Research Update:

Qatar-Based Mekdam Holding Downgraded To 'gcBB' From 'gcBBB-' On Weaker Profitability And Short-Term Debt Accumulation

March 23, 2023

Rating Action Overview

- Mekdam Holding’s increasing reliance on a short-term debt to fund its project-related working capital fluctuations exposes the company to higher repayment risk, and we now see the company’s liquidity as less than adequate.

- Profitability declined over the past two years despite strong revenue growth, indicating fierce competition, margin pressure, and incurred one-off fixed cost. EBITDA margins dropped to 8.2% in 2022 from 11.5% in 2021 and 15.9% in 2020 and are unlikely to exceed 10% in 2023-2024.

- We think the company’s credit profile has deteriorated and is unlikely to recover in the next year even if, positively, we consider substantial working capital releases in 2023 should bring down leverage below the 1.5x mark, in line with historical levels and down from the peak of 3.3x in 2022.

- We therefore lowered our long-term Gulf Cooperation Council (GCC) regional scale rating on Mekdam to 'gcBB' from 'gcBBB-'.

Rating Action Rationale

Increasing reliance on short-term debt to finance operations weakens the capital structure and liquidity. Mekdam depends on timely collection of receivables from clients to repay associated project-related short-term maturities. Historically, it did not experience significant delays in collecting receivables and its counterparties are mostly government-owned entities. However, very rapid revenue growth in the past two years (68.5% in 2021 and 85.4% in 2022), partly on the World Cup in Qatar, has led to substantial increase in receivables collection and therefore of working capital outflows. The company experienced substantially negative free operating cash flow of Qatari riyal (QAR) 72.7 million (about $20 million) in 2022 and QAR11.9 million in 2021. To finance its daily operations and offset temporary working capital outflows (because we see the...
risk of nonpayment from clients are minimal), the company increased its reliance on short-term debt, resulting in a higher repayment risk given that all debt is due in less than 12 months. This is a change compared with the capital structure that previously supported the 'gcBBB-' rating. This is especially true in a challenging economy with increased interest rates and inflation risks. A very low weighted-average maturity of 1.1 years and planned dividend payouts, coupled with limited cash sources (excluding possible working capital inflows, whose timing is uncertain) to cover liquidity needs led us to revise our assessment of liquidity to less than adequate.

The backlog supports revenue visibility, but inflation and competition threaten profitability recovery. Mekdam's strong backlog of QAR1.4 billion will continue to support its earnings visibility, at more than 2.5x revenue. We anticipate that the company's access to international service providers, coupled with its track record of working with Qatari government-owned entities, will support its ability to secure new contracts. Despite the government's realization of the National Vision 2030 program and growth of the domestic market, Mekdam's revenue growth should moderate to 3%-8% in the next two years, after extremely fast growth of 68.5% in 2021 and 85% in 2022, boosted by the World Cup. The company's profitability decreased in 2021-2022 due to an increasingly competitive environment, as well as its strategy to expand its customer base, reducing prices and incurring one-off fixed costs to support growth. Mekdam generated an EBITDA margin of 8.2% and 11.5% in 2022 and 2021, respectively, compared with 15.9% in 2020. We expect the company's EBITDA margin will be stable at 8.5%-9.0%, as any scale efficiencies gained because of client-base expansion, together with promotion of higher value-added products to existing customers, will be offset by continued pressure from competition and inflation. Future EBITDA margins being about half historical ones and below-average for global peers is another indication of the deterioration in credit quality, in our view. Our assessment further captures inherent volatility of EBITDA and credit metrics, limited scale with EBITDA of about $12 million, geographical concentration in Qatar, and dependence on the local economy.

Peak leverage is likely to come down to historically low levels of below 1.5x. Mekdam realized massive top-line growth of 70%-85% annually in the past two years, in line with our expectation, and financed associated working capital outflow through project-related short-term debt, which built up significantly in second-half 2022. S&P Global Ratings-adjusted debt reached QAR141 million by the end of 2022 and adjusted debt to EBITDA hiked at 3.3x (versus 1.4x in 2021). Because we expect modest revenue growth in 2023-2024, absent large external drivers, finalization of large one-off projects should lead to significant working capital release. Despite sustained dividends of 50%-60% of the previous year's net income, the company should generate positive discretionary cash flow (DCF; free operating cash flow after dividends) of QAR45 million-QAR55 million in 2023 and about QAR15 million in 2024. We expect this will reduce gross debt and leverage below 1.5x in 2023-2024, close to historical levels. We believe if Mekdam were to experience a further decline in profitability or higher volatility in margins, causing DCF to remain negative for a prolonged period and leverage to exceed 2.0x (during years of rapid growth), this would be detrimental for the rating. Similarly, if liquidity were to deteriorate because of higher-than-expected spending needs, we could lower the rating.

Shareholders provided a loan and a facility totaling QAR39 million, adding visibility to Mekdam's deleverage trajectory in 2023. The company's major shareholders (chairman Sheikh Nawaf Bin Nasser Al-Thani and CEO Ehab Naser), who own about 71% of the company, provided an interest-free loan of QAR14 million in 2022 and a facility with similar terms of QAR25 million, drawn in first-quarter 2023. We believe the loan and facility meets our criteria of a noncommon equity, as these mature beyond the maturity's dates of all other debt, does not benefit from any...
guarantees and are structurally subordinated to all other debt in the capital structure. We expect these funds to support the company's liquidity in the next few months, although not alleviating all of the risk from the short-term maturities, and support its target to deleverage below 1.5x in 2023-2024.

Company Description

Mekdam is a Qatari-based public shareholding company established in 2017. In 2022, it generated QAR527 million of revenue and QAR43.4 million of adjusted EBITDA. The company is a business service provider and operates quasi-exclusively in Qatar, mainly through the following wholly owned subsidiaries:

- Mekdam Technology (61% of 2022 revenue; 39% of 2022 reported EBITDA), a one-stop integrator of more than 65 different systems spanning information communication technology, audio-visual, safety and security, services and maintenance, engineering, and mobile telephony products.
- Mekdam Technical Services (32% of 2021 revenue; 27% of 2022 reported EBITDA), which provides manpower outsourcing and recruitment services, with expertise across various sectors including oil and gas, IT, and health care.
- Mekdam CAMS (4% of 2022 revenue; 25% of 2021 reported EBITDA), which offers a centralized alarm-monitoring system across Qatar, with more than 4,000 active connections. It has something of an exclusivity, with connectivity to the national command center (NCC) grid, including 100% coverage of malls, exchanges, schools, petrol stations, hotels, and The Pearl City. We understand this is tailor-made software in collaboration with the Ministry of Interior, Civil Defense, and the NCC.
- Mekdam Steel (2% of 2022 revenue) has a production facility in Mesaieed, Qatar, with a monthly production capacity of 300 tons of steel fabrication. It undertakes structural steel works for high profile projects like Qatar Rail, FIFA stadiums, and light rapid transit. It has a client base comprising governmental, semigovernmental, and private organizations. It executed projects valued at about QAR25 million in 2022.

The company is listed on the Qatar Stock Exchange and was moved to Main Market in January 2023 from the ventures market, where it was listed since July 2022. Mekdam is ultimately controlled by Chairman Sheikh Nawaf Bin Nasser Al-Thani (66%), non-executive director Tariq Bader Al Sada (5%), and CEO Ehab Naser (5%), with the rest being free float.

Our Base-Case Scenario

Assumptions

- Real domestic GDP growth in Qatar of 2.3%-2.5% in 2023 and 2024.
- Consumer price index inflation in Qatar of 2.0%-2.3% in 2023 and 2024.
- Revenue increasing 3%-8% in 2023-2024, in line with economic trends in the country and supported by Qatar's National Vision 2030 program realization.
- EBITDA margin remaining near 8.5%-9.0% in 2023-2024 (8.2% in 2022). We expect the positive effect on profitability coming from reduced recurring expense and operating costs, absent
one-time expense in 2022 due to the company's aggressive growth strategy. On the other hand, these supportive factors are likely to be offset by increasing price pressure amid growing competition in Qatar and higher inflation.

- Annual capex of QAR1 million-QAR3 million per year, less than 1% of consolidated revenue and in line with historical trends.
- A working capital inflow of QAR40 million-QAR45 million in 2023, in line with stabilizing revenue and assumption of no changes in payment terms for clients and suppliers.
- Dividends of QAR20 million-QAR25 million in the coming two years, translating into a payout ratio of 50%-60% of the previous year's net income.
- A shareholder-provided facility of QAR25 million, drawn at first-quarter-end 2023.
- No planned acquisitions.

Key metrics

Based on these assumptions, we arrive at the following credit measures:

- Adjusted debt to EBITDA below 1.5x in 2023-2024 (compared with 3.3x in 2022).
- Positive DCF of QAR45 million-QAR55 million 2023 and about QAR15 million in 2024 (compared to negative QAR 90.2 million in 2022), due to minimal capex and working capital normalization.
- Adjusted debt of QAR50 million-QAR60 million in 2023-2024, compared with adjusted QAR141.4 million in 2022.

Liquidity

We assess Mekdam's liquidity as less than adequate over the 12 months from Jan. 1, 2023, as sources to uses is expected to be about 1.0x. Our assessment incorporates material debt maturities and dividend payouts, partly offset by the existing cash balance, working capital release expected in 2023, and the undrawn facility provided by the major shareholder. Mekdam has good relationships with Qatari banks that provide short-term financing for its projects, but access to public funding can be limited due to the company's scale and high interest rates.

Principal liquidity sources for the 12 months starting Jan. 1, 2023, include:

- Cash and cash equivalents of about QAR21.7 million.
- Cash funds from operations of QAR35 million-QAR40 million.
- Working capital release of QAR40 million-QAR45 million.
- Shareholder provided facility of QAR25 million, drawn in first-quarter-end 2023.

Principal liquidity uses in that time include:

- Debt repayments of approximately QAR119 million.
- Capex of about QAR3 million.
- Dividends of QAR20 million-QAR25 million.
Covenants

Compliance expectations

As of Dec. 31, 2022, Mekdam complied with the two covenants below. We forecast adequate headroom in our base-case scenario.

Requirements

The company has two bank covenants—one stipulating a minimum liquidity ratio of 1.0x and the other stipulating a maximum ratio of debt to equity of 3-to-1.

Environmental, Social, And Governance

ESG credit indicators: E-2, S-2, G-3

Governance factors constrain our credit rating analysis of Mekdam, in particular our assessment of the board’s effectiveness when compared with that of global peers. This is due to the business’ relatively small scale and the composition of some committees, such as the investment committee. Two of three committee members are not independent, although we understand that it is not a mandatory governance requirement to have independent board members. We see the company’s transparency improving with listing on the Venture Market of the Qatar Stock Exchange in July 2021, and eventually to the Main Market in January 2023, for example with the introduction of quarterly reports, but governance practices are still evolving.

Ratings Score Snapshot

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Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- General Criteria: Methodology For National And Regional Scale Credit Ratings, June 25, 2018
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | General: The Treatment Of Non-Common Equity Financing In Nonfinancial Corporate Entities, April 29, 2014
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- Qatar Upgraded To 'AA' On Declining Debt Burden; Outlook Stable, Nov. 4, 2022

Ratings List

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Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceld/504352 Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; or Stockholm (46) 8-440-5914
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