Saudi Electricity

Overweight

Target Price (SR) 18.50

Current price (SR)	**13.90**

Stock details

52-week range H/L (SR)			12.7/9.3
Market cap ($mn)			48,957
Shares outstanding (mn)			4,167
Listed on exchanges			Tadawul
Price perf. (%)	**1M**	**3M**	**12M**
Absolute	5.9	(3.7)	18.1
Rel. to market	18.9	5.7	19.0

Avg daily turn.(mn)	**SR**	**US$**
3M	27.4	7.3
12M	25.1	6.7

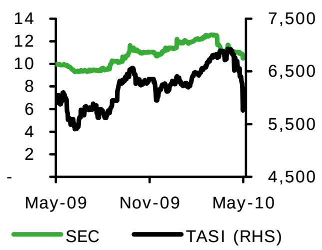
Reuters code	5110.SE
Bloomberg code	SECO AB
Website	www.se.com.sa

Valuation multiples

	09	10E	11E
P/E (x)	49.7	24.1	13.4
P/B (x)	1.2	1.1	1.1
EV/EBITDA (%)	8.6	7.0	5.5
Div yield (%)	5.0	5.0	5.0

Source: NCBC Research estimates

Share price performance



Source: Bloomberg

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Further upside is likely

We maintain our Overweight rating and price target at SR18.5/share over the next 12 months. We expect revenue and profits to increase due to higher electricity tariffs and improving cost controls. The stock has increased 29% since our upgrade and we expect further upside as the company reports its 3Q10 results.

- **Outperformed the market since our upgrade:** SEC's stock price has increased 29% since our upgrade versus 5% for the Saudi market (TASI). This was on the back of the newly implemented tariff structure which positively impacts the company's profitability.
- **Second quarter results were higher than expected:** Although the new tariff structure had no impact on the company in 2Q10; SEC was able to beat consensus by 33% and exceeded our estimates by 12%. The two key drivers were; the increase in revenue above our estimate because of the hotter than normal summer, and a much tighter control over operating and maintenance costs.
- **Difficult to estimate 3Q10 earnings:** Although we have a good idea of the expected impact of the tariff change on a full year basis, it is far more difficult to reliably estimate the impact on a quarterly basis. This is due to the high seasonality of consumption and the complexity of the new tariff structure. Bearing that in mind, we estimate net income to be SR2.4bn for 3Q10, good for 41% YoY growth.
- **Market has not yet fully realized the potential upside:** The new tariff structure that will affect industrial, commercial and government customers will have a significant impact on profitability. We believe this has not been fully priced in by the market despite the 29% increase since our upgrade.
- **Remain Overweight with further 30% upside potential:** Despite the 29% rise since our upgrade, we still see further upside to the current market price that we expect will be triggered by the 3Q10 results.

Financials

		2009	2010E	2011E	2012E	2013E
Revenues	SR mn	23,851	26,606	29,940	31,573	33,323
EBITDA	SR mn	8,327	10,231	12,997	13,240	13,277
Net income	SR mn	1,170	2,413	4,344	3,929	3,183
Total debt	SR mn	19,340	26,849	43,457	53,519	51,727
Div per share	SR	0.70	0.70	0.70	0.70	0.70
EBITDA margin	%	34.9	38.5	43.4	41.9	39.8
Net margin	%	4.9	9.1	14.5	12.4	9.6
ROE	%	2.4	4.8	8.2	7.0	5.3
Debt-to-capital	%	28.2	34.5	44.2	47.9	45.9
EPS	SR	0.28	0.58	1.04	0.94	0.76

Source: Company, NCBC Research estimates

Estimating 3Q10

We estimate that the new tariff structure which was announced recently will result in incremental revenue of SR3.2bn in 2011e, which is in line with company guidance. While our annual forecasts therefore look reasonable, the quarterly model represents a more challenging task, however.

Modeling revenues on an annual basis

Unlike most other market participants, we estimate revenues by modeling each revenue line. Electricity sales are by far the largest component of revenue (92% of total revenues in 2009). Hence, we will only describe our approach for modeling electricity sales.

We model electricity sales by customer category and the sum of that is simply the total revenue from electricity sales. For each customer category, revenue from electricity sales is the energy sold to that customer category multiplied by the weighted average revenue/kwh for that particular category.

We estimate the weighted average revenue (for each category) using the tariff schedule and the different consumption levels within that category. SEC reports sold energy (in Kwh) by customer category, but does not provide revenues from each category. Hence, we use data provided by the regulator (Electricity & Co-generation Regulatory Authority "ECRA") and work backwards with the consumption levels for each customer category to estimate weighted average revenue/kwh.

Exhibit 1: Simplified structure of our revenue model

Electricity Sales	A
Meter Reading & Maintenance Tariff	B
Electrical service connection tariff	C
Total revenues	**=A+B+C**
Total electricity sales	
Residential	D
Commercial	E
Government	F
Industrial	..
Agricultural	..
Others	..
	A = D + E + F + ..+ ..
Residential electricity sales	
Energy sold (in Kwh)	G
Weighted average revenue/kwh	H
	D = G * H

Source: NCBC research

In order to check the accuracy of our estimates, we calculate total electricity sales for the past several years using disclosed consumption levels for each category and our estimate of weighted average revenue/kwh for each category; then we compare our estimate with the actual reported total electricity sales. Our approach results in less than 1% variance. Hence, we believe our estimate of weighted average revenue for each segment is accurate enough as a forecasting base.

Our model suggests that the new tariff structure will add around SR3.2bn of revenue (assuming a full year impact) which is basically in line with ECRA's estimates.

Modeling revenues on a quarterly basis

SEC's quarterly performance has been quite predictable over the past few years. The best way to estimate the company's earnings for a given quarter was to allocate the annual revenue estimate over the quarters. This proved to be quite reliable due to the company's steady business over the past few years.

The 3Q10 will be different, however. The recently announced new tariff structure for commercial, government and industrial customers will affect the company's revenues for the first time in 3Q10 which makes estimating earnings for the next quarter a major challenge. This is mainly due to the lack of detailed information on consumption patterns by the different customer categories on a quarterly basis.

Although we are quite comfortable with our annual revenue estimate for 2011e and beyond; estimating quarterly revenues is more challenging. Historically, around 55 - 56% of annual revenue was generated in the second half of the year. This year will be different as the change in tariff will only affect the second half and the tariff structure itself is the highest in 3Q10. The uncertainty in estimating revenues for 3Q10 makes the estimate for net income even more so.

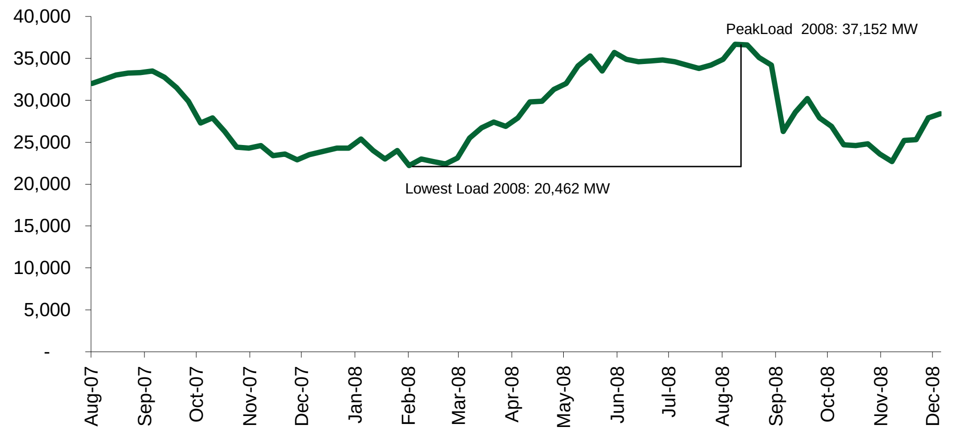
Here, we will try to "guesstimate" revenues for 3Q10 based on the information we currently have. However, we need to highlight that regardless of the exact figure (higher or lower than our estimate) the impact of one quarter on valuation is minimal compared to longer term consideration. But, we believe the high income in this quarter compared to historical levels will attract investors' attention and be the key that will trigger a further upside to the stock.

SEASONALITY OF CONSUMPTION

Our analysis of seasonal consumption patterns indicates that the majority of energy sales take place in 3Q of every year (assuming 2007/2008 is representative of every year) and the same conclusion can be drawn from quarterly revenue figures.

Exhibit 2: Overall consumption seasonality (2007 and 2008)

Loads MW (Weekly 2007/2008)



Source: ECRA, NCBC research

Although consumption seasonality is highest among residential and commercial customers (due to the nature of consumption); industrial and government consumption also exhibits clear seasonality.

Facts we have considered in estimating revenues for 3Q10:

- A significant part of the rise in consumption in the summer comes from residential consumers who are not going to be affected by the change in tariffs. Hence, the increase in 3Q is expected to be less than proportionate to the annual incremental revenue. However, average revenue per kwh for residential customers usually rises in the summer due to higher consumption levels.
- Commercial and government consumption also peak in summer. Given the new tariffs, average revenue per kwh will increase by approximately 25% (based on our estimates). We believe the contribution to revenue from these segments will be the highest in this quarter. See appendix for details of new tariffs.
- In light of the new tariff structure, industrial tariffs are dependant on the timing of consumption (month and time during the day) versus the old tariff structure where the rate was flat at SR0.12/kwh. This makes it very difficult to estimate how the new tariff will affect average revenue per kwh. See the appendix for further details.
- To add to the complexity, it is highly likely to see some industrial establishments (especially smaller ones) adjusting their consumption behavior in order to avoid the higher tariffs. Most likely we will see more consumption shifting to off-peak times. Although this is basically the purpose of the tariff reform, this will be limited by 2 key factors:
    - Larger manufacturers sometimes operate in 3 shifts (24 hours) which gives them less flexibility in choosing time of operations.
    - The electricity cost of smaller manufacturers (or even large manufacturers who are not in heavy-intensive industries) is usually a very small fraction of the total cost of production. This will limit the incentive to switch or adjust operating hours.

  However, to take the behavioral factor into account, we apply a 5% discount to an estimate of revenue per kwh of industrial customers that assumes consumption is spread evenly over the period.

By combining all the above with the data we have, our base case estimate for the 3Q10 is the following:

Exhibit 3: Revenue and net income estimates in 3Q10

SRmn, unless otherwise stated

	3Q10E	2Q10	% chg QoQ	3Q09	% chg YoY
Revenue	8,715	7,355	18.0	7,882	11.0
Net income	2,441	1,068	128.0	1,731	41.0

Source: Company, NCBC Research estimates

Appendix

Exhibit 4: New and old tariff for commercial and government custumers

Segment	Consumption Category	Old tariff (Halalas)	New Tariff (Halalas)
Commercial			
	1 - 1000	5	12
	1001 - 2000	5	12
	2001 - 3000	10	12
	3001 - 4000	10	12
	4001 - 5000	12	20
	5001 - 6000	12	20
	6001 - 7000	15	20
	7001 - 8000	20	20
	8001 - 9000	22	26
	9001 - 10000	24	26
	More than 100000	26	26
Government			
	1 - 1000	5	26
	1001 - 2000	5	26
	2001 - 3000	10	26
	3001 - 4000	10	26
	4001 - 5000	12	26
	5001 - 6000	12	26
	6001 - 7000	15	26
	7001 - 8000	20	26
	8001 - 9000	22	26
	9001 - 10000	24	26
	More than 100000	26	26

Source: Company, NCBC Research

Exhibit 5: New Tariff Structure vs Old Tariff Structure at 12 Halalas for ALL

	Seasonal Tariffs		Tariffs that change	
Period of consumption	**Time of consumption**	**Tariff (Halalas)**	**Time of consumption**	**Tariff (Halalas)**
Industrial (Small)				
Beg of Oct - End of April	All Times	12	All Times	12
Beg of May - End of Sept	All Times	15	Sat-Thurs: 00:00 - 08:00 & Fri: 00:00 - 09:00 and 21:00 – 00:00	10
			Sat - Thurs: 12:00 - 17:00	26
			Remaining time	15
Industrial (Large Consumers)				
Beg of Oct - End of April	All Times	14	All Times	14
Beg of May - End of Sept	All Times	15	Sat-Thurs: 00:00 - 08:00 & Fri: 00:00 - 09:00 and 21:00 – 00:00	10
			Sat - Thurs: 17:00 - 12:00	26
			Remaining time	15

Source: Company, NCBC Research

Financials

Exhibit 6: Income statement

In SR millions, unless otherwise stated

	2008	2009	2010E	2011E	2012E	2013E
Gross Revenue	22,289	23,851	26,606	29,940	31,573	33,323
Cost of revenue	(14,563)	(15,208)	(16,050)	(16,607)	(18,010)	(19,738)
Gross Profit	**7,726**	**8,643**	**10,556**	**13,333**	**13,563**	**13,585**
S.G. & A. Expenses	(217)	(316)	(325)	(336)	(323)	(308)
EBITDA	**7,508**	**8,327**	**10,231**	**12,997**	**13,240**	**13,277**
Depreciation Expense	(6,744)	(7,515)	(8,193)	(9,024)	(9,925)	(10,889)
EBIT	**764**	**812**	**2,038**	**3,973**	**3,315**	**2,389**
Other Income	340	357	437	482	715	876
Net Profit Before Taxes/Zakat	**1,104**	**1,170**	**2,475**	**4,455**	**4,030**	**3,265**
Zakat Provision	-	-	(62)	(111)	(101)	(82)
Net Profit Zakat	**1,104**	**1,170**	**2,413**	**4,344**	**3,929**	**3,183**
Outstanding Shares ('000s)	4,167	4,167	4,167	4,167	4,167	4,167
EPS (SR)	0.27	0.28	0.58	1.04	0.94	0.76
Dividends/Share (SR)	0.70	0.70	0.70	0.70	0.70	0.70

Source: Company, NCBC Research estimates

Exhibit 7: Balance sheet

In SR millions, unless otherwise stated

	2008	2009	2010E	2011E	2012E	2013E
Cash & Cash Equivalents	1,232	3,883	2,128	2,395	2,526	5,749
Current receivables	15,074	10,586	11,398	12,269	12,938	13,655
Net Inventory	5,807	5,623	5,509	5,260	5,227	5,206
Other Current Assets	2,898	1,956	1,946	1,947	2,106	2,299
Total Current Assets	**25,011**	**22,048**	**20,981**	**21,871**	**22,797**	**26,909**
Fixed Assets	118,212	141,324	161,690	183,798	207,559	219,601
Equity Investments	2,160	2,353	2,790	3,273	3,987	4,864
Notes Receivables (from customers)	-	366	-	-	-	
Total Long Term Assets	**120,372**	**144,043**	**164,481**	**187,070**	**211,546**	**224,465**
Total Assets	**145,382**	**166,091**	**185,462**	**208,942**	**234,343**	**251,374**
Accounts Payable	38,279	47,351	52,833	54,733	65,102	79,541
Accruals & Other Payables	1,314	1,440	1,519	1,572	1,705	1,868
Total Current Liabilities	**39,593**	**48,791**	**54,352**	**56,305**	**66,806**	**81,410**
Non-current operating liabilities	47,033	48,786	53,221	54,343	55,798	57,383
Total operating liabilities	**86,626**	**97,576**	**107,573**	**110,648**	**122,604**	**138,793**
Total debt (incl. current portion)	10,204	19,340	26,849	43,457	53,519	51,727
Total Liabilities	**96,830**	**116,916**	**134,422**	**154,104**	**176,124**	**190,519**
Total Shareholders' Equity	48,553	49,175	51,040	54,837	58,219	60,855
Total Liab. & Shareholders' Equity	**145,382**	**166,091**	**185,462**	**208,942**	**234,343**	**251,374**

Source: Company, NCBC Research estimates

Exhibit 8: Cash flow statement

In SR millions, unless otherwise stated

	2008	2009	2010E	2011E	2012E	2013E
Net Income before Zakat	1,104	1,170	2,413	4,344	3,929	3,183
Depreciation & Amortization	6,744	7,515	8,193	9,024	9,925	10,889
Change In Operating Activities	10,612	16,198	9,675	2,451	11,162	15,299
Cash flows from op. Activities	**18,460**	**24,882**	**20,281**	**15,819**	**25,016**	**29,371**
(Inc) dec in property & plant	(22,154)	(30,627)	(28,560)	(31,131)	(33,686)	(22,932)
(Inc) dec in investments	(513)	(193)	(437)	(482)	(715)	(876)
Cash Flows from Investing Activities	**(22,668)**	**(30,820)**	**(28,997)**	**(31,613)**	**(34,401)**	**(23,808)**
Dividend Paid + Remuneration(Board)	(529)	(547)	(547)	(547)	(547)	(547)
Change in debt	379	9,136	7,509	16,608	10,062	(1,793)
Cash Flows from Financing Activities	**(150)**	**8,589**	**6,961**	**16,061**	**9,515**	**(2,340)**
Net change cash & cash equivalents	**(4,358)**	**2,651**	**(1,754)**	**267**	**131**	**3,223**
Cash & cash equiv at start of year	5,589	1,232	3,883	2,128	2,395	2,526
Cash & cash equiv at year end	**1,232**	**3,883**	**2,128**	**2,395**	**2,526**	**5,749**

Source: Company, NCBC Research estimates

Exhibit 9: Key ratios

	2008	2009	2010E	2011E	2012E	2013E
Per share ratios (SR)						
EPS	0.27	0.28	0.58	1.04	0.94	0.76
Div per share	0.70	0.70	0.70	0.70	0.70	0.70
Book value per share	11.7	11.8	12.2	13.2	14.0	14.6
Valuation ratios (x)						
P/E	52.6	49.7	24.1	13.4	14.8	18.3
Implied P/E	69.8	65.9	31.9	17.7	19.6	24.2
P/BV	1.2	1.2	1.1	1.1	1.0	0.9
EV/sales	3.2	3.0	2.7	2.4	2.3	2.1
EV/EBITDA	9.5	8.6	7.0	5.5	5.4	5.4
Div yield (%)	5.0	5.0	5.0	5.0	5.0	5.0
Profitability ratios (%)						
Gross margins	34.7	36.2	39.7	44.5	43.0	40.8
Operating margin	33.7	34.9	38.5	43.4	41.9	39.8
EBITDA margins	3.4	3.4	7.7	13.3	10.5	7.2
Net profit margins	5.0	4.9	9.1	14.5	12.4	9.6
ROE	2.3	2.4	4.8	8.2	7.0	5.3
ROA	0.8	0.8	1.4	2.2	1.8	1.3
Liquidity ratios (x)						
Current ratio	0.6	0.4	0.3	0.3	0.3	0.3
Quick Ratio	0.5	0.3	0.2	0.3	0.2	0.2
Interest coverage	12.2	10.8	10.1	9.2	7.6	6.5
Production Capacity						
Generation capacity (MW)	34,470	37,913	41,380	42,954	45,471	46,786
Purchased capacity (MW)	4,772	6,572	4,772	4,772	6,672	9,872
Total available capacity (MW)	39,242	44,485	46,152	47,726	52,143	56,658
Energy sold (Gwh)	181,098	193,472	206,477	220,347	234,312	249,377
Utilization (%)	59.5	56.1	57.7	59.6	58.0	56.8

Source: Company, NCBC Research estimates

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NCBC INVESTMENT RATINGS

Overweight:	Target price represents expected returns in excess of 15% in the next 12 months
Neutral:	Target price represents expected returns between -10% and +15% in the next 12 months
Underweight:	Target price represents a fall in share price exceeding 10% in the next 12 months
Price Target:	Analysts set share price targets for individual companies based on a 12 month horizon. These share price targets are subject to a range of company specific and market risks. Target prices are based on a methodology chosen by the analyst as the best predictor of the share price over the 12 month horizon

OTHER DEFINITIONS

NR:	Not Rated. The investment rating has been suspended temporarily. Such suspension is in compliance with applicable regulations and/or in circumstances when NCB Capital is acting in an advisory capacity in a merger or strategic transaction involving the company and in certain other situations
CS:	Coverage Suspended. NCBC has suspended coverage of this company
NC:	Not Covered. NCBC does not cover this company