Shock Therapy

We initiate coverage on Saudi Electricity Company (SECO) with a 12-month target price of SAR 16.50 and Buy recommendation. While dividends have captured the spotlight, we believe the Company is unfairly viewed as heavily debt-laden on a never ending capex program with inadequate return on capital. We see it differently. In our view, SECO is an intermediary fulfilling the state's energy objectives, therefore associated costs and liabilities are passed through to the government. In return shareholders are incentivized through constant dividends. At current price we believe shares are undervalued. Buy.

Differentiating accounting from realizable liabilities reveals value

As a conduit for implementing state energy policy, we believe capex will pass-through to the government. Dues to state-owned entities are converted to long-term, interest-free loans that will be realized decades later, if at all. As such, we carved-out 70% of total debt, dues to SOEs and associated capex, yielding an adjusted capital structure and enterprise value. We then applied four equal-weighted valuation methodologies to arrive at our fair value of SAR 16.62. Plans to split SECO into 6 entities will unlock value of under-appreciated assets and could accelerate given the current push to privatization. Spin-offs have created greater value for the parent with subsequent share price rally.

Aggregate +48% increase in tariff expected through 2020

Effective Jan-2016, electricity tariffs were increased as the government moved towards gradual removal of subsidies, targeting market price. As such, we believe further increments are in the pipeline. By 2020, we forecast an aggregate +48% increase in average tariffs from 2015 levels and point-out that relative to global comparables, KSA is at the lower end of the range in terms of rates but at opposite end by consumption per capita. We project industrial segment will be hardest hit with an average annual revenue per customer increase at +8.4% CAGR to SAR 1.5 mln. The sword cuts both ways as fuel costs are also on the rise. Some 50% generation capacity is gas powered, which is now +67% more expensive. Key risk will be fuel cost increments outpacing tariff hikes.

Margins neutralized as fuel cost offsets revenue gain

In setting our forecasts, we factored economic environment, population growth, impact on consumption, average revenue per customer and IPP contribution. We expect +23% Y/Y spike in topline growth for 2016 followed by moderation to +7% Y/Y by 2020. The previous rate adjustment in mid-2010 resulted in +11% Y/Y growth which excluded residential customers and left maximum rate unchanged. Increased IPP contribution should reduce fuel consumption but not cost. Despite maintenance-related savings, we project gross margins to cluster around mid-single digit. Earnings are expected at +12% CAGR with a decelerating trend over the next five year period.

Defensive stock with dependable dividends

In a volatile market where "cash is king" and path of oil price uncertain, we like the defensive nature of SECO shares and dependable SAR 0.70 DPS. We expect another 10-year renewal of government waiver on dividends which will expire in 2019. Yielding 5%, SECO shares should be added in an income-geared portfolio. Irrespective of fiscal constraints, we believe the Company will continue undistracted from newsflow.

SAR 16.50	Buy
12-Month Target Price	Recommendation

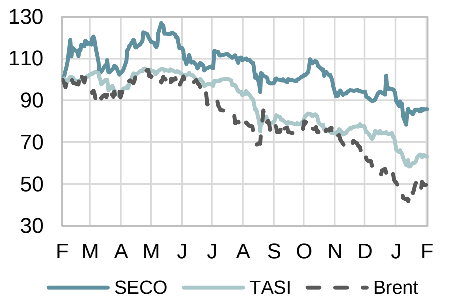
Stock Details (SAR)	
Last Close Price	14.05
Upside to Target	17.4%
Dividend Yield	5.0%
Expected Total Return	22.4%
Market Capitalization (bln)	58.5
Shares Outstanding (bln)	4.2
52-Week High / Low	21.00 / 12.40
Price Change (YTD)	(10.6%)
12-Mth ADTV (mln)	2.9
Reuters / Bloomberg	5110.SE / SECO AB

SAR	2015	2016E	2017E
Revenue (mln)	41,565	51,090	59,584
EBITDA (mln)	16,474	18,235	19,724
EPS	0.36	0.69	0.72
DPS	0.70	0.70	0.70

Key Shareholders	
Government	74%
Saudi Aramco	7%
Free Float	19%

Price Multiples	2015	2016E	2017E
P / E	38.8x	20.4x	19.5x
EV / EBITDA	15.6x	14.1x	13.1x
P / S	1.4x	1.1x	1.0x
P / B	1.0x	0.9x	0.9x

1-Year Share Performance



Source: Bloomberg, Tadawul

Asim Bukhtiar, CFA
abukhtiar@fransicapital.com.sa
+966 11 282 6844

Summary Financials

SAR mln, ending Dec-31 st

Income Statement	2015	2016E	2017E	2018E	CAGR 2012-15	CAGR 2015-18E	1Q16E	1Q15	Y/Y Chg	4Q15	Q/Q Chg
Sales	41,565	51,090	59,584	66,881	*7%*	*17%*	8,931	7,486	*19%*	8,985	*(1%)*
Cost of sales	39,010	47,382	55,686	63,003			10,507	8,697		10,330	
Gross profit	2,555	3,708	3,898	3,879	*(11%)*	*15%*	(1,576)	(1,211)		(1,344)	
G&A	1,013	1,170	1,274	1,426			222	190		436	
Operating income	1,541	2,538	2,623	2,453	*(19%)*	*17%*	(1,797)	(1,402)		(1,781)	
Other income	(34)	335	375	375			30	(538)		336	
Zakat	-	-	-	-			-	-		-	
Net income	1,507	2,873	2,998	2,828	*(16%)*	*23%*	(1,767)	(1,940)		(1,445)	
Shares outstanding (mln)	4,166	4,166	4,166	4,166			4,166	4,166		4,166	
EPS (SAR)	0.36	0.69	0.72	0.68			(0.42)	(0.47)		(0.35)	
EBITDA	16,474	18,235	19,724	21,463	*6%*	*9%*	2,103	2,204	*(5%)*	2,150	*(2%)*
DPS (SAR)	0.70	0.70	0.70	0.70							

SAR mln, ending Dec-31 st

Balance Sheet	2015	2016E	2017E	2018E	CAGR 2012-15	CAGR 2015-18E
Cash & equivalents	2,119	5,616	9,979	2,312	*(11%)*	*3%*
Receivables	20,546	24,116	28,502	32,049		
Other current items	15,341	18,785	20,856	23,217		
Current assets	38,006	48,517	59,337	57,578	*11%*	*15%*
PP&E + Construction in progress	315,690	333,268	365,138	373,098		
Other assets	4,333	4,000	3,650	3,400		
Total assets	358,029	385,785	428,125	434,076	*14%*	*7%*
Payables	52,558	61,051	88,151	81,877		
Other current items	10,225	10,781	12,110	12,650		
Current liabilities	62,783	71,832	100,261	94,528	*15%*	*15%*
LT debt	57,207	59,940	60,940	61,440		
Gov't payables and loans	140,437	147,000	151,000	155,000		
Other liabilities	37,383	44,423	50,934	55,817		
Total liabilities	297,810	323,196	363,135	366,785	*17%*	*7%*
Total equity	60,219	62,589	64,990	67,291	*4%*	*4%*
Total liabilities & equity	358,029	385,785	428,125	434,076	*14%*	*7%*

SAR mln, ending Dec-31 st

Statement of Cashflows	2015	2016E	2017E	2018E	CAGR 2012-15	CAGR 2015-18E
Net income	1,507	2,873	2,998	2,828	*(16%)*	*23%*
Non-cash items	15,464	16,277	17,601	18,710		
Receivables	(4,938)	(3,570)	(4,387)	(3,547)		
Prepayments	726	(865)	(1,614)	(718)		
Inventories	103	(2,579)	(457)	(1,643)		
Payables	13,436	8,493	27,100	(6,274)		
Accruals & other payables	1,292	703	1,329	541		
Defered revenue & other	3,464	6,480	6,035	5,198		
Cash from operations	31,054	27,813	48,606	15,095	*12%*	*(21%)*
Purchase of PP&E	(56,186)	(33,305)	(49,000)	(27,000)		
Other investing activities	159	387	305	285		
Cash from investing	(56,027)	(32,918)	(48,695)	(26,715)	*14%*	*(22%)*
Dividends paid	(532)	(547)	(547)	(547)		
Debt (payments) / proceeds	20,680	9,149	5,000	4,500		
Cash from financing	20,148	8,602	4,453	3,953	*19%*	*(42%)*
Change in cash	(4,824)	3,497	4,363	(7,668)		
Beginning cash	6,944	2,119	5,616	9,979		
Ending cash	2,119	5,616	9,979	2,312		

Growth (Y/Y)	2015	2016E	2017E	2018E
Sales	8%	23%	17%	12%
EBITDA	12%	11%	8%	9%
EBIT	40%	65%	3%	(6%)
Net income	(58%)	91%	4%	(6%)
CFO	(0%)	(10%)	75%	(69%)
DPS	-	-	-	-

Margins	2015	2016E	2017E	2018E
Gross	6.1%	7.3%	6.5%	5.8%
EBITDA	40%	36%	33%	32%
EBIT	3.7%	5.0%	4.4%	3.7%
Net	3.6%	5.6%	5.0%	4.2%

Ratios	2015	2016E	2017E	2018E
Current	0.6x	0.6x	0.5x	0.6x
ROAE	2.5%	4.7%	4.7%	4.3%
ROAA	0.4%	0.8%	0.7%	0.7%
ROIC	0.5%	0.7%	0.7%	0.6%
Payout (ex-gov shares)	36%	19%	18%	19%
LT D / E	3.3x	3.3x	3.3x	3.2x
LT D / E (ex-gov't)	0.9x	1.0x	0.9x	0.9x
Net debt / EBITDA	12.1x	11.2x	10.4x	10.1x

Valuation	2014	2015	2016E	2017E
P / S	1.5x	1.4x	1.1x	1.0x
P / E	16.2x	38.8x	20.4x	19.5x
P / B	1.0x	1.0x	0.9x	0.9x
EV / EBITDA	17.6x	15.6x	14.1x	13.1x

Key Statistics	2014	2015E	2016E	2017E
Customers (mln)	7.6	8.0	8.4	8.8
Gen capacity (MW)	48,624	53,124	58,124	63,124
Avg tariff (¢ / KWH)	7.0	7.0	8.2	9.1

** Note: 2015 is an estimate*

Valuation Summary (SAR)	
Adjusted DCF	13.65
Dividend discount model	13.03
Relative valuation @ 7.6x EV / EBITDA	19.46
Transaction multiple @ 7.8x EV / EBITDA	20.33
Equal-weighted average	**16.62**

Investment Thesis

SECO holds monopolistic position in electricity transmission and distribution while generating some 70% of the aggregate capacity exceeding 66,000 MWH. Independent power producers are expected to add 14,200 MWH capacity through 2020. Increased use of purchased power will ease generation-related capital expenditure which we estimate will total SAR 221 bln between 2016 and 2020. Deployed capital was almost entirely funded through external sources with government share comprising 70% of total debt.

In addition to long-term, interest-free loans, state support includes waiver of dividends, deferred fuel payments and higher tariffs for governmental users. Despite fiscal constraints, we expect state support to continue and view the Company as a key partner in implementing the broader economic vision. The heavily subsidized electricity tariffs were revised in Dec-2015 and implemented immediately with the highest rate set at SAR 0.30 / KWH from SAR 0.26 for non-governmental users. We believe further increments are in the pipeline targeting market price, though a benchmark has not been defined. Relative to international comparables, Saudi tariffs are at the lower end of the scale while per capita consumption is at the opposite end. Through 2020, we estimate average tariff will increase by a total +48% from pre-2016 level. On the other hand, fuel cost hikes will have a neutralizing effect on SECO margins which relies on gas for 50% of its generation capacity. Gas is now +67% higher at $1.25 / mmBTU with potential further hikes on the cards. Greater contribution from IPPs will moderate fuel consumption but not necessarily cost.

In setting our forecasts, we factored slowing economic environment, constant population growth, changes in consumption patterns, average revenue per customer and impact of IPP contribution. We expect revenue growth to spike in 2016 to +23% Y/Y and decelerate to +7% Y/Y by 2020. We note that the last tariff adjustment in mid-2010 resulted in +11% Y/Y growth which excluded residential customers and left maximum rate unchanged. Further, despite cost savings we believe gross margins will cluster around mid-single digits. We project EBITDA and earnings growth at +8% CAGR and +12% CAGR, respectively between 2015 and 2020.

Mounting debt burden, massive capex with inadequate ROIC, thin margins and declining earnings growth: where is the value in this stock? We argue that SECO is a conduit for state-funded energy policy. As such, we carve-out government-related debt, liabilities and associated capex to determine an adjusted financial position. Fuel, purchased power and fees are eventually converted to long-term government loans booked as an accounting liability that will likely remain unrealized. Valuing SECO is unusual in that no single methodology fully captures the shares’ fair value. As such, we applied an equal-weighted average of four methodologies (adjusted DCF, DDM, relative value and transaction multiples) that ranged between SAR 13.03 and SAR 20.33 to arrive at SAR 16.62. The Company plans to split into 6 entities: 4 GENCOs, 1 transmission and 1 distribution which may be offered to the public. In our view, this can unlock significant value of under-appreciated assets, and given the push towards privatization (airports, Aramco, other state assets), the timeframe may be accelerated. In this scenario, key risk will be divestiture of government stake and possible impact on continued state support.

We initiate coverage on Saudi Electricity Company (SECO) with a 12-month target price of SAR 16.50 and Buy recommendation. In a volatile market where “cash is king” and path of oil price uncertain, we like the defensive nature of SECO and dependable DPS of SAR 0.70. Government’s waiver of dividends will expire in 2019 but we expect another 10-year extension. Our total expected return of 22% includes 5% dividend yield, which presents an attractive addition to income-geared portfolios.

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Investment Risks

Saudi Electricity has enjoyed strong state support in the form of soft loans since its formation in 2000. Given the push towards economic transformation and eventual adoption of market-based pricing, state support could potentially pull back in an effort to enforce fiscal discipline. SECO is dependent on external financing to fund growing electricity demand. In a regulated tariff environment, drying funding could pose substantial challenges. We identify the following risk factors that could impact SECO's operating environment.

Fuel costs outpace tariffs

As part of the 2016 budget package, increases in fuel costs and electricity tariffs were announced effective January 2016. For SECO, higher fuel costs will be offset by higher tariffs. Previous tariff adjustment took effect in July 2010 primarily aimed at non-residential customers. The government plans to further increase fuel and electricity charges in the coming years, eventually reaching market prices. If fuel costs outpace tariff increase, SECO's profitability will be impaired and funding gap widened. Resistance to tariff hikes, particularly from residential users, could potentially defer or ease increments. Further, removal of cheap energy could have broader economic implications for industrial and commercial users posing ambivalence for policymakers.

Funding constraints and rising borrowing costs

SECO enjoys the highest credit rating in the country (A1/AA-/AA-, S&P/Fitch/Moody's) giving it access to cheap domestic and international funding. Mounting leverage coupled with macro headwinds created by near $30 oil, could prompt sovereign rating downgrades. Consequentially, SECO's rating may be at risk, contributing to higher borrowing costs. Further, we note that 3-month SAIBOR has sharply climbed from about 90 bps at end-November to over 165 bps, inline with US interest rate liftoff. Subsequent rate increases in the US are expected in 2016 adding pressure to SAIBOR to track higher. SECO's bank borrowing and sukuks are priced at a spread to SAIBOR and will result in rising financing charges.

Dividend claims by government

Since 2006, SECO has distributed SAR 547 mln in annual dividends to non-government shareholders (18.8% ownership) amounting to SAR 0.70 per share. The government (74.3% ownership) has agreed to waive its claim to dividends for 10 years beginning 2009. We believe that even with objectives of raising non-oil revenue the government will likely extend its dividend waiver for another 10 years, since the amount is not substantial (SAR 406 mln). However if the waiver is not extended then the dividends will decrease to about SAR 0.13 per share – significantly diminishing our investment case. Aramco (6.9% ownership) has an ongoing dispute regarding claims to dividends which SECO counters by classifying the oil giant as a state entity and therefore not eligible to receive dividends.

Rise in delinquent accounts and regulatory changes

Non-government receivables amounted to SAR 7.1 bln in 2014. Rising tariffs could potentially further increase delinquent accounts. Environmental and safety regulations could change to reduce carbon footprint. Consequently, SECO may be required to improve emissions and safety standards which may have substantial cost implications.

Unfavorable outcome of pending disputes

Over the course of business, disputes arise with suppliers and customers creating liability for the Company. An unfavorable outcome poses financial risk. For example, if Aramco can successfully claim entitlement to dividends, then the distribution would drop to near SAR 0.50 per share.

Industry Overview

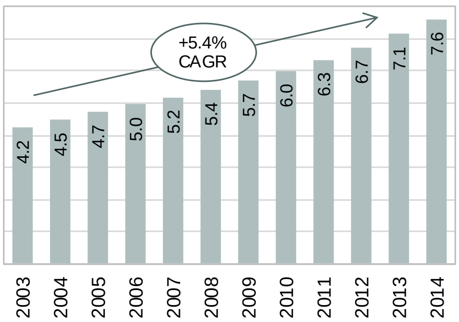
The electricity industry is governed by the Ministry of Water and Electricity in Saudi Arabia through the Electricity Law enacted in 2005. The industry is regulated by the Electricity and Co-generation Regulatory Authority (ECRA). Tariffs are proposed and set by ECRA with the approval of the Council of Ministers, particularly for residential users.

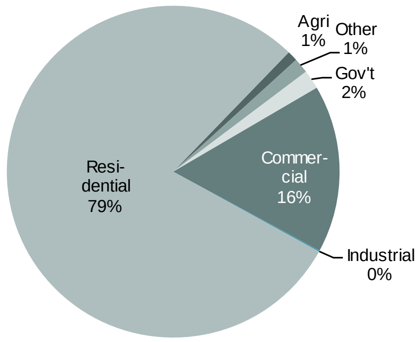
Saudi Electricity Company (SECO) is a monopoly for electricity transmission and distribution in the country and comprises roughly 70% of the total generation capacity. During peak demand, energy is purchased from SWCC (Saline Water Conversion Corp) for a maximum charge of SAR 38 / MWH and Saudi Aramco. In 2007, private sector participation was encouraged through the IPP (independent power producer) program valued at SAR 33 bln including domestic and international partners. The program launched several projects to add nearly 14,200 MW generation capacity. Two of these projects reached commercial operation in 2013: Rabigh-I at 1,204 MW and Riyadh 11 at 1,729 MW. The remaining projects are expected to come online through 2019. SECO off-takes power from the IPPs to meet the country's growing energy needs through long-term take-or-pay contracts.

IPPs expected to add 14,200 MW through 2019

Between 2003 and 2014, total customers have increased at +5.4% CAGR reaching some 7.6 million. Since 2012, customer growth accelerated to over +6.0% Y/Y due to population and industrial growth (economic cities, plant expansion). Residential customers comprise 79% of the total base, followed by Commercial at 16%.

Fig 1: Customers (mln) and Distribution by Type

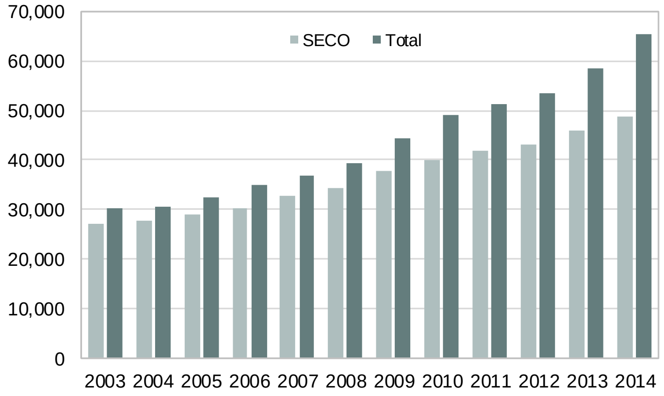




Source: Company Reports

Between 2003 and 2014, SECO's generation capacity increased at +5.5% CAGR to reach 48,624 MW. Contribution from IPPs and other power generators such as SWCC, Marafiq, Saudi Aramco and diesel units took total generation capacity to 65,506 MW. While the Company's generation capacity has kept pace with customer growth, private sector participation was necessitated to shoulder the capital expenditure burden. SECO projects energy-related expenditure of SAR 500 bln through 2023 versus an estimated spend of some SAR 335 bln between 2003 and 2015. Energy demand, driven by population growth and industrial cities, is projected to grow by +37% over the next five years – reinforcing the need for continued investments.

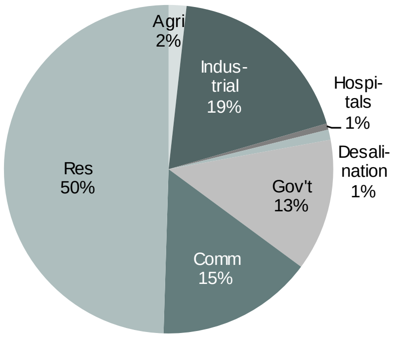
Fig 2: Generation Capacity (MW)



Source: Company Reports

Total energy sold surpassed 274,500 GWH in 2014 with the highest growth in commercial segment at +12% CAGR between 2005 and 2014, followed by government and residential users at +9% and +6%, respectively. Half of the energy consumption comes from residential users followed by industrial and commercial at 19% and 15%, respectively.

Fig 3: Consumption by Customer Type



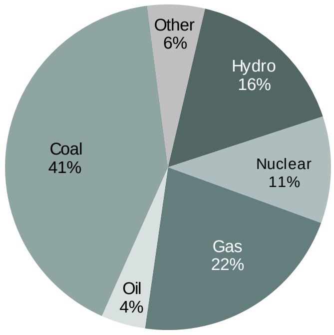
Source: Company Reports

Generation

50% installed capacity is gas and 35% steam powered

SECO generates electricity through 63 stations scattered around Eastern (17), Western (21), Southern (12) and Central (13) regions. Of the total stations, 41 are gas, 4 steam, 14 diesel, 3 combined and 1 solar. Some 50% of installed capacity is gas and 35% steam powered units. Over the past three years, high efficiency combined-cycle generation has more than doubled to some 37,500 GWH while reliance on diesel has dropped by 30%.

Fig 4: Fuel Share in Global Generation



Source: IEA

Old Fuel Cost (per mmBTU)

Natural gas	$0.75
Diesel	$0.63
Light crude oil	$0.74
Heavy fuel oil	$0.32

To fire the plants, fuel is sourced from Saudi Aramco including: gas, crude oil, heavy oil and diesel. In 2003, SECO consumed an estimated 648 mln mmBTU of natural gas and 42 mln barrels of crude. Since then, total generated energy has increased 67% allowing us to estimate current gas and crude consumption at 1.1 bln mmBTU and 70 mln barrels, respectively. Aramco's gas output and domestic crude consumption in 2014 was some 4.2 bln mmBTU and 1,205 mln barrels, respectively, suggesting energy generation consumes a quarter of total gas produced and 6% of crude consumed. We point out that following the announced price revisions, SECO will pay $1.25 / mmBTU, up from $0.75, effective Jan-2016. The industry is moving towards alternative sources of energy including solar and nuclear. According to KA CARE (King Abdullah Center for Atomic and Renewable Energy) by 2032, 50% of the electricity generated in the country will be from non-fossil fuels. Continuous investment in electricity is vital to power economic growth suggesting limited prospect of easing funding requirement.

Transmission

Electricity produced in power plants needs to be transmitted to end users through high voltage wires. At the source, power is generated at 25,000 volts and must be boosted to higher voltage (400KV) by passing through a transformer, which allows for energy transfer across distances through high voltage wires (380KV). Substations housing transformers near end users convert high voltage back down to lower voltage for industrial use and even lower levels (220V) for residential customers.

SAR 21-29 bln annual spend through 2018

Over the last 12 years, the transmission network has nearly doubled from 33,000 km to 60,000 km reaching nearly 99% of populated areas covering 13,000 cities and villages. As residential communities expand to suburban areas and industrial cities erect in remote regions of the country, the requirement for transmission and distribution networks will continue. Between 2014 and 2018 some SAR 21-29 bln per annum spend is projected by the Company to minimize network congestion, interconnect isolated regions and connect new plants to the grid.

Tariffs

Maximum rate raised from 26 halalas to 30

Tariffs in Saudi Arabia are regulated by ECRA and distinguished between residential, commercial, industrial and governmental users. Further, tariffs are tiered by the amount of consumption as well as months and time of use (TOU). Since SECO's formation in 2000, tariffs were revised in 2010 for non-residential users; however the maximum charge of SAR 0.26 / KWH remained constant. Efforts to reform tariffs continued in order to rationalize the economics of the state utility company. In late-2015, as part of the budget package, new tariffs were announced taking effect immediately. The maximum tariff was raised to SAR 0.30 / KWH for non-governmental users, and subsequent increases were potentially placed in the pipeline. According to ECRA, 87% of residential users will be unaffected by the tariff increase (consuming less than 4,000 KWH per month). While commercial, industrial and governmental segments will be charged higher tariffs across the board. Electricity pricing is a sensitive topic in many countries as it affects residents and businesses across the board. The very survival of some industries depends on the cost of energy. The KSA government has indicated an intention to raise utilities to market prices.

Table 1: Evolution of Electricity Tariffs Since 2000

Residential	Tariff (SAR / KWH)		
Monthly Consumption Bracket (KWH)	2000	2010	2016
1 - 2,000	0.05	0.05	0.05
2,001 - 4,000	0.10	0.10	0.10
4,001 - 6,000	0.12	0.12	0.20
6,001 - 7,000	0.15	0.15	0.30
7,001 - 8,000	0.20	0.20	0.30
8,001 - 9,000	0.22	0.22	0.30
9,001 - 10,000	0.24	0.24	0.30
> 10,000	0.26	0.26	0.30

Governmental	Tariff (SAR / KWH)		
Monthly Consumption Bracket (KWH)	2000	2010	2016
1 - 2,000	0.05	0.26	0.32
2,001 - 4,000	0.10	0.26	0.32
4,001 - 6,000	0.12	0.26	0.32
6,001 - 7,000	0.15	0.26	0.32
7,001 - 8,000	0.20	0.26	0.32
8,001 - 9,000	0.22	0.26	0.32
9,001 - 10,000	0.24	0.26	0.32
> 10,000	0.26	0.26	0.32

Commercial	Tariff (SAR / KWH)		
Monthly Consumption Bracket (KWH)	2000	2010	2016
1 - 2,000	0.05	0.12	0.16
2,001 - 4,000	0.10	0.12	0.16
4,001 - 6,000	0.12	0.12	0.24
6,001 - 7,000	0.15	0.20	0.24
7,001 - 8,000	0.20	0.20	0.24
8,001 - 9,000	0.22	0.20	0.30
9,001 - 10,000	0.24	0.26	0.30
> 10,000	0.26	0.26	0.30

Agricultural	Tariff (SAR / KWH)		
Monthly Consumption Bracket (KWH)	2000	2010	2016
1 - 2,000	0.05	0.05	0.10
2,001 - 4,000	0.10	0.10	0.10
4,001 - 5,000	0.10	0.10	0.12
5,001 - 8,000	0.12	0.12	0.12
> 8,000	0.12	0.12	0.16

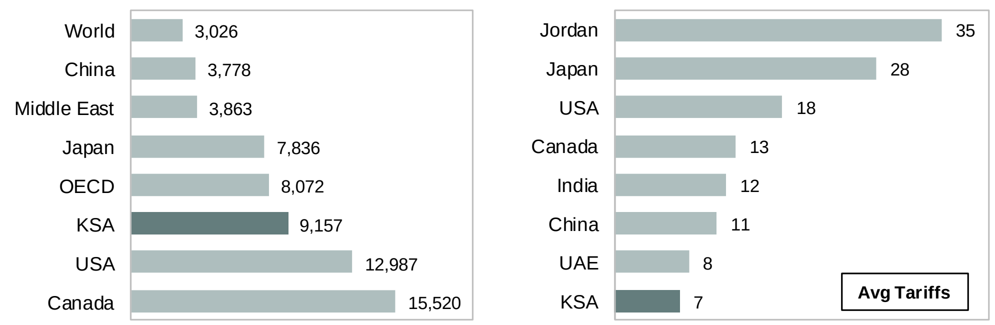
Industrial, Private Hospitals & Schools	Tariff (SAR / KWH)		
Monthly Consumption Bracket (KWH)	2000	2010	2016
Small (1 MVA or less)	0.12	0.12	0.18
Large (more than 1 MVA)	0.12	0.14	0.18

Source: ECRA, Ministry of Water and Electricity

KSA average tariff of ¢7 below group average ¢17

Comparing average tariffs in KSA with a mix of regional and international countries shows that KSA is substantially lower at ¢7 per KWH versus the group average of ¢17. A close regional comparable is UAE which has a slightly higher tariff at ¢8 while Jordan, KSA's northern neighbor charges ¢35. IEA data shows that in terms of per capita electricity consumption, KSA is at the higher end of the range with Canada leading the group.

Fig 5: Per Capita Electricity Consumption (KWH) and Average Tariff (¢/KWH)



Source: IEA, Statista, DEWA

The government's intention to eventually raise utilities to market prices will likely consider energy-advantaged countries as a benchmark. In which case, increments may not be as steep. In the case of SECO the probability of fuel increases outpacing tariff hikes poses substantial risk.

Global Electricity Providers

Table 2 below includes a comparison of regional and international utility providers. Although we note a wide dispersion in operating metrics, net margins tend be in the single digits with Qatar Electricity & Water Co as a notable exception. High leverage characterizes the industry with thin return on assets.

Table 2: International Utility Providers Key Metrics (2014)

Company	Country	Margins Gross	Margins Operating	Margins Net	Debt / Equity	Debt / Assets	ROE	ROA
Qatar Electricity & Water Co	Qatar	43.8%	41.4%	52.4%	0.7x	0.4x	24%	12%
Electricity Holding Co	Oman	28.5%	17.3%	15.3%	0.5x	0.2x	9%	4%
Hydro One	Canada	n.a.	18.6%	11.4%	1.2x	0.4x	10%	3%
PG&E	USA	n.a.	14.3%	8.5%	1.0x	0.3x	9%	2%
GDF Suez	France	n.a.	9.0%	4.2%	0.7x	0.2x	6%	2%
EDF	France	n.a.	9.3%	4.0%	1.9x	0.3x	7%	1%
National Grid	UK	25.4%	24.9%	13.2%	2.2x	0.5x	17%	4%
E.ON	Germany	11.7%	4.2%	2.1%	0.5x	0.1x	7%	2%
Iberdrola	Spain	40.6%	13.1%	7.9%	0.8x	0.3x	7%	3%
KEPCO	Korea	6.4%	2.8%	0.3%	1.2x	0.4x	0%	0%
Saudi Electricity Co	KSA	5.3%	2.9%	9.4%	3.0x	0.6x	6%	1%
Median		**25.4%**	**13.1%**	**8.5%**	**1.0x**	**0.3x**	**7%**	**2%**

Source: Company Reports

Company Background

Private and semi-private electricity providers were consolidated into four majority state-owned utilities known as Saudi Consolidated Electricity Companies (SCECO). These entities were subsequently merged into a single integrated provider, Saudi Electricity Company (SECO), in 1999. With headquarters in Riyadh, SECO employs some 35,300 personnel across the Kingdom, segmented into four operating regions: Eastern, Western, Central and Southern.

The Company is 74% government-owned, 7% Saudi Aramco and the remaining 19% by general public. Board composition consists of government, Aramco and independent members. Since 2009, Dr. Saleh Al-Awajji has served as the Board Chairman, who is also the Deputy Minister of Water and Electricity. Eng Ziyad Al-Shiha, ex-Aramco executive, assumed the helm as CEO in 2014.

Peak load over 56,000 MW verus 30,000 MW ten years ago

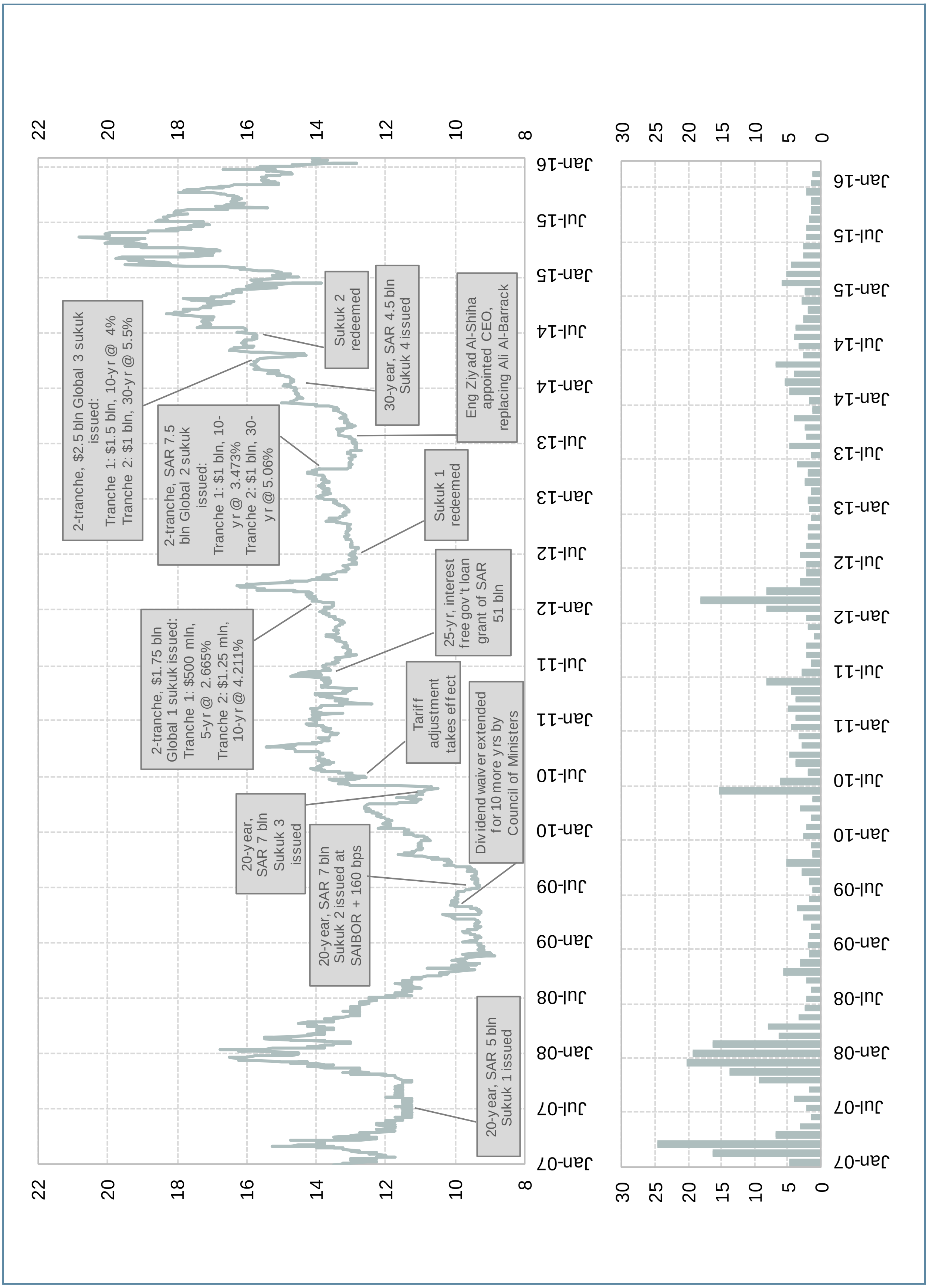
SECO reached generation capacity of some 48,600 MW in 2014, roughly 70% of aggregate, and sold 274,500 GWH of energy. Peak load in the country has increased from 30,000 MW to over 56,000 MW over the last ten years, exerting great demand on energy. The demand is fueled by not just population growth but rapid economic expansion focused on infrastructure, mega cities, airports and education centers. As such, the Company expects to spend SAR 78 bln through 2018 to increase installed capacity to over 68,200 MW. In addition, SAR 29 bln spend is projected on improving the transmission network between 2014 and 2018. To expand and improve the distribution network a further SAR 10-17 bln per annum will be deployed. Clearly the Company has massive funding requirements that will be primarily satisfied through state support and external sources.

Company to split into 6 entities

Saudi Electricity receives state support in various forms including: subsidized loans, waiver of dividends, higher tariffs to governmental users, subsidized fuel and deferred payments. We believe that without this crucial support, SECO will be extremely challenged to maintain its current level of service, particularly in a controlled tariff environment. In an effort to boost efficiency, further transformation of the Company is expected that will see SECO split into 6 entities: 4 GENCOs, 1 distribution and 1 transmission. In 2012, the transmission business was setup as a subsidiary called National Grid. Eventually, the 6 entities may be listed through an initial public offering, with SECO as a holding company.

Shares outstanding were increased to 4,166 mln in 2006, following a 5-for-1 split. Current market capitalization stands at SAR 58.5 bln making SECO the fifth largest listed company on the Saudi Exchange (Tadawul). The stock hit 52-week high-low of SAR 21.00-12.40 with an average daily volume of 2.9 mln shares.

Fig 6: Share Price (SAR) and Monthly Average Volume (mln shares)



Source: Bloomberg, Company Reports, SFC

Financial Analysis

With the tariff revision, the first in five years, SECO's topline growth will be a combination of customer growth, average consumption and pricing. In our forecasts, we project further tariff hikes through 2020 in each year with a combined increase of 48% in average tariff from 2015 level. Further, we have assumed some cutback in consumption as tariffs increase, particularly in the residential and commercial segments. Conversely, industrial and governmental customers are likely to absorb price increases with minimal adjustments in consumption patterns.

Revenue Forecast

Residential contributes 29% of sales and comprises 79% of customer base

We project total customers to reach some 10.2 mln by 2020 at +5.0% CAGR versus 7.6 mln in 2014. Bulk of the growth is expected from the residential segment, while industrial customer growth slows down to +3.6% CAGR reflecting the broader economic trend. As the largest segment by customers, residential contributes some 29% of total electricity sales, followed by governmental at 25% and industrial at 22%. Interestingly, average annual revenue per residential customer is an estimated SAR 1,700 versus SAR 853,000 for industrial users. By 2020, we project the average annual revenue to increase to SAR 2,200 for residential and SAR 1.5 mln for industrial users, equating to +3.8% CAGR and +8.4% CAGR, respectively. In addition, we believe governmental customers will see an increase in average revenue to some SAR 61,500 at +7.7% CAGR. Embedded in these figures are our estimates for changes in consumption patterns and segments most exposed to subsequent tariff hikes.

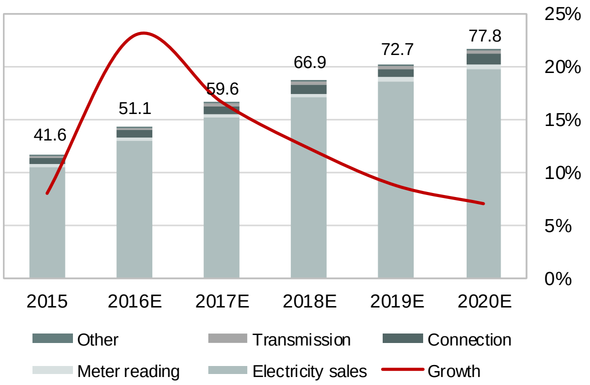
Fig 7: Average Annual Revenue per Customer

SAR	2013		2020E
Residential	1,693	+3.8% CAGR	2,201
Commercial	6,130	+6.6% CAGR	9,592
Industrial	853,028	+8.4% CAGR	1,503,790
Governmental	36,624	+7.7% CAGR	61,499
Others	8,353	+3.3% CAGR	10,485

Source: SFC

We highlight that when tariffs were adjusted in mid-2010, the Y/Y jump in revenues was +11% versus +2% in each of the prior two years and +4% in each of the subsequent two years. As such, we expect a topline spike in 2016 followed by moderating revenue growth.

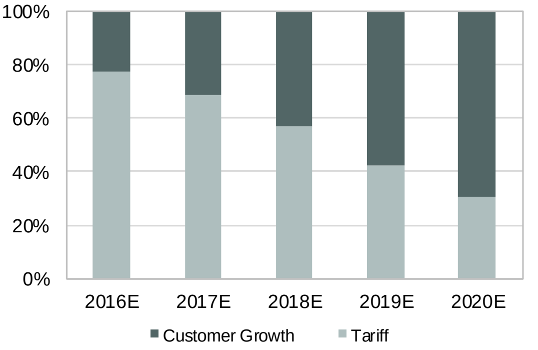
Fig 8: Revenue Projection (SAR bln)



Source: SFC

The contribution of higher tariffs versus customer growth will be magnified in 2016 and gradually trend down through 2020. We believe that subsequent tariff adjustments will ease over the next four years. The government has indicated that energy costs will eventually match market prices. The benchmark for market prices is not yet defined, however we believe the increments will be weighed against competitive advantage of industrial users.

Fig 9: Contribution to Revenue Growth



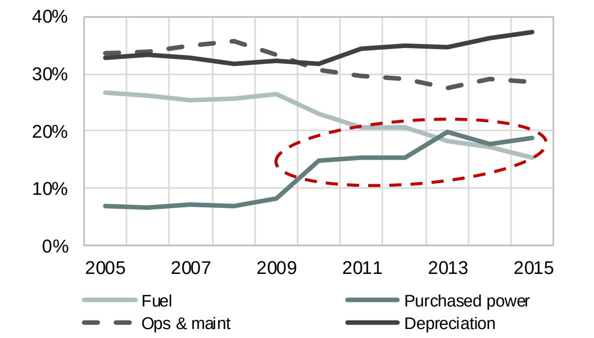
Source: SFC

Mid-Single Digit Gross Margins

SECO's main components of input costs include fuel (15%), purchased power (19%), operations & maintenance (28%) and depreciation (37%). Over the last ten years, two initiatives had significant bearing on cost composition: IPPs and heavy capital expenditure. We expect these factors to continue playing a role in future cost structure. Prior to the introduction of the IPP program, SECO sourced energy from SWCC and Saudi Aramco to bridge supply-demand gap. During this period, purchased energy comprised a steady 7% of cost of sales. As of 2010, purchased energy composition doubled to 15% and maintained an uptrend as Rabigh-1 and Riyadh-11 came online. Further four projects are expected to become operational through 2020 resulting in rising purchased energy. The opposite effect of this factor has been declining fuel composition in cost of sales from about 27% to 15% between 2005 and 2015, and gradual reduction in operations & maintenance composition. In addition, over the last ten years, SECO's assets have tripled thanks to massive capital expenditure, resulting in an escalating depreciation composition.

Four IPP projects to come online by 2020

Fig 10: Cost of Sales Breakdown (SAR bln)



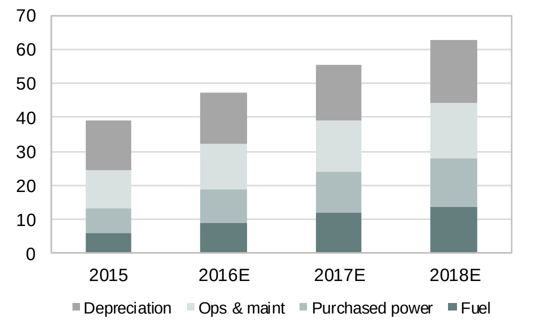
Source: SFC

In setting our cost forecasts, we assumed that purchased power will continue to rise along with depreciation over the next five years. However, with greater private sector participation, fuel and operations categories will begin to ease. If cost savings and efficiency initiatives bear fruit, operations & maintenance may see a meaningful downtrend. The announced adjustments in fuel costs at end-2015 will have dramatic cost inflation effect for SECO which primarily relies on gas. SECO will not have reprieve from higher gas cost of $1.25 / mmBTU, beginning 2016, representing some 67% increase. No disclosure provided on crude oil increase, although we estimate that in the past the Company was paying around $4.50 per barrel. We believe the largest cost impact will arise from higher gas price which may further

Cost inflation from higher gas price of $1.25 / mmBTU

escalate in subsequent years as the government targets charging market price. Therefore, despite IPPs, price hikes may neutralize fuel cost savings. Key risk in our view is if cost inflation outpaces tariff hikes.

Fig 11: Cost of Sales Breakdown (SAR bln)

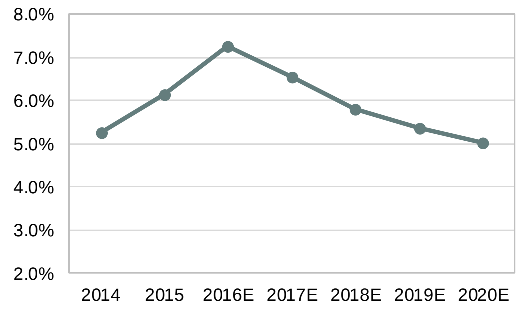


Source: SFC

Gross margins in mid-single digits as tariffs offset by fuel

Through 2020, we expect gross margins to trend lower to mid-single digits. On balance, higher tariffs will be offset by higher fuel costs. Second, purchased power is relatively more expensive than Company generated electricity which will pressure margins lower. SECO has secured purchased power through long-term contracts. While we do not expect purchase price adjustment in the near-term, future adjustments at contract renewals is a possibility.

Fig 12: Gross Margin Forecast

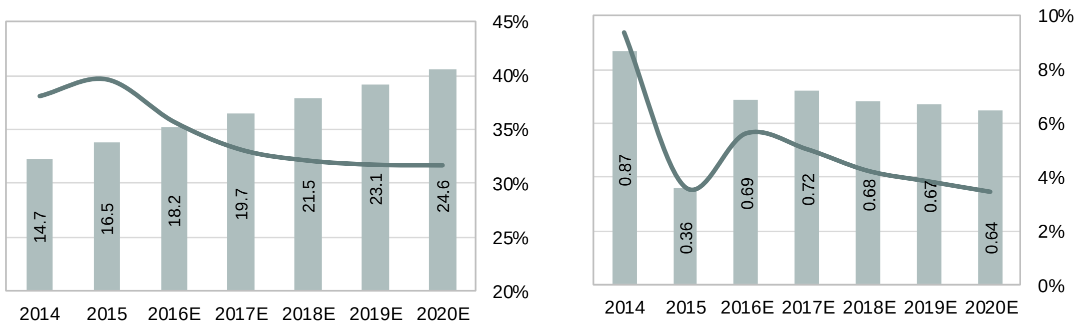


Source: SFC

Scope for Overhead Reduction

G&A expenses may be rationalized through headcount optimization and other cost reductions (for example training and travel allowances). However the impact on EBITDA margins is expected to be muted which will compress from lower gross margins. We project EBITDA growth at +8.4% CAGR between 2015 and 2020.

Fig 13: EBITDA (SAR bln), EPS (SAR) and Margins



Source: SFC

2014 earnings were boosted by SAR 2.6 bln reversal of doubtful receivables. Between 2015 and 2020, we project EPS growth at +12% CAGR reaching SAR 0.64. We believe that the Company will continue to have negative zakat base and will not incur associated expense through our forecast horizon.

Mounting Debt Burden

Saudi Electricity's main sources of financing include soft loans from the government, commercial loans and sukuks. As of 2015, SECO had some SAR 53 bln in accounts payable, mainly due to Saudi Aramco for fuel and SWCC for purchased power. In 2010, the Company's ballooning payables were transferred to long-term government payables line item. Effectively the government assumed fuel and purchased power cost from the Company. In 2015, payables were converted to government loan, which is interest free with 25-year term. We project the accounts payable to build over the next three years and subsequently transfer to government payables.

We have modeled escalating government debt from SAR 140 bln in 2015 to SAR 186 bln by 2020. In addition, we forecast commercial loans to rise from SAR 26 bln in 2015 to SAR 31 bln by 2020. Further, the Company had some SAR 35 bln in local and global sukuks in 2015. Over the next four years, we project the figure to rise to SAR 40 bln. In summary, SECO had over SAR 200 bln in debt at end-2015 versus SAR 60 bln equity (3.3x debt-to-equity) and SAR 358 bln in assets (0.6x debt-to-assets).

Table 3: Local and Global Sukuks

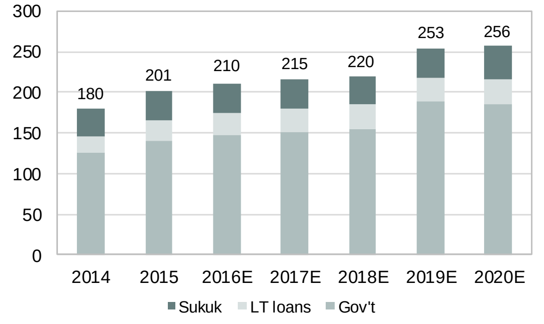
Issue	Size	Issue Date	Tenor	Maturing	Rate
Sukuk 3 - local	SAR 7.0 bln	May-2010	20-yr	2030	SAIBOR + margin
Sukuk 4 - local	SAR 4.5 bln	Jan-2014	30-yr	2054	SAIBOR + margin
Global-1					
Tranche 1	$0.5 bln	Apr-2012	5-yr	2017	2.67%
Tranche 2	$1.25 bln	Apr-2012	10-yr	2022	4.21%
Global-2					
Tranche 1	$1 bln	Apr-2013	10-yr	2023	3.47%
Tranche 2	$1 bln	Apr-2013	30-yr	2053	5.06%
Global-3					
Tranche 1	$1.5 bln	Apr-2014	10-yr	2024	4.00%
Tranche 2	$1 bln	Apr-2014	30-yr	2054	5.50%

Source: Company Reports

Quasi-sovereign credit rating may be downgraded

The Company will continue to require external financing and will be subject to credit ratings. Although SECO is near Saudi sovereign rating, we believe weaker oil price and reserve drawdown could prompt rating downgrade at the country and company level. Subsequent financings may be more expensive for SECO and may raise the prospect of equity financing via rights issue. Second point worth highlighting is the uptrend in borrowing rates with 3M SAIBOR now close to 1.7%, up from 1.0% at the beginning of November. And third, the dependence on state financial support is crucial without which the Company may struggle to meet its obligations. The following figure highlights debt evolution over the next four years.

Fig 14: Company Debt (SAR bln)



Source: Company Reports, SFC

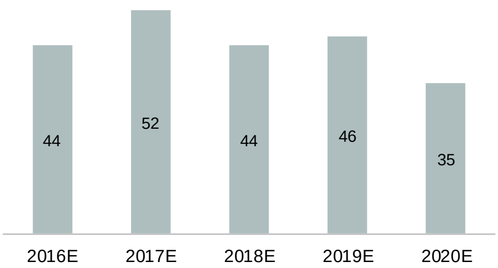
Capex to Continue

Between 2008 and 2015, we estimate SECO's total capital expenditure at SAR 226 bln on generation, transmission and distribution. Despite plans for lower government spending, we believe the Company will continue aggressive spend over the next four years, however scope reduction and opportunities for cost cuts may be explored. Capex plans are developed based on projected energy demand over a five to ten year period. Key inputs include population growth and major industrial and infrastructure projects. In our view, population growth will continue at +2.5% annual rate reaching some 34 mln by 2020. Key demographic trends affecting energy consumption will be smaller household size and greater urbanization. We believe average household size will continue to shrink from 5.6 (persons / household) as larger proportion of Saudis enter the workforce and eventually start families away from an extended household. The gap between demand and housing supply will widen and could reach 4 million housing units over the next ten years. Second, roughly two-thirds of the country's population is concentrated in four cities including: Riyadh, Jeddah, Khobar-Dammam and Makkah. We expect greater urbanization over the coming decade causing expansion of city limits. In search of affordable housing, shift towards suburban communities will gather pace. Combined, these factors will demand unabated generation and distribution investment. Absence of which could result in degradation of service quality, slowdown in housing development and potentially wider economic impact.

Urbanization and household size to sustain demand

The second critical factor considered in planned capex is industrial expansion. In this case, economic environment plays a major role, particularly government spending outlook. We believe a slowdown is on the cards which could result in some project delays and scope rationalization. The government intends to launch an economic transformation plan which could include industrial clusters and additional economic cities. Implementation of the plan will require substantial energy investment. Mindful of these considerations, we set our capex forecast through 2020 totaling some SAR 221 bln taking generation capacity to 72,000 MW from 48,600 MW in 2014.

Fig 15: Capital Expenditure Forecast (SAR bln)



Source: SFC

Valuation

We applied four methodologies to value SECO including: adjusted DCF, dividend discount model, relative valuation and acquisition multiples.

Adjusted Discounted Cashflow Model

Using a discounted cashflow model to value SECO has two problems: negative working capital and sustained elevated capex, which result in negative free cash flow. We believe DCF inputs are distorted and require adjustments to current liabilities and capex which are shouldered by the government. In the case of current liabilities, some 65% of accounts payable is due to Aramco, SWCC and municipalities for fuel, purchased power and fees which has historically been converted to long-term government loan. The loan is interest-free for 25 years and has a high probability of rollover, meaning the Company has effectively shifted the cost to the government. Second, we assume 70% of capex is funded through long-term government loan and same logic applies that the state has owned the associated spend.

Table 4: DCF Valuation (SAR mln, except per share)

Without Adjustment

DCF	2017E	2018E	2019E	2020E
EBIT	2,623	2,453	2,432	2,321
+ Depreciation & amortization	17,101	19,010	20,623	22,310
- Zakat	-	-	-	-
- WC changes	21,971	(11,641)	(13,528)	(24,047)
- Capex	(52,000)	(44,000)	(46,000)	(35,000)
FCFF	**(10,305)**	**(34,178)**	**(36,473)**	**(34,416)**

Assumptions

Risk-free rate	3.50%
LT growth rate	3.25%
Beta	0.87
Equity risk premium	6.50%
Cost of equity	9.2%
Cost of debt	3.65%
% Debt	69%
% Equity	31%
Total capital	91,896
WACC	5.37%

Mix of population & economic growth

Removed gov't share of debt & equity

Adjusted Cashflows

DCF	2017E	2018E	2019E	2020E
EBIT	2,623	2,453	2,432	2,321
+ Depreciation & amortization	17,101	19,010	20,623	22,310
- Zakat	-	-	-	-
- WC changes	4,356	(7,563)	(7,947)	(10,945)
- Capex	(15,600)	(13,200)	(13,800)	(10,500)
FCFF	**8,480**	**700**	**1,309**	**3,187**
PV of FCFF	8,048	630	1,119	2,585
Sum of discounted FCFF	12,381			
PV of terminal value	101,987			
Enterprise value	114,368			
Net debt	57,525			
Equity value	56,844			
Shares outstanding	4,166			
Value per share	**13.65**			

Removed 65% of AP due to Aramco, SWCC & munis

Removed 70% of capex attributable to gov't

Removed gov't share of debt

Source: SFC

Long-term growth rate reflects population and economic growth

Our long-term growth rate assumption of 3.25% reflects a mix of population and economic growth. We note that the Company has added customers at +5.4% CAGR between 2003 and 2014 and expect moderation over the next two decades. SECO's cost of debt is estimated at 15 bps spread to sovereign rate which we project will rise to 3.5% by end-2016 as the debt-to-GDP ratio rises to near 30% and SAIBOR trends higher. Our cost of capital of 5.37% is based on ex-government capital structure. Further, we excluded government portion from net debt to arrive at a per share value of SAR 13.65.

Dividend Discount Model

SECO shares have paid a fixed dividend of SAR 0.70 in each of the last nine years. SAR 547 mln are distributed to non-government shareholders (782 mln shares). The government and by association, Aramco, have waived their portion of dividends for a period of 10 years which will lapse in 2019. Our view is that the waiver will renew post upcoming expiry, however non-renewal is a risk. Further, the Council of Ministers resolution stipulates that if dividends exceed 10% of par value (equal to SAR 1 per share), the government will receive dividends as other shareholders. Effectively, this stipulation caps dividend growth for the foreseeable future. We note that Aramco has an ongoing dispute with SECO for its share of the dividends. We project that SAR 0.70 DPS will continue over the long-term and creates a relevant valuation scenario as zero growth perpetuity. We applied the same required return as above to arrive at a per share fair value of SAR 13.03.

Relative Valuation

On a relative value basis, SECO is expensive on most metrics with the exception of price-to-book ratio. The Company is trading at 2016E P/B of 0.9x versus international group median 1.5x. Considering that the global median ROE is 7% (see Table 2) versus 6% for SECO, we apply 1.1x P/B to arrive at a fair value of SAR 16.53.

Table 5: Comps Table

	BBG		Mkt Cap	P / E			P / B			EV / EBITDA			Dividend Yield (%)		
Company	**Symbol**	**Country**	**($ mln)**	**2015**	**2016E**	**2017E**	**2015**	**2016E**	**2017E**	**2015**	**2016E**	**2017E**	**2015**	**2016E**	**2017E**
QATAR ELECTRICITY & WATER CO	QEWS QD	QATAR	5,680	14.0x	12.6x	10.8x	3.0x	2.6x	2.3x	15.9x	15.1x	12.4x	4.0	4.2	4.7
LYONNAISE DES EAUX DE CASABL	LYD MC	MOROCCO	364	13.1x	12.1x	11.4x	2.1x	1.8x	1.7x	4.2x	4.1x	3.9x	-	5.8	6.2
TAQA MOROCCO	TQM MC	MOROCCO	1,432	12.6x	16.4x	13.9x	2.2x	2.8x	2.6x	7.7x	7.1x	6.9x	-	5.7	5.9
UMEME LTD	UMEM UG	UGANDA	280	13.8x	6.3x	5.6x	3.1x	3.5x	2.9x	8.3x	4.8x	3.0x	4.8	7.8	11.0
KENYA POWER & LIGHTING LTD	KPLL KN	KENYA	229	3.1x	2.9x	1.6x	0.4x	0.3x	0.3x	4.4x	4.1x	3.3x	4.2	6.3	4.2
KENYA ELECTRICITY GENERATING	KEGC KN	KENYA	128	1.2x	3.8x	2.6x	0.1x	0.4x	0.3x	7.7x	6.1x	5.3x	10.6	9.9	9.7
NATIONAL GRID PLC	NG LN	BRITAIN	53,362	17.2x	16.1x	15.8x	3.0x	2.8x	2.7x	10.9x	10.6x	10.4x	4.4	4.5	4.6
SSE PLC	SSE LN	BRITAIN	20,732	29.1x	12.7x	12.4x	2.4x	3.2x	3.2x	13.7x	8.1x	8.0x	6.2	6.4	6.5
DUKE ENERGY CORP	DUK US	USA	53,002	17.4x	16.5x	15.7x	1.3x	1.3x	1.3x	9.1x	9.9x	9.5x	4.2	4.4	4.6
NEXTERA ENERGY INC	NEE US	USA	52,031	20.1x	17.3x	16.2x	2.3x	2.1x	1.9x	10.4x	9.4x	8.7x	2.7	3.5	3.9
DOMINION RESOURCES INC/VA	D US	USA	41,781	20.4x	17.7x	15.7x	3.3x	2.7x	2.4x	13.4x	11.0x	9.8x	3.7	4.2	4.6
SOUTHERN CO/THE	SO US	USA	45,356	17.8x	16.9x	16.3x	2.2x	2.1x	2.0x	11.1x	10.1x	9.6x	4.3	4.5	4.6
EXELON CORP	EXC US	USA	27,587	11.6x	11.8x	11.2x	1.1x	1.0x	0.9x	6.0x	6.7x	6.3x	4.1	4.2	4.2
AMERICAN ELECTRIC POWER	AEP US	USA	30,328	16.8x	15.8x	14.7x	1.7x	1.6x	1.5x	8.0x	8.6x	7.9x	3.5	3.8	4.0
P G & E CORP	PCG US	USA	27,201	18.1x	14.9x	14.9x	1.6x	1.5x	1.4x	10.1x	7.0x	6.6x	3.3	3.5	3.7
PPL CORP	PPL US	USA	24,169	15.2x	15.5x	15.0x	2.4x	1.8x	1.8x	9.4x	10.5x	9.9x	4.2	4.3	4.4
EDF	EDF FP	FRANCE	24,727	8.5x	6.6x	7.9x	0.6x	0.6x	0.6x	2.9x	2.9x	2.9x	10.8	9.5	8.3
ENEL SPA	ENEL IM	ITALY	38,532	64.2x	12.1x	11.2x	1.1x	1.0x	1.0x	6.2x	6.6x	6.4x	3.8	4.8	5.4
IBERDROLA SA	IBE SM	SPAIN	45,051	17.1x	16.0x	15.1x	1.1x	1.1x	1.1x	9.3x	8.5x	8.2x	0.5	4.4	4.6
E.ON SE	EOAN GR	GERMANY	20,700	n.m.	12.1x	11.9x	1.0x	0.9x	1.0x	2.9x	3.9x	3.8x	3.5	5.4	5.5
CHINA YANGTZE POWER CO LTD-A	600900 CH	CHINA	30,419	16.9x	15.9x	14.8x	2.3x	1.9x	1.8x	10.1x	8.7x	8.0x	3.6	4.1	4.2
KOREA ELECTRIC POWER CORP	015760 KS	SOUTH KOREA	28,359	2.8x	5.4x	5.2x	0.5x	0.5x	0.4x	4.9x	4.4x	4.3x	1.2	2.9	3.2
TENAGA NASIONAL BHD	TNB MK	MALAYSIA	18,041	13.1x	10.7x	10.6x	1.5x	1.3x	1.2x	5.7x	6.7x	6.4x	2.6	2.6	2.8
SAUDI ELECTRICITY CO	SECO AB	KSA	15,658	38.8x	20.4x	19.5x	1.0x	0.9x	0.9x	15.6x	14.1x	13.1x	5.0	5.0	5.0
Median				**16.8x**	**13.8x**	**13.2x**	**1.7x**	**1.5x**	**1.5x**	**8.7x**	**7.6x**	**7.4x**	**3.9**	**4.4**	**4.6**

Source: Bloomberg, SFC

Net debt of SAR 57.5 bln ex-gov't share

By carving out government owed debt, we determine a 2016E net debt of SAR 57.5 bln. Further, if we apply the group median 2016E EV/EBITDA multiple of 7.6x, we arrive at a fair value per share of SAR 19.46. Our view is that the government owed portion of interest-free debt will be rolled-over when it comes due sometime over the next two decades – suggesting that it is an accounting liability more than a realizable cash drain.

Transaction Multiples

We looked at industry transaction multiples going back nearly 20 years across different geographies and found that the median EV/EBITDA multiple paid equated to 7.8x – a slight premium to market multiple (see Table 5). However for deal size greater than $1 bln, the median EV/EBITDA multiple was 8.8x while for transactions less than $1 bln, the median was 6.7x. This is potentially reflective of the relative industry positioning of the target company - smaller providers historically received a valuation discount. Further, Capital IQ data pegs the average EV/EBITDA multiple at 11.1x on total transaction value exceeding $1.6 trillion with an average deal size of $585 million. Multiple of sales paid was 3.0x. Geographically, the median EV/EBITDA multiple for Asia was 10.8x, Europe was 7.1x and South America plus Russia was 6.4x. In our view, these multiples provide guidance on value from a strategic acquirer's perspective and reflect potential market mispricing. SECO getting acquired is an improbability, however the Company does plan to eventually split into six entities which may be offered to the public. Thus, the breakup could unlock value where sum-of-the-parts may exceed consolidated entity. For example, Home Depot's (NYSE:HD) spinoff of Home Depot Supply (NYSE:HDS) in 2013 led to +62% rally in HDS and +230% in HD shares in the subsequent 18 months.

Table 6: Transaction Multiple

Announce Date	Target	Acquiror	Ent Value ($ mln)	EV / EBITDA
13-01-16	Isagen SA ESP	Investor Group	1,978	12.5x
31-12-15	Inter RAO EES	UCP	153	2.6x
22-10-15	Infinis Energy Plc	Monterey Capital II SARL	269	7.7x
20-07-15	Energy Developments Ltd	DUET Group	1,382	8.9x
23-03-15	Japan Wind Development Co Ltd	JWD Holdings	282	11.6x
13-03-15	Fortum Distribution AB	Investor Group	6,954	20.1x
02-03-15	Cia de Eletricidade do Estado da Bahia	Neoenergia SA	179	6.7x
25-02-15	UIL Holdings Corp	Iberdrola USA Inc	4,666	11.5x
23-02-15	Empresa Electrica Pilmaiquen	Statkraft Chile Inversiones	314	17.1x
19-12-14	Swissgrid AG	IST3 Investmentstiftung	293	8.7x
13-10-14	Kenon Holdings Ltd	Shareholders	3,242	10.9x
12-10-14	CGE	Gas Natural Fenosa Chile SpA	5,522	8.0x
11-09-14	Enersis SA	Enel SpA	1,165	5.5x
30-07-14	Bahia de Bizkaia Electricidad	BP Global Investments Ltd	149	2.1x
27-06-14	Electrica SA	EBRD	100	5.2x
23-06-14	Integrys Energy Group Inc	Wisconsin Energy Corp	9,120	11.3x
30-04-14	Generandes Peru SA	Enersis SA	413	5.2x
23-02-11	Electricity Generating PCL	Mitsubishi Corp,Tokyo Electric Power Co Inc	273	25.8x
12-08-09	Thuega AG	Mainova AG	4,124	71.3x
24-04-09	Transmissora Alianca de Energia Eletrica SA	Cia Energetica de Minas Gerais	1,008	8.6x
08-10-08	Akenerji Elektrik Uretim AS	CEZ AS	303	14.3x
15-05-08	T Plus PJSC	Integrated Energy Systems ZAO	1,149	21.1x
15-10-07	E.ON Russia JSC	E.ON SE	4,555	7.4x
12-09-07	Empresas Emel SA	Cia General de Electricidad SA	660	5.3x
07-09-07	Electricite de Strasbourg SA	Electricite de France SA	207	4.8x
17-08-07	Lenenergo PAO	Unified Energy System OAO	398	3.6x
06-06-07	ENEL RUSSIA PJSC	Enel SpA	1,517	3.8x
28-03-06	Light SA	Rio Minas Energia Participacoes SA	1,627	5.4x
28-03-03	Cia Electrica del Rio Maipo	CGE Distribucion SA	203	6.6x
03-12-01	Bewag Holding AG	Vattenfall AB	1,630	5.5x
23-11-99	EnBW Energie Baden-Wuerttemberg AG	Electricite de France SA	2,521	4.7x
01-07-98	Electricity Generating PCL	CLP Holdings Ltd	235	25.8x
18-06-98	South Western Electricity PLC	PPL Corp	170	5.1x
28-11-97	Gullsprang Kraft AB	Fortum Power and Heat Oy	202	11.4x
Median				**7.8x**

Source: Bloomberg, Reuters

Although 8.8x EV/EBITDA was the multiple paid for large transactions, in the case of SECO a discount is relevant considering a tightly regulated tariff environment. As such we believe 7.8x is appropriate, reflecting the median multiple, which yields a fair value of SAR 20.33.

Valuation Summary

Table 7: Valuation Summary (SAR)

Adjusted DCF	13.65
Dividend discount model	13.03
Relative valuation	19.46
Transaction multiple	20.33
Equal-weighted average	**16.62**

Source: SFC

Valuing Saudi Electric is unusual in the sense that a single methodology does not adequately capture the true worth of shares. The Company enjoys monopolistic position with strong financial support from the state, yet will never realize the required return on its massive capital expenditure due to tightly regulated tariffs. Ostensibly burdened with debt, SECO is truly liable for only 30% of the pile-up and could potential seek assistance for this portion as well. As such, we applied a combination of four equal-weighted methodologies to arrive at a per share fair value of SAR 16.62.

Recommendation and Conclusion

We round-off the ascribed fair value and initiate coverage on Saudi Electricity Company with a SAR 16.50 12-month target price and Buy recommendation. Our valuation is an equal-weighted average of four methodologies as we believe a single approach fails to adequately capture the true fair value of shares. We argue that on surface the Company appears heavily debt-laden but some 70% of the amount is due to the state on interest-free, long-term basis which will likely get rolled-over. Therefore, capital expenditure has shifted to the government and the associated liability will not be realized over the next several decades, if at all.

SECO enjoys monopolistic position in transmission and distribution with increasing shift to purchased power. Barriers to entry are high which will cushion SECO from competitive threat. We view the Company as an extension (enabler) of the government, tasked with providing electricity to all corners of the country where adequate return on capital may never get realized. Further, the Company is a key partner in ensuring economic growth through ample generation capacity and service quality. In return, the state funds the Company's capital requirements.

We believe the next five years will be pivotal for SECO and the electricity industry as higher energy costs take shape. Subsequent tariff hikes will enforce changes in consumption patterns for residential and commercial users. The government appears determined for gradual removal of subsidized electricity costs and eventual implementation of market prices. Topline growth will be combination of higher tariffs and rising customer base which will not entirely pass-through to the bottom line due to higher gas cost. We estimate on balance the effect of tariff hike will be neutralized by costs through 2020.

In a volatile market with uncertain path of oil price, we highlight SECO shares for their defensive nature - relatively immune to the commodity. The probability of deep positive or negative surprises is low. In an environment of "cash is king", steady SAR 0.70 DPS yielding 5.0% is an attractive addition to an income-oriented portfolio.

Research and Advisory Department

Rating Framework

BUY

Shares of company under coverage in this report are expected to outperform relative to the sector or the broader market.

HOLD

Shares of company under coverage in this report are expected to perform inline with the sector or the broader market

SELL

Shares of company under coverage in this report are expected to underperform relative to the sector or the broader market.

Saudi Fransi Capital

Call Center | 800 125 9999

www.sfc.sa

Commercial Registration | 1010231217

Research and Advisory

P.O. Box 23454

Riyadh 11426

Saudi Arabia

Head Office | Riyadh

research&advisory@fransicapital.com.sa

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Saudi Fransi Capital LLC
C.R. 1010231217
P.O Box 23454
Riyadh 11426
Saudi Arabia
Head Office | Riyadh