term strategy is to establish its own retail chains, however, this is unlikely to happen within the next 4-5 years, and the focus will remain on concessions in the short to medium term. As of March 31st, 2007, BMB occupied a total floor area of 19,345 m² (18,124 m² of which inside the UK, and the rest outside the UK in locations including Macy's in the USA). This constitutes a decrease of 17.4% over a total area of 23,403 m² the previous year, but is expected to increase again with the group acquiring additional concession areas, including "New Look". BMB offers brands including Alexandre Saville Row, Haggard, Jeff Banks, Baracuta and Arrow. The BMB business was loss-making in FY05/06, while a positive net profit of £1.01 million was recorded in FY06/07, as the benefits of the restructuring that started in 2005 are showing off. In reorganizing its operations, BMB succeeded in significantly reducing its operating costs, closing down manufacturing facilities, dealing with 1 warehouse instead of 3, and exiting one of their local suppliers to shift to lower cost producers like Egypt and China. The BMB experience will definitely be the first tangible evidence of the effect of further acquisitions on the main structure of Arafa. Moreover, Arafa is using BMB management's expertise in the European region in spotting the right acquisitions to support its overall strategy (see Business Strategy), the latest of which was Sweden's Melka, which should benefit BMB, as it opens new markets for both companies.

BMB is the UK's largest formal men suits' provider and Arafa's biggest contributor to revenues...

Concrete & Euromed

Concrete is currently a very strong local brand in Egypt for total look casual, smart-casual and formal menswear. It has a 40 stores located mainly in Cairo and Alexandria with a total floor area of 6,512 m² as at March 31st, 2007. This constitutes a 25% increase over the 5,224 m² the previous year. Of these, only 3 stores are owned and the rest are rented or franchised, which is the strategy that Arafa has with its retail branches. Concrete's profitability improved tremendously since its acquisition by Arafa, and is now one of the major contributors to the company's bottom line, although its contribution to revenues is limited. Concrete Garments Company is the only company in the group that falls under 2 different segments, namely Retail and Apparel & Tailoring. We see a significant potential for growth especially in the newly reformed Egyptian market (see Opportunities) and the current local demand boom. Concrete has been also recently capitalizing on "Concrete Generation" for kids wear, a largely untapped segment in the Egyptian market. Among the new introductions is "Concrete Concept" which specializes in formal menswear, and which should offer strong growth in the local market, given the low local quality available and the very expensive imported suits, with little in between. Euromed is Arafa's first venture into women's wear, with their stores "Brands for Less" which sell excess supply of the apparel & tailoring segment, besides other imported brands.

Concrete is a strong brand that is growing in a booming Egyptian retail market

Querini

Querini was recently formed through a joint venture between Arafa Holding and the Italy-based Forall Group, the second largest Italian manufacturer and retailer of high-quality men suits. A new production line has been set to produce exclusively for the Querini brand name. An order of 8,000 suits has been executed and shipped to Querini Italy, which will handle the distribution and marketing of the products. This step is considered an important one for the business, as it gives Arafa access to a new high-end niche market in Italy and expands the company's retail network indirectly.

Querini gives Arafa access to a new high-end market in Italy

Apparel & Tailoring

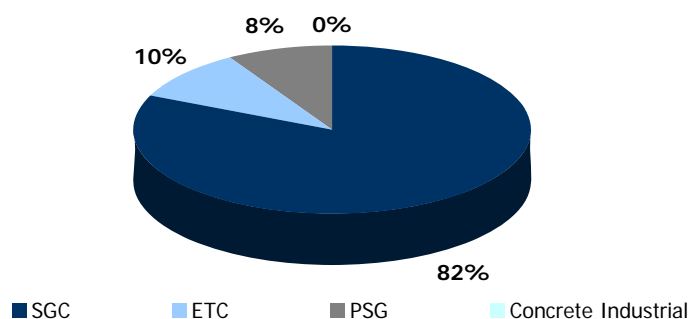
Arafa's indispensable production arm...

The Apparel & Tailoring (A&T) segment is Arafa's manufacturing arm. It produces casual wear, including woven shorts and trousers, and formal wear, including trousers, jackets and tailored suits. As of March 31st, 2007, the group's A&T facilities produced a total of 2.3 million suits. Although this segment contributes only 31.1% of Arafa's consolidated sales, it is the largest contributor to Arafa's consolidated net income, accounting for 60% of the total group's net income in FY06/07. Moreover, the A&T segment is an important link in the business model, allowing Arafa Holding to maintain its edge by procuring the raw materials from the textile segment in less than a day, and providing a complete solution to the retail customer starting from garment design, through finishing and finally delivering the products to customer warehouses in 5 weeks. The success of the A&T segment is evident in the high quality standard, minimal lead time and the reduced costs allowing Arafa to compete more efficiently internationally.

... catering to the export markets with already contracted deals

The segment's products are mainly targeted at export and international markets as well as famous brands and retail chains, including Valentino, Jaeger and Haggar, Gap and Target. Sales are mainly directed to the US and the UK markets. Although the A&T segment sells to more than 20 clients, revenues are derived from a limited number of clients (A&T segment sold 70% of their products to only 5 customers in FY06/07). This creates a sales concentration risk, whereby the failure of a single client might adversely affect the performance of the whole group. This is, however, common according to industry norms, as it strengthens, to a large extent, the relationship with customers, given the significant volumes. On the other hand, all of the apparel sales are actually made before the production starts, i.e. the client places the order with required raw materials to be used and accordingly a price is determined before one of its companies starts the manufacturing. The segment is also competing internationally with local suppliers in the US by recently succeeding in offering services such as replenishing the stores directly to cater to customers' need. The A&T segment works through 4 subsidiaries, namely, The Swiss Garments Company (SGC), Egypt Tailoring Company (ETC), Port Said Garments Company (PSG), which has a JV with Bagir (M&S' sourcing agent) through a local company METCO, and finally, Concrete Industrial.

Figure 3 | Contribution of each Subsidiary to the Total Segment Sales in FY06/07



Source: Arafa Holding, Beltone Financial estimates

... and a major contributor to profitability with strong sales growth and healthy bottom lines

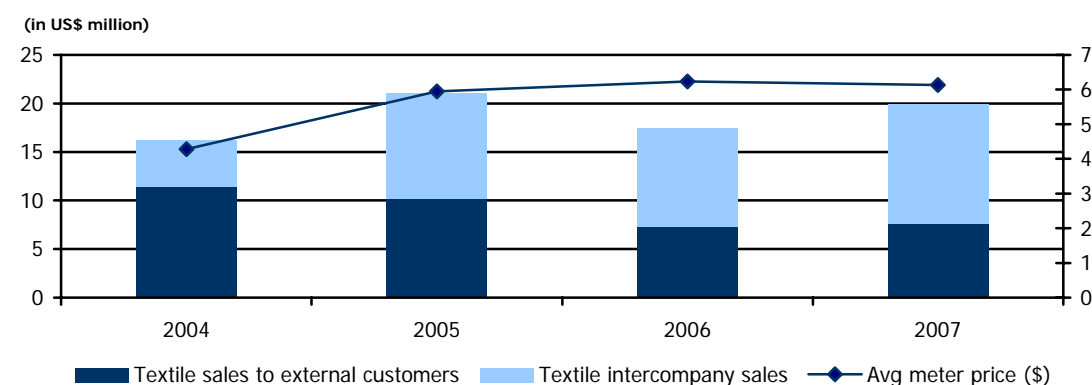
From March 2004 to March 2007, the standalone sales of the apparel and tailoring segment increased 68% from US\$66.0 million to US\$111.0 million, while the structure of the segment's sales evolved through a slight shift towards formal wear. Formal wear accounted for an average of 63.7% of the total apparel and tailoring sales over the period from 2004 to 2007, indicating Arafa's emphasis on the expansion in that particular segment. On the other hand, export sales accounted for an average of 90.3% over the same period from 2004 to 2007. On a consolidated basis (removing inter-company sales), the apparel and tailoring segment reported total sales of US\$91.0 million and a segment-attributed net profit of US\$14.7 million implying a healthy net profit margin of 16% in FY06/07.

Textiles

Minimal bottom line contribution, however cutting down lead time to the least...

The textiles segment provides the basic input to Arafa's vertically integrated model, producing yarns and fabrics necessary for the apparel and tailoring segment. Although the textiles segment only contributed 2.6% to the group's total sales, it generated 8.3% of the total net income for FY06/07. The textile segment is currently basically producing for sister companies' use, as there is only little value added to sell a standalone product. Textile manufacturing is a very capital intensive industry and that is why the company is not relying on any long term advantage to sell textiles. Accordingly, total textiles external sales decreased from US\$11.4 million in 2004 to US\$7.6 million in 2007, while a greater portion of the standalone sales was being directed towards the inter-company and intra-segment sales. Although the textiles segment's relative involvement in the group may seem limited, its presence is of strategic importance since it minimizes the lead time for garment production by supplying ready input material for the apparel and tailoring segment in less than a day.

Figure 4 | Evolution of External versus Inter-company Textile Sales



Source: Arafa Holding, Beltone Financial estimates

... with production ranging from yarns to fabrics through two subsidiaries

Fabrics supplied to the apparel and tailoring segment are produced through two subsidiaries in the textile segment: White Head and Goldentex. White Head is responsible for purchasing wool tops, to produce yarns which are the input material used to produce the fabrics. The wool tops are mainly imported from Australia and are purchased at international prices. As Arafa basically operates through demand-driven manufacturing, any raw material price increases are already incorporated into the final prices. Goldentex procures wool yarns from White Head, which are dyed, woven and finally wool and wool blended fabrics are produced. Current production capacity at Goldentex ranges from 3 to 4 million meters of fabric depending on the quality. As of March 31st 2007 a total of 3.0 million meters of fabrics were sold either as exports or as domestic sales. The reason why White Head is not merged under Goldentex Group is that it enjoys a tax exemption until 2013, which is not applicable for the rest of the group.

Trend to shift to more inter-company supply

As of March 31st, 2007 the textiles segment sold a total of US\$19.9 million, of which US\$5.4 million were sold domestically to external customers, US\$13.3 million were sold as indirect exports namely to sister companies SGC and METCO, since they are listed in the free trade zones, while the remaining US\$1.1 million were sold as yarns. A total of US\$4.6 million were generated as net profit before minority interest, for FY06/07 by the textiles segment, compared to US\$28.1 million generated by the three segments in total. Looking forward, however, we expect the textile segment's contribution to the company to remain flat or even decline, due to rising wool prices and the minimal value added in manufacturing.

Business Strategy

A focus on growth through acquisitions...

Arafa Holding is set to witness a complete turnaround in the next year or so. This is due to the fact that the company will be aiming for acquisitions that will probably enable it to at least double its bottom line in 3 years from the FY05/06 level. Acquisitions are to focus on already established brand names with a strong local management team, and are to be funded using a 70/30 debt to equity mix to acquire a stake that ensures a sufficient control. The company has secured funding from the recent public offering as well as a new committed bank line to support its upcoming acquisitions. BMB's experienced management team and different members of the company's board will play a key role in spotting the right acquisitions in the region. In that sense, Arafa Holding would be relying on non-organic growth of its retail segment to generate organic growth for the other 2 segments.

... supported by a market-driven manufacturing strategy...

Arafa manufactures its products mostly only in response to customer demands. This means that the company can maintain its minimal inventory policy. It also means that prices are set before the actual production process starts through having pre-determined orders. Moreover, most of the company's clients dictate the type of raw material to be used, the quality of different inputs and, accordingly, a price to charge the manufacturer. Accordingly, Arafa has a chance to maximize efficiencies and realize cost savings by producing in the competitive Egyptian market with the low labour costs.

... and capitalizing on a vertically integrated business model with important synergies

The vertical integration between the 3 segments is one of Arafa's strongest features. Arafa is aiming to maintain the supply chain inside one company, Arafa Holding, although targeting different countries. The company also intends to capitalize on the natural advantage created through the partial integration of its business segments. The idea behind the fact that integration is not fully implemented is that it is quite important not to be largely dependent on a single supplier, even if this supplier is one of the sister companies. The vertical integration, on the other hand, creates important synergies between the different companies under the umbrella of Arafa. For instance, the company intends to benefit from the newly acquired Swedish entity Melka to be able to distribute some of BMB and Querini products, as the latter might be appealing to the Scandinavian population. Moreover, some of the Swedish products might eventually be manufactured in Egypt. This highlights Arafa's strategy to leverage on the supply benefit from low cost markets, while capitalizing on the synergies created between distributors.

Strong local expansion to be dictated by the strong local demand...

The Egyptian market has not been fully addressed by Arafa in the past, given the weak economic conditions that Egypt experienced. However, following the installation of the new, private sector-oriented cabinet, the significant reduction in personal income taxes, and the halving of corporate income taxes, demand is booming and sentiment has become more positive than it has been in decades. With economic growth now running at around 7%, we have a strong reason to believe that demand for consumer goods, including clothing, will be significantly increasing, going forward. Egypt's most recent high end shopping mall "City Stars" received 21 million visits in its first 12 months of full operations, with an estimated 4-5 million Egyptians who could afford the purchase of expensive brand names. So, although the competition remains fierce, with many international brands opening stores in Egypt's largest shopping malls, local players with the necessary high quality are few in number, which improves prospects for Arafa Holding's Concrete. This will, however, depend on the company's ability to maintain the good quality products offered at competitive prices. Arafa is still trying to study its local market and is constantly revising its approach to the market to determine future strategy.

... while regional markets would become more of a focus through Concrete...

Similar to the Egyptian situation, regional Arab and Gulf markets have not been attractive for Egyptian producers over the past few years. The potential inherent in those markets, despite the small population, cannot be ignored as they have proven, over the years, to be major buyers of Egyptian goods in the Egyptian market. Arafa Holding will be looking to establish a presence in those markets, through establishing a strong brand name (Concrete), high quality products, and competitive prices.

Industry Analysis

The Global Supply Chain Starts from the Store

From an analytical standpoint, it would not be of much use to look at the apparel manufacturing industry in isolation so as to predict its future. Recent trends in the industry increasingly point out to the final customer as the spark that ignites the whole process in the value chain. Lately, social factors have forced retailers to consolidate and lower their costs to maintain decent profit margins. We can now visualize modern “lean retailers” as a sophisticated network of operations in a global supply chain, which starts from design through production and finally to shipping and distribution.

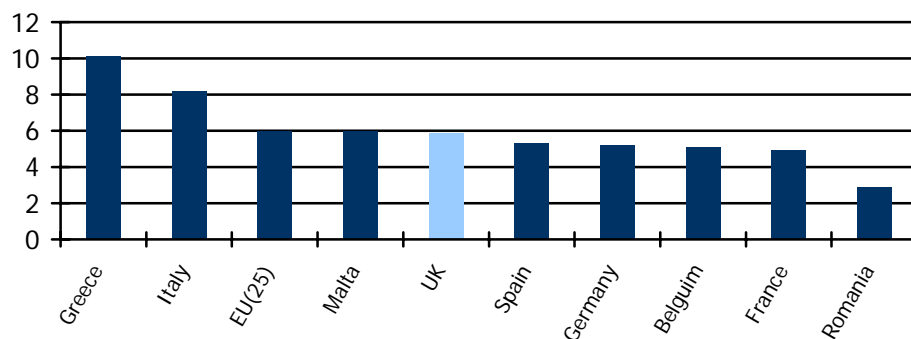
To compensate for the lower portion of consumer spending on clothes, retailers entice consumers by increasing their inventory turnover and offering a variety of collections in a single season, as opposed to traditionally a single collection per season. Production is then sliced up into several activities, where each activity could be located in a different geographical location, primarily to lower the production cost and delivery time. This is where the textile and clothing manufacturer comes in. Retailers, which are bigger and with stronger bargaining power, will choose the manufacturer with the lowest production cost, least lead time, highest quality and consistency and nearest to the retailer’s distribution center. That is specifically the reason why most apparel producers produce on demand, where their entire inventory is already sold out before it is finished. Having noted this, we believe that, in the future, more power will be shifted from the clothing and textile production to the retailers, who are in turn squeezed by changing social patterns and are continuously pursuing new nascent markets to find demand.

Where Arafa stands in global trends

The current strategy of Arafa, which is moving upward in the supply chain by continuously acquiring retail chains in several markets, indicates that management is realizing such developments in the global clothing industry and acting upon it. Although this strategy might not come to fruition in the short term due to the restructuring that accompanies the acquired firms and the slowdown in the consumer markets, we believe (depending on the quality of the acquisitions in the future) that it would be value adding in the long term. Arafa has realized early enough that the tearing of the supply chain that the global industry is currently witnessing -due to de-localization of labor intensive processes- is a major problem. That is why Arafa Holding is striving to keep the supply chain in one company while serving different countries and different markets. On the other hand, and as major acquisitions will probably be in the European market, it makes sense for us to be studying the markets in Europe, and especially the UK, where we believe Arafa will continue to have the largest exposure. The major difference between the UK and the rest of Europe is that the UK retail market is dominated by branded retail chains and department stores, while the rest of Europe is dominated by independent distributors. Thus, the recent acquisition of Melka by Arafa is set to capitalize on the individual shop concept in the rest of Europe.

Figure 5 | Percentage of Household Expenditure on Clothing & Footwear of Total Household Expenditure, 2004

(% of total household consumption expenditure)



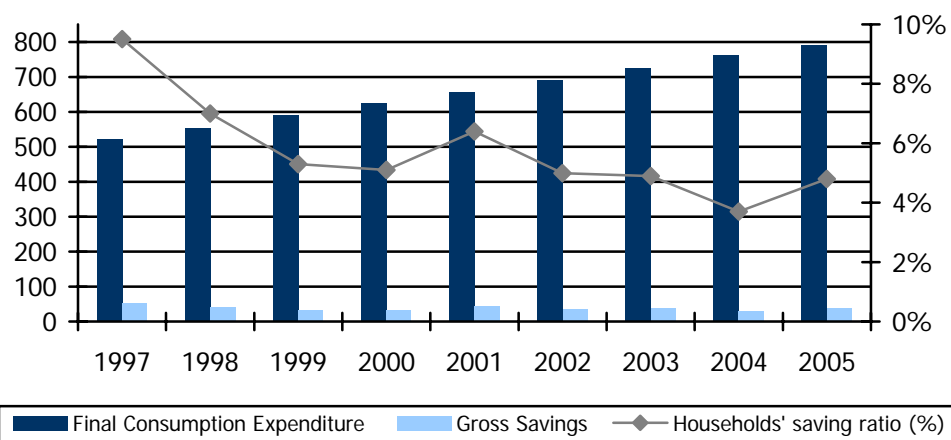
Source: Eurostat

A Peek into the UK Retail Sector

The UK is home to 60.2 million consumers as of mid-2005, with an annual average growth rate of 0.5% since mid-2001. Over FY04/05, the UK's GDP grew by 4.1% recording £1.224 trillion in 2005, of which household consumption accounted for 65%. Moreover, the household disposable income distribution segments the total population evenly, making it easier for retailers to accurately target few and visible income classes. Another aspect of the UK society is the increasing rate of the experienced consumerism in 2005. The saving ratio was just 4.8% out of a total household gross disposable income of £800.915 billion compared to 9.5% for 1997 in the UK. Out of £748.0 billion of household final consumption expenditure in 2005, 5.1% were dedicated to the consumption of clothes, of which £35.7 billion were directed to the consumption of ready made garments. Growth in the consumption of ready made garments waned from 2002 to 2005, declining from a growth rate of 5.9% during 2002-2003 to a growth rate of 2.6% during 2004-2005. However, growth spiked again in 2005 towards 2006, as garment sales reached £37.6 billion growing by 5.4% in a single year.

Figure 6 | Breakdown of National Disposable Income in the UK (1997-2005)

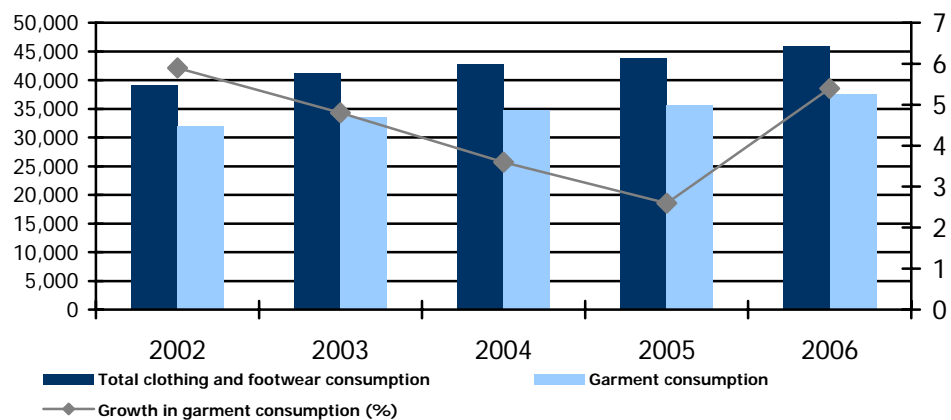
(in UK£ billion)



Source: UK National Statistics

Figure 7 | Clothing and Garment consumption Growth in the UK (2002-2006)

(in UK£ million)



Source: UK National Statistics

Visualizing that snapshot of the UK's retail segment, it remains to be seen whether an accelerated growth of garments sales will be sustained, following the hike in real estate prices (most favourite assets in UK retail portfolios), and if so, for how long. Nevertheless, one cannot deny the fact that some phenomena in the UK's demographic structure pose challenges for retail growth in the future, compared with some emerging markets such as China or India, which host large, young populations and rapidly rising middle classes with large appetite for consumption. Most alarming to the UK market is the slow growth rate of its population; during the period from 2001 to 2005 the population grew from 59.1 million to 60.2 million. Additionally, the Office of National Statistics estimates that by 2021, UK's population would reach just 64.7 million, growing by only 0.05% annually.

The Manufacturing Journey from Yarn to Garments (Textile and Clothing Production Processes)

Textile manufacturing starts with spinning to produce the yarn. The yarn could be made from natural fibers such as wool for men's suits, cotton for casual wear, and silk or synthetic fibers such as polyester for other products. The yarn is then woven to produce the fabrics, which are then passed through dyeing and printing. The systematic procedures, which take place in that process enabled the textile industry to evolve to become more capital-intensive over time. However, the clothing industry is characterized by the progressive bundling system, where each worker is specialized in a number of operations. The fabric is first cut, grouped by parts of the garment, and then sewn together. The changes in designs and the complexity of such an operation prevented the clothing industry from evolving technologically as fast as the textile industry. Thus, the nature of the clothing industry makes it competitive based on the lower cost of labor and proximity to the retailers' distribution centers.

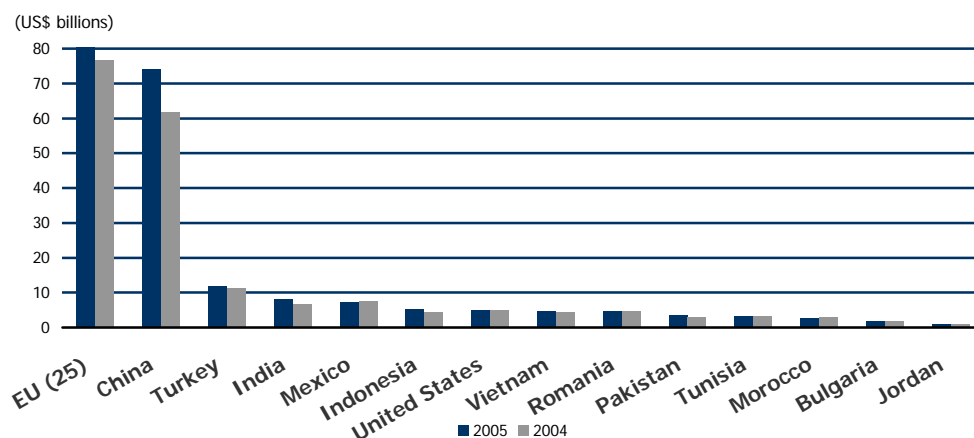
Where Arafa stands in manufacturing

In the case of Arafa Holding, the backward vertical integration of the textile industry allows it to cater flexibly for faster client orders, by producing its fabrics in-house and feeding it into the apparel manufacturing facilities, ultimately lowering the production lead time.

Global Trade Trends: Producers Move Eastwards and Markets Move Westwards...

In 2005, world trade in clothes recorded sales of US\$276 billion, with a share of 2.7% in world merchandise trade and 3.8% in world exports of manufactured goods. This signifies the relative importance of the apparel and tailoring industry in the global economy; it becomes even more important if the level of employment it draws is put into consideration, making garment production a sensitive industry for social stability. Major flows of garment trade in 2005 were in the Euro Zone, from Asia to North America and from Asia to Europe, which amounted to US\$57.7 billion, US\$47.6 billion and US\$34.8 billion respectively. However, the EU is becoming more and more interesting to global producers as a potential market, not because it is a net importer of US\$48.35 billion, (for the United States is a bigger net importer of US\$75 billion) but because the inter-EU trade amounted to US\$58 billion, implying a substitution for European producers as their costs of production increase and their competitive advantage declines. Similarly, Asian producers are becoming increasingly more important as garment producers in the global arena. As of 2005, Asian garment exports reached US\$131.5 billion, an increase of 10% from 2004. In 2005, China alone exported US\$74.2 billion, accounting for 27% of the world's clothing exports, while Turkey exported US\$11.8 billion.

Figure 8 | Largest Global Clothing Exporters



Source: WTO

...which makes garment production lose ground in the EU...

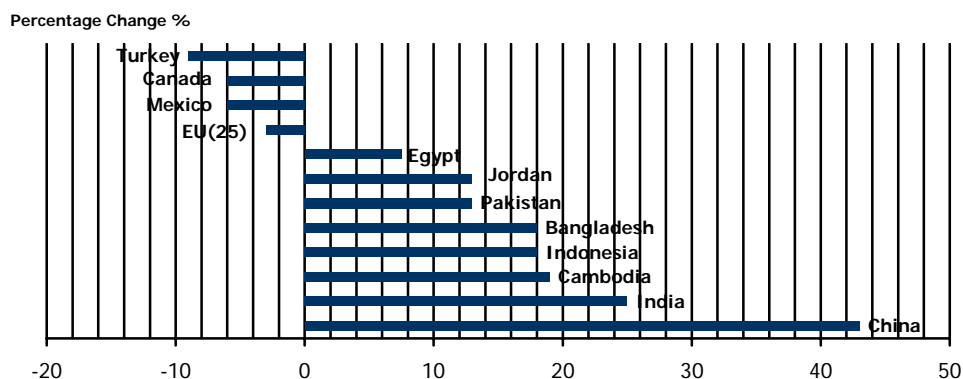
As shown by the trend of gradual decline in the value added output of clothing in the EU (25) from 1995 till 2005, the clothing industry is waning in Europe. In Italy, which is the highest contributor to clothes value added within the region, the growth of garment exports waned from 9.3% during 2004 to 8.3% during 2006 recording EUR27.2 billion of exports in 2006. Owing to the fact that garment production is highly labor-intensive, the drop in output is explained mainly by the rise in the average personnel cost in most EU countries. Even Romania, which is considered to be the manufacturing hub of the EU due to its lower production costs, experienced a decline in clothing exports to the EU(25) in 2005. Looking forward, this fact is even more alarming when it is viewed in a bigger context: China's clothing exports to the EU(25) during 2005 increased by 43% and that of India grew by 27% during the same period. That leads to several implications: the decrease in EU nations' competitiveness as producers and exporters of garments, ultimately being substituted by their lower cost counterparts in Asia and the gradual outflow of foreign direct investors from the Euro Zone to regions where the cost of labor is lower.

... and global players are reshuffled...

During 2005 the growth rate of trade in clothing was 6%, less than that of 2004 and 2003 which was 11% and 13% respectively. Nevertheless, the year 2005 was not by all means the least active in terms of trading dynamics, as it marked the phasing out of the Agreement on Textiles and Clothing (ATC), during which dramatic changes took place. The ATC, which took over the Multifibre Arrangement (MFA) in 1995, passed through four steps over a period of 10 years and ultimately resulted in a quota-free trade for textiles and garments. Consequently, imports previously dictated by bilateral and multilateral relations were simply substituted by imports from the most efficient producer, in that case the countries with the lower labor costs. In 2005 alone exports of textiles and apparel from China to the United States and the European Union jumped 43% and 41.5% respectively, while India's export growth in 2005 was 25% to the US and 18.1% to the EU. Indonesia, Pakistan, Bangladesh and Jordan were among the countries to record double digit export growth to the US but they were hit in the EU markets as their exports declined sharply. On the other hand, a number of countries witnessed a decline of textile and apparel exports, most notably East Asia and Sub-Saharan Africa. East Asia, which consists of Hong Kong, Korea, Macao and Taipei, lost 17% in exports to the US and 28% to the EU in a single year. Turkey's exports to the US declined by 9% but it was partially offset by a 3.8% increase to the EU. The EU (25) exports of textile and apparel to the US declined by 3%, and Romania's exports to the EU dropped by 5.1%.

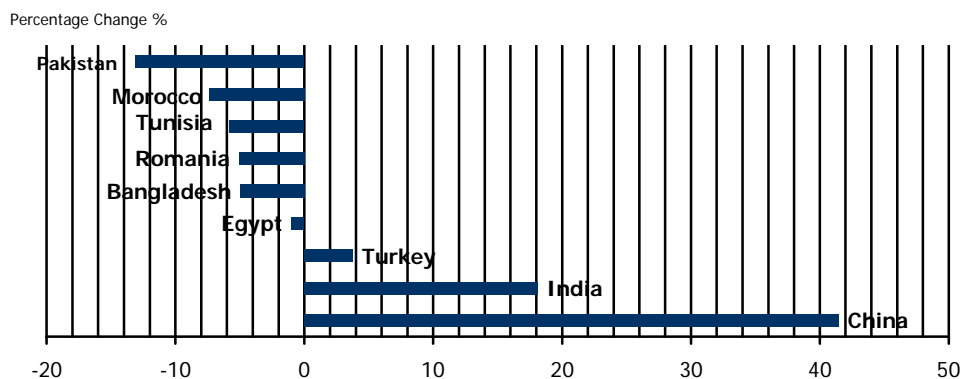
These developments have created market disruption in the largest textile and apparel markets; the European Union and the United States, which lead them to renegotiate new trading terms to postpone and minimize the effect of the surge in Chinese exports. On November 8th 2005, a memorandum of understanding (MOU) was signed between the United States Trade Representative and the Minister of Commerce of the People's Republic of China to limit the Chinese exports into the US through declining quantitative restrictions up till 2008. Similarly, a MOU was signed on June 10th 2005 between the European Commission and the Ministry of Commerce of the People's Republic of China on the export of certain Chinese textile and clothing products to the EU for 10 categories for 2005, 2006 and 2007.

Figure 9 | Percentage Change of Major Exporters to the US Market (2004-2005)



Source: Eurostat, U.S. International Trade Commission, Beltone estimates

Figure 10 | Percentage Change of Major Exporters to the EU Market (2004-2005)



Source: EuroStat

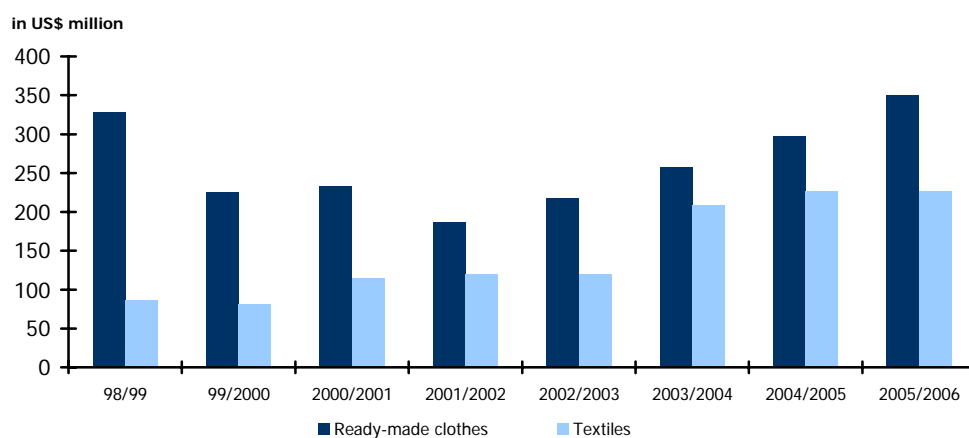
... giving Egypt a competitive advantage as a lower cost producer

With the global clothing and textiles trade now put in context, and the challenges facing the clothes and textile producers clarified, several questions now emerge, pertaining to Egypt's survival and progression as a world class garment producer. Where does Egypt stand as a clothing and textile producer in the global arena? Does Egypt's clothing industry possess the traits that would enable it to compete in an increasingly harsh environment? What are the signs that show progress in recent years?

The textile and clothing industries are of strategic importance to Egypt, since they contributed 3% of the total GDP in 2005, 30% to the industrial value added, and absorbed approximately one million people of the nation's labor force during 2005.

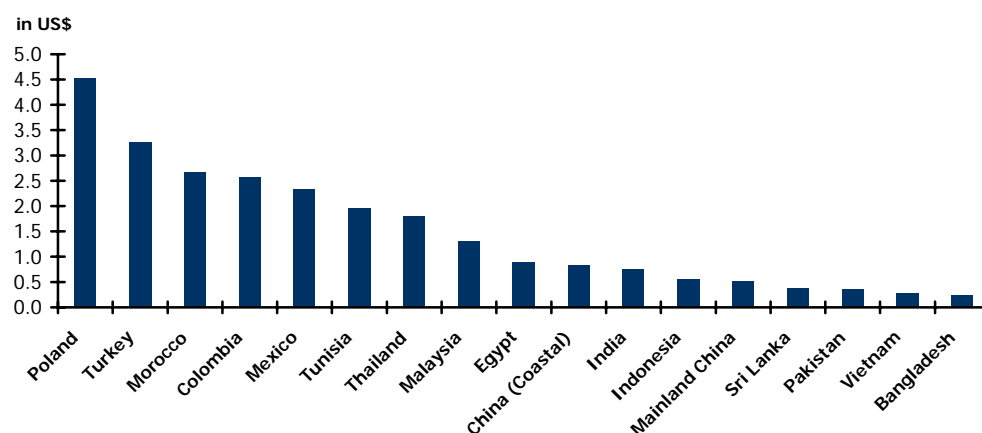
During the fiscal year 2005/2006, Egypt's exports of ready-made garments reached US\$350.5 million compared to US\$296.9 during 2004/2005, an increase of 18%. The exports of cotton textiles reached US\$226.3 million in the fiscal year 2005/2006 down from US\$305.8 in 2004/2005, declining for the first time in 5 years. These figures seem minor when considering the long history of Egypt in the textile and clothing industry and comparing it to other relatively new entrants such as Jordan, which exported US\$1 billion worth of Textile and clothes in 2004. The challenges confronting the textile manufacturing and competitiveness are increasing since it is becoming more capital intensive globally, while the local textile industry is dominated by the public sector characterized by lack of maintenance, overstaffing and low productivity. We believe, however, that much potential awaits the clothing industry to compete in the international arena and acquire a decent market share. This is due to a number of reasons including low labor costs attracting foreign direct investments from higher labor cost counties, lower building costs, international trade agreements, which facilitate the flow and movement of products, and strategic geographic locations and proximity to the EU market decreasing the lead time for garments shipment which is a critical factor dictating competition between major retail players.

Figure 11 | Exports of Egypt's Textile and Ready-Made Garments



Source: Central Bank of Egypt, Ministry of Trade and Industry (Egypt)

Figure 12 | Cost of Labor per Hour in Textiles in Strategic Markets



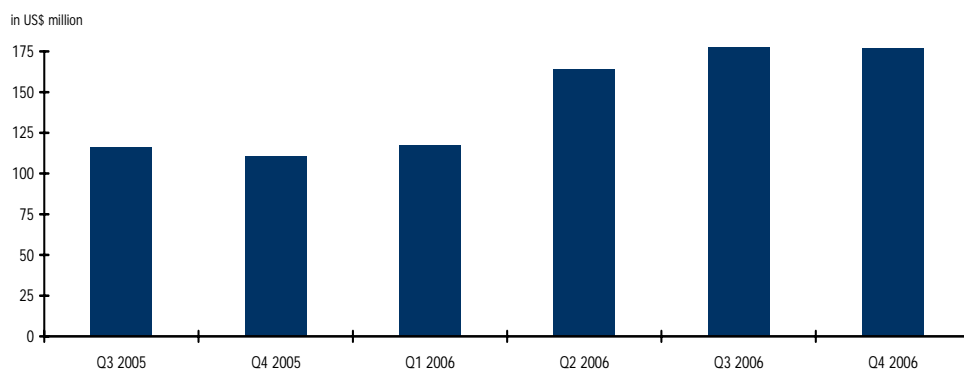
Source: Werner International 2004

International trade agreements governing Egyptian trade

Qualifying Industrial Zones Agreement (QIZ). In an attempt to maintain peaceful relations and encourage cross border cooperation, the US, Israel, and Egypt entered in an agreement in 2005 initiated by the US government to promote trade between the three parties. Qualifying Industrial Zones are areas in Egypt where industrial products that originate in Egypt and satisfy the 11.7% Israeli component criterion are granted duty free entry into US customs zones. Textile companies represent 79% of the 655 companies currently registered in QIZ. The value of QIZ exports of textiles and ready made garments have been steadily increasing since Q2 2005, which recorded exports worth US\$ 61.6 million, reaching US\$ 176.7 million by Q4 2006.

Egypt's QIZ agreement was a rendition of Jordan's FTA with the US in 2001, which grants the duty-free entry of Jordanian exports that are produced in qualified industrial zones and that satisfy the 8.5% Israeli content. This agreement is exceptional in its liberal rules of origin whereby, products using inputs imported from cheaper sources still qualify for duty-free access¹. The prospect of a similar Egypt-US FTA could prove to be very beneficial for Egypt.

Figure 13 | Export Value of Textile and Ready Made Garments from the QIZ



Source: Ministry of Trade and Industry, Egypt

Egypt – EU Association Agreement. Originally signed in 2002, the agreement came into effect in June 2004. The agreement allows for the duty-free entry of all industrial and some agricultural exports originating in Egypt into the EU provided that custom duties on EU imports are gradually removed over a 12 to 15 year period. The EU is Egypt's largest importer accounting for 37% of Egyptian exports². Textiles and clothing account for 15% of exports to the EU. The Egypt-EU Agreement, however, has very restrictive rules of origin whereby clothes produced using fabrics imported from third party countries are not eligible for tariff reductions. This restricts Egypt's ability to reduce input costs by importing lower cost fabrics for production.

The Egypt-EU AA is part of the EU's Euro-Mediterranean Partnership that includes Turkey, Jordan, Syria, Morocco, Tunisia, Palestinian Authority, Israel, Algeria, and Lebanon. The partnership has aimed to gradually establish free trade areas across the specified region by 2010. This was to be achieved through bilateral agreements between the EU and individual member nations, including the Egypt-EU AA, as well as other agreements between the member nations, including the Agadir Agreement, COMESA, and GAFTA.

The Agadir Agreement. A bilateral agreement between Jordan, Egypt, Tunisia, and Morocco was signed in Feb 2004 aimed at establishing an FTA. As part of the Euro-Med Partnership the Agadir Agreement allows for diagonal culmination whereby products produced and traded among its members

¹ This allows Jordan to import cheaper production inputs; thereby, decreasing costs and increasing efficiency.

² EU goods account for 42% of Egyptian imports tipping the trade balance in favor of the EU.

satisfy EU rules of origin. Therefore, products made using Moroccan, Tunisian or Jordanian inputs are considered to be originating in Egypt (provided that the production process satisfies the EU protocol).

Common Market for East and South Africa (COMESA). Signed in 1994, the Common Market for East and South Africa came to replace the Preferential Trade Agreement between nations of that region. Egypt joined the COMESA in 1998. In 2000 Egypt was among the eight nations to complete the tariff reduction program on goods produced in member nations with at least 45% local value added.

Greater Arab Free Trade Area (GAFTA). Also known as the Pan-Arab Free Trade Area (PAFTA). The agreement was developed by the Arab League in 1997 to create free trade and co-operation between Arab nations through gradual dismantling of tariffs on industrial and agricultural products. Since 2005, all eligible products have duty-free access to GAFTA markets. As of 2006, the members were Bahrain, Egypt, Iraq, Jordan, Kuwait, Lebanon, Libya, Morocco, Oman, Palestine, Qatar, Saudi Arabia, Sudan, Syria, Tunisia, UAE, and Yemen. Rules of origin are being established to help moderate the problems arising as a result of free trade. Currently, products with 40% Arab value-added are granted free trade entry.

Other Preferential Trade Agreements with MENA Nations. Egypt has several PTAs with other MENA nations including Sudan, Lebanon, Morocco, Tunisia, Libya, Jordan, and Syria. Only Libya has a free trade agreement since 1990 that includes a tariff exemption on textile and clothes. Syria's 1991 agreement exempts cotton yarn not prepared for retail purposes.

... given that Egypt meets the challenges ahead

Despite the above mentioned competitive advantages of Egypt's clothes industry, some impeding obstacles still exist, which could raise the cost of the local products in the global markets and dilute the competitive effects of other factors. Among those are the expensive port costs and inefficient logistical and transportation services, and imposed customs and tariff barriers on several textile imports, which limits manufacturers' ability to lower their costs and use higher quality yarns and fabrics

Risks and Challenges Ahead

Excessive growth

Arafa Holding's main strategy is to expand its operations and exports, mainly through the acquisition of already established brand names and large distribution networks. Arafa targets entities which are likely to have a strong local management team and acceptable gearing ratios. The aim is to use the acquired company as a distributor for sister companies, as well as to capitalize on possible synergies created from integrating different companies in different geographical locations. However, given that Arafa has recently moved from being a family-owned, albeit mostly non-family managed, business to a large corporate group, it is already a challenge to manage current operations, leaving aside the recent acquisitions. We expect the task of spotting the right acquisitions, monitoring the performance of newly-added entities to the group, as well as fully integrating the businesses, to remain a major challenge for Arafa. Failure to do so could mean an added financial burden to the company, which might cause it to review its operational structure.

High concentration

The apparel & tailoring division's top 5 customers contribute more than 70% of total revenues in a normal year, which makes the loss of one of these a significant negative event for the overall performance of Arafa. Those are basically Gap, BMB, M&S (through Bagir), Macy's and Philip. BMB is already owned by Arafa Holding, and so there is no current risk of losing this business. However, the situation is different for the other 4, exposing the company to a high concentration risk, especially that there is no way to secure long-term contracts with them. This is, however, a common phenomenon in this kind of business and normal according to industry standards. Moreover, the segment has more than 20 customers in different locations in the world, which can open different markets for it, in case it loses any of its old customers.

Mature UK market

Most of Arafa's revenues are generated from the retail segment, which is mainly supported by BMB's distribution network in the UK. That is why we view the UK market as key to Arafa; and given the current slowing down in demand in this market, we consider this to be a key risk for the company. BMB is, however, trying to expand its operations beyond the maturing formal suit business to include the casual wear and shirting business, a segment which still has some room for growth. Moreover, the recent and future acquisitions would give BMB a way to distribute their products in Europe, reducing their current high reliance on the UK market.

Competition

The retail, apparel & tailoring and textile industries are very competitive industries with a large number of recent entrants dominating the market. Competition is not only strong on a group level, but also extremely fierce on a macro level, i.e. between countries. This may lead to the company losing key contracts to competing groups inside or outside Egypt, including companies that may be considering to move their manufacturing activity to even lower cost countries.

Exchange rates

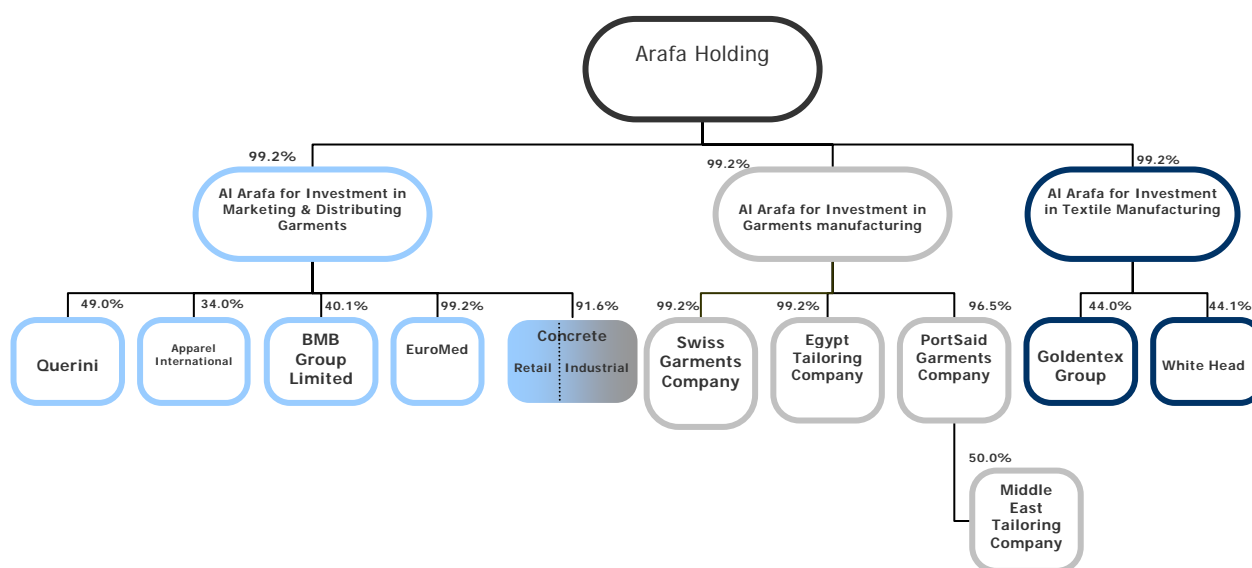
Arafa's main revenues are derived in Sterling pounds, US dollars, and to a lesser extent Euros, similar to their main costs. This makes managing sources and uses of funds a challenging process, and that is why Arafa Holding has initiated some hedging transactions and intends to continue doing so in the future due to the nature of their business. Moreover, the company reports in US dollars, which results in large losses or gains from foreign exchange translations, and makes the prediction of these very difficult.

Arafa Holding - Restructuring and Corporate Governance

Restructuring to prepare for going public

Arafa Holding boasts a long track record in the textile and garments industry, which dates back to 1907. The company has, however, significantly evolved, especially as it witnessed a series of events from state nationalization in 1956 and resumption under Arafa's family ownership in 1974 to the acquisition of a stake in UK's BMB in 2004, which marked an important transformation for the group. The Arafa group of companies was expanding rapidly, which led to a process of restructuring starting during 2005. The process was almost fully completed in September 2006 before the company went public, when Al Arafa for Investment and Consultancies was created as the holding company over three subsidiaries, namely: Al Arafa for investment in Marketing and Distributing Garments, Al Arafa for Investment in Garment Manufacturing and Al Arafa for Investment in Textile Manufacturing.

Figure 14 | Organizational Structure



Source: Arafa Holding

Corporate Governance

One of the major tasks that will be increasingly important, following the recent restructuring of Arafa, is to maintain the controls necessary to ensure general governance guidelines are applied. Inter-company dealings should be specifically monitored, as segments can not be given preferential treatment in pricing or delivery time, affecting the treatment of external customers. On the other hand, and although the company is managed by experienced industry leaders, the fact that Arafa was originally a family-owned business should be taken into consideration when assessing the key-man risk. We believe this has become of a much lesser relevance, as the company went public and will therefore be expected to establish the necessary procedures to be as transparent as possible about its future strategy and succession planning. Moreover, the Arafa business was never the type of business that was solely family managed, as currently the only member of the family that is contributing directly to the business is Dr. Alaa Arafa, the CEO and chairman of Arafa Holding.

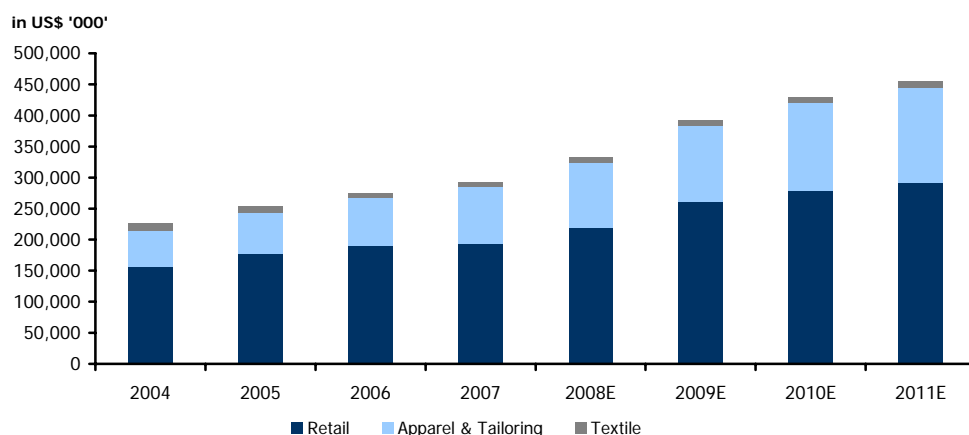
Arafa Holding – Financial Analysis and Projections

NOTE: For the purpose of this report, we will be analyzing Arafa's pro-forma consolidated financial statements from FY03/04 to FY05/06 inclusive. The only actual figures that we are using are those of the most recent year ending March 31st, 2007 (FY06/07). The pro-forma statements are the best representation of the historical operations of the group of companies under the current umbrella of Arafa, as we try to assess performance, going forward.

Revenues

Arafa Holding's revenues are mainly generated from 3 segments: retail, apparel & tailoring and textile. As the retail segment is the main driver behind the apparel & tailoring and textile segments major orders, we have followed a top-down analysis in our forecasts, which starts by analyzing the expected revenue stream of the retail segment and concludes with the textile segment. We expect the company to grow its revenues by a CAGR of 11% over the next 4 years to reach US\$454 million by 2011. As it is highly probable that Arafa will be making a major acquisition in the short term, and as we have limited information to be able to incorporate the direct effect of the acquisition on revenues, we chose to include the indirect effect of acquisitions through assuming more inter-company sales. This means that the company is actually growing more than is shown in net revenue figures, as a larger portion of sales is directed to other segments.

Figure 15 | Historical and Expected Revenues



Source: Arafa Holding, Beltone Financial estimates

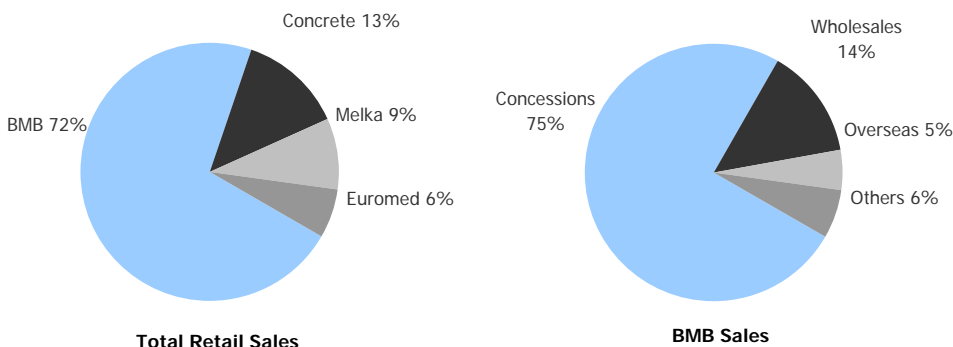
The Retail Segment

We analyzed the sales breakdown of BMB, Concrete Commercial, Euromed, and the newly acquired Melka to arrive at our forecasts up until 2011. Overall, we expect retail revenues to increase slightly, going forward, excluding further direct effect of acquisitions. However, total retail sales would witness a peak in FY08/09 as Melka would start contributing to revenues. The scenario could be further inflated if the company succeeds in using Melka's large network to distribute other products such as Querini's and BMB's, but that remains to be seen.

BMB Sales

BMB is the basic contributor of retail revenues with 86% of the total segment's sales as of March 31st, 2007. Sales from concessions, which accounted for 76% of BMB's sales in FY06/07, is forecast to witness an increase, as BMB adds "New Look" in its concessions' list increasing the area in m², and consequently increasing total sales, as sales per m² are expected to be more or less stable.

Figure 16 | Retail Sales Breakdown 2009E



Source: Arafa Holding, Belltone Financial estimates

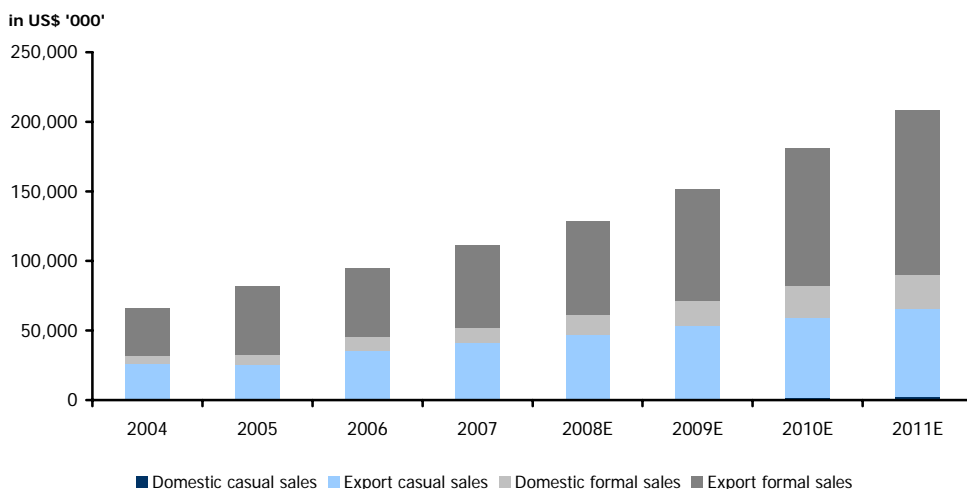
Local Market

Moving on to the local market, we have forecast Concrete and Euromed total sales to experience faster growth rates in the coming year or so, supported by the successful track record as well as a booming retail market in Egypt. This growth will be realized through an increase in the number of stores, and sales per m² for the directly owned, franchised and other stores.

The Apparel & Tailoring Segment

Sales of apparel & tailoring are broken down into casual and formal wear sold domestically and exported. Total segment sales are expected to grow at a CAGR of 17% over the next 4 years to reach E£208 million by 2011. We assumed, however, that a larger portion of total sales would be directed at the retail segment, as Arafa benefits from new acquisitions through directing more orders to the A&T segment. For instance, while inter-segment sales to retail accounted for 17.1% in FY06/07, we expect this to reach about 27% in FY10/11. The sales of export formal wear accounted for 53.6% of the total segment sales for FY06/07, while the domestic casual wear accounted for just 0.4% during the same period. We maintain the same general mix, going forward, although we expect the retail market in Egypt to rise on the back of the 30% customs duty on imported garments that should prevent aggressive competition and sharp price declines. On the other hand, formal wear is expected to witness impressive sales growth, at an annual average of 20% till 2011, supported by preferential trade agreements such as the QIZ and the geographical proximity of Egypt to Europe.

Figure 17 | Apparel and Tailoring Revenues*



Source: Arafa Holding, Belltone Financial estimates
 * Gross Revenues, i.e. including inter-segment sales

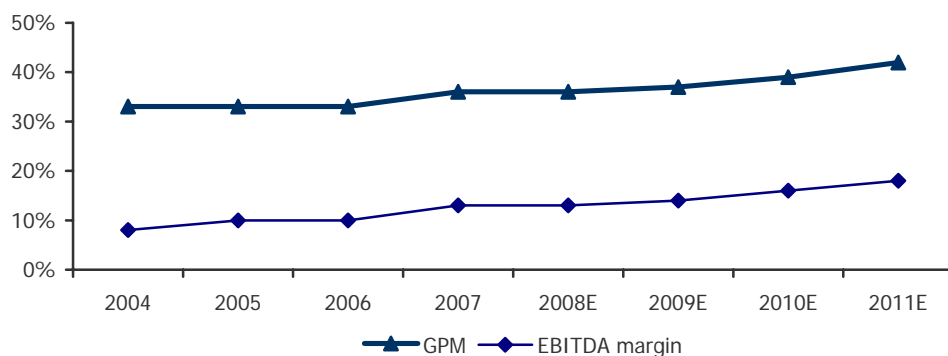
The Textile Segment

Unlike the apparel and tailoring segment, the textile segment has a limited capacity since it is basically capital intensive and expansions are, to a large extent dependant on additional expenditure rather than just addition of manual labor. Having said so, we have moderated the growth of total fabric sales to an average annual increase of 9%. The total meters sold is forecast to rise from 3.0 million meter in FY06/07 to 4.1 million meter by 2011. Throughout our forecast period, export sales directed to Arafa’s free zone subsidiaries, namely, SGC and METCO, are expected to rise faster than domestic sales directed externally, due to the higher demand from the A&T segment. Ultimately, the weight of fabric sales should shift more towards export sales, which would contribute 87% as of March 2011 up from 71.3% as of March 2007. On a different front, yarns and tops sales were forecast to remain contributing a constant percentage of total textiles sales of 5% and 1% simultaneously. Yarn sales would amount to US\$1.3 million as of March 2011, while Tops sales are forecasted to record US\$327K.

Gross and Operating Profit Margins

We expect to see a major improvement in margins, after remaining relatively flat over the past 3 years. This is dictated by: (a) better performance of the main contributor to revenues, the retail segment, as BMB’s restructuring has come to an end; and (b) improved synergies between the subsidiaries, resulting in some companies leveraging on the supply advantage that the company has, which would consequently be saving in the “cut & make” costs. FY06/07 would be the base for further improvement.

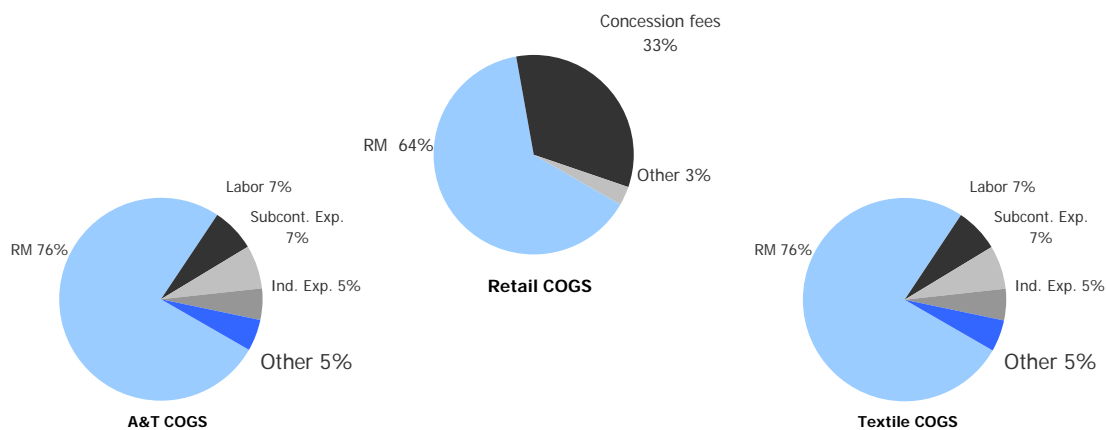
Figure 18 | Gross and Operating Profit Margins Evolution*



Source: Arafa Holding, Beltone Financial estimates

* We chose to exclude export rebates from Arafa’s operating profit, as we believe that operations could easily be sustained (and remain competitive enough) without government protection

Figure 19 | COGS Breakdown FY06/07



Source: Arafa Holding, Beltone Financial estimates

Liquidity & cash flow adequacy

Arafa's liquidity is currently adequate, pursuant to the recent IPO, whose funds have not yet been fully utilized. Cash and cash equivalents stood at US\$70.8 million at March 31st, 2007, versus only about US\$24 million of short term debts. In fact, of the net proceeds of the IPO of about US\$90 million, US\$53 million were used to repay outstanding loans, while about US\$6 million were used for the acquisition of Melka. Moreover, the company has unutilized loans in the total amount of US\$200 million, which it will probably use to finance its future acquisitions. Funds from operations (FFO) interest coverage was around 4x in FY06/07, but is expected to improve to about 7x in the medium term.

Capital structure

Arafa Holding will be pursuing acquisitions, and will be financing them mostly using debt (70%), while equity funds are already put aside from the recent IPO to contribute the remaining 30%. Although it is highly probable that Arafa would be acquiring one or more companies, we do not have enough information to be able to include them directly in our analysis. However, Arafa would probably be aiming to maintain a 60/40 debt to equity mix over the medium to long term.

Discounted Cash Flow Valuation

We chose to value Arafa on the basis of DCF, as we believe that no peers are currently suitable for comparison with the company, given the unique vertical integration. The company's DCF valuation resulted in a fair value per share of US\$2.11, which is 33% higher than the current market price of US\$1.59 per share. The valuation is based on a cost of equity of 16.3%, a WACC of 13.0%, and a perpetual growth rate of 5.0%. We believe that Arafa could derive more value if future acquisitions turn out to be successful, and resulting synergies start contributing to overall operations. On the other hand, if growth is not coupled with careful management of expansions, and the acquired brands do not realize the aspired synergies, the derived value could go down.

Financial Statements

Income Statement Summary

US\$ '000'

Year ended March 31 st	2004PF	2005PF	2006PF	2007A	2008F	2009F	2010F	2011F
Revenues	225,720	253,898	275,334	292,411	332,097	392,538	429,486	453,831
COGS	-151,796	-169,621	-183,254	-188,183	-210,949	-246,914	-262,341	-264,063
Gross Profit	73,924	84,277	92,079	104,228	121,149	145,624	167,145	189,768
General & Administrative Expenses	-21,452	-16,159	-16,921	-21,033	-23,247	-27,478	-30,064	-31,768
Other operating expenses	-34,624	-41,517	-47,245	-43,947	-53,163	-62,802	-68,947	-75,903
EBITDA	17,848	26,600	27,914	39,248	44,739	55,344	68,134	82,097
EBIT	15,006	21,959	20,836	31,782	36,504	47,109	59,899	73,862
Net Interest Expense	-3,570	-4,729	-5,528	-5,603	-5,847	-6,847	-7,449	-8,300
FX gains/losses	-1,708	-1,429	2,583	2,094	0	0	0	0
Export rebates and recurring income	4,734	4,140	5,290	4,486	5,646	6,673	7,301	7,715
Profit Before Tax	13,355	18,551	22,366	32,423	38,499	43,450	55,148	68,213
Net Income	9,593	12,918	18,746	24,230	30,524	38,387	48,356	58,625

Source: Arafa, Beltone Financial

Cash Flow Summary

US\$ '000'	2005PF	2006PF	2007A	2008F	2009F	2010F	2011F
Cash flow from operations	18,610	15,141	10,329	33,375	33,459	51,801	70,193
Cash flow from investment	-11,761	-13,932	-11,411	-13,337	-14,471	-30,171	-50,171
Cash flow from financing	16,461	31,908	72,816	24,484	17,348	11,665	15,220

Source: Arafa, Beltone Financial

Balance Sheet

US\$ '000'

Year ended March 31 st	2004PF	2005PF	2006PF	2007A	2008F	2009F	2010F	2011F
Cash and cash equivalents	6,470	8,278	16,270	70,834	79,403	92,941	98,748	99,396
Net receivables	36,386	39,172	43,106	51,834	59,425	70,986	78,054	82,710
Inventories	66,343	73,264	75,552	84,280	87,142	101,999	108,371	109,083
Other current assets	20,960	8,066	7,707	11,144	12,123	13,458	14,054	14,164
Total current assets	130,160	128,780	142,635	218,093	238,093	279,384	299,227	305,352
Net Plant & Equipment	48,840	53,548	60,969	67,270	70,175	77,761	85,346	92,932
Investments	803	2,661	2,730	1,153	10,000	10,000	25,000	60,000
Other non-current assets	4,822	4,321	12,362	8,137	8,051	8,701	9,351	10,001
Total assets	184,624	189,310	218,696	294,654	326,320	375,846	418,924	468,285
Total short-term debt	41,141	47,475	57,006	36,946	61,430	75,715	84,318	96,475
Other Current Liabilities	70,506	61,645	57,112	53,437	55,882	67,406	72,364	74,957
Total current liabilities	111,647	109,120	114,117	90,384	117,312	143,121	156,682	171,432
Long-term borrowings	22,451	27,256	21,168	25,162	22,100	22,100	22,100	22,100
Other non-current liabilities	1,845	3,085	9,073	3,578	3,578	3,578	3,578	3,578
Minority interest	17,645	16,170	17,400	21,107	18,226	18,911	19,415	18,850
Shareholders' Equity	31,007	33,678	57,284	154,424	165,104	188,137	217,150	252,325
Total Liab. and Shareholders' Equity	184,624	189,310	218,696	294,654	326,320	375,846	418,924	468,285

Source: Arafa, Beltone Financial

Financial Ratios

Year ended March 31 st	2004PF	2005PF	2006PF	2007A	2008F	2009F	2010F	2011F
Profitability								
Gross Profit Margin	33%	33%	33%	36%	36%	37%	39%	42%
EBITDA margin	8%	10%	10%	13%	13%	14%	16%	18%
Net Profit Margin	6%	7%	7%	10%	10%	10%	11%	13%
ROA	7%	9%	9%	10%	10%	10%	11%	13%
Coverage								
EBITDA interest coverage	4.1x	5.1x	4.8x	5.8x	7.7x	8.1x	9.1x	9.9x
FFO interest coverage		3.8x	3.5x	4.1x	5.9x	6.2x	7.2x	7.8x
Leverage								
Total Debt/EBITDA	3.6x	2.8x	2.8x	1.6x	1.9x	1.8x	1.6x	1.4x
Total Debt/Equity	2.1x	2.2x	1.4x	0.4x	0.5x	0.5x	0.5x	0.5x

Source: Arafa, Beltone Financial

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