الراجحي المالية
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Key themes

The Saudi telecom sector has witnessed a number of regulatory changes in the past. Most of the changes are unlikely to have a material impact on the sector. We have revised our estimates on the companies to take into account all these changes.

What do we think?

Stock	Rating	Price Target
STC	Neutral	SAR72.0
Mobily	Neutral	SAR27.0
Zain KSA	Under Review	-

Saudi Telecoms:
What to expect?

Q4 is likely to see a 'normalized performance' after two quarters of uncertainty post the fingerprint exercise, which saw increase in costs and cancellation of subscribers. Unlike the last quarter, we expect no major one-offs this quarter. After the resolution of the arbitration between Mobily and Zain, both the companies expect no impact from the outcome on Q4 earnings. Amortization is guided to be lower as well. Post the Hajj season and cancellation of subscribers in Q3, we expect no major shift in subscriber base for the companies. Therefore we do not expect any major deviation in reported earnings from our expectations based on the above factors. STC's stock price has rallied sharply post our last report in October (+32%), and bested our earlier target price of SAR70. Post revising estimates, we are now Neutral on STC and Mobily. We remain Under Review on Zain post the management change. Our new TPs are SAR72 for STC and SAR27 for Mobily.

Q4 earnings: Post the plethora of regulatory changes in the past few quarters, we expect Q4 to reflect more of a steady state performance. These regulatory changes (except the finger print exercise) are unlikely to have a material impact on the companies in the medium term. Therefore, we believe that the Q4 earnings is likely to be the new base for the companies as we do not expect the sector to face any impending regulatory risk. With no major q-o-q growth in revenue, Mobily will likely see flattish net income in Q4 (cost savings and lower amortization offsetting sharp boost from zakat/other items in Q3). Zain will accelerate towards net profit breakeven with the help of new amortization schedule, while upside potential for STC (though not significant) would be from an increase in Q4 dividends above SAR 1/share, which is possible given the company's strong balance sheet and cash flow generation.

Unified license provided to competitors. CITC provided a 15 year license extension for a fee of 5% of net profit (for that specific 15 year period) and also offered to change all licenses to a unified license for a meagre amount of SAR5mn.

Accounting impact - EPS accretive – but no cash benefit for another decade: Zain and Mobily stand to benefit (in accounting terms) the most from the move as they get to amortize their high license expense over a longer period of time, resulting in lower amortization costs and higher earnings (non-cash). Moreover, the cost of the license (5% of net profit for that 15-year period) will also be significantly lower that what the two companies are currently charging on an annual basis. STC mentioned that there will not be a material impact on its financials. Nevertheless, this will not have an impact on our DCF company valuations for the next 10-15 years, as it is only a non-cash charge.

Valuation impact- less meaningful: The impact on valuation will only be seen if cash flows are impacted, which will come only after at least 12 years. The license cost for the extended period of 15 years will be higher for STC than what the company is currently charging on its income statement, while it likely to be much lower for Mobily and Zain. Based on STC's current profitability, 5% profit

Figure 1 Estimated quarterly saving from license extension and Q4 profit estimates (SARmn)

Company	Estimated quarterly benefit from amortization	Q4 preliminary profit estimates
STC	23	2,134
Mobily	65	(160)
Zain	108	(171)

Source: Company data, Al Rajhi Capital

would be close to ~SAR400mn (based on current profit). However, the cash impact (5% of net profit) is too far down the road to materially impact company valuations (2028 for STC, 2029 for Mobily and 2033 for Zain KSA).

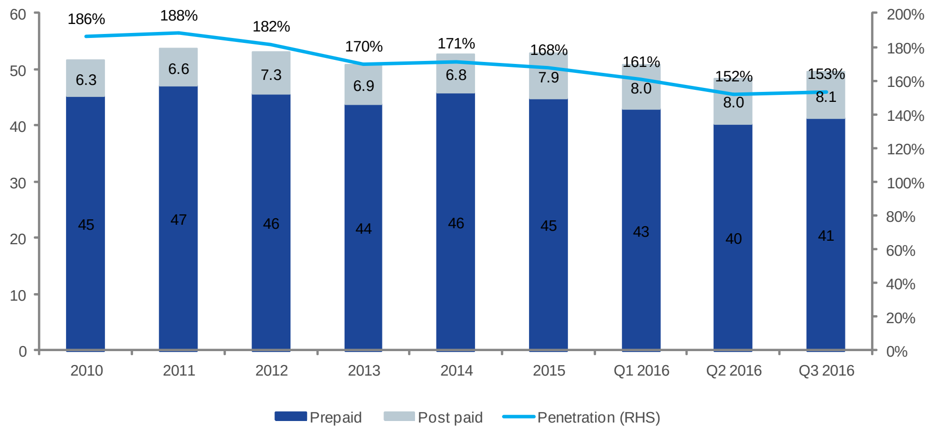
Increased competition - Not much impact on mobile: The unified license allows Zain and Mobily to start offering fixed line services that these companies were restricted from till now (Zain: Fixed line voice and broadband, Mobily: Fixed voice and ADSL). With the unified licence Mobily and Zain can look at offering triple play services, however, we don't believe this poses a major threat to STC's existing businesses. We believe STC continues to enjoy a competitive advantage due to the following reasons.

- ***Fixed voice a declining market:*** Fixed telephone line subscriber numbers have been declining in the Kingdom since 2012 due to competition from mobile services. Household tele-density has fallen from 67.6% in 2012 to only 31.1% in Q2 2016. Only business line subscriptions have increased from 1.44 in 2012 to 1.72mn in H1 2016 (though down from 1.8mn in 2015-end). Thus, there is not much scope to compete in a declining market. Rather than market share loss of the legacy business, we believe the new players will be sharing in new opportunities.

- ***Fixed broadband - FTTx forms very small portion of revenues:*** Fixed broadband is the only market which offers growth within the fixed line business. With penetration currently at 41%, there is scope for strong growth in the near future. ADSL, which forms the majority of the fixed broadband is old technology and does not make sense investing in. Leased line and FTTx, which is the future of fixed line broadband, offering next generation speeds, forms a very small portion of revenues currently (2-3% of revenues). However, FTTx technology involves large upfront capex and offers relatively low margins. Mobily already offers FTTx services.

Subscribers declined further on new regulatory requirements: Total mobile subscribers have been on a declining trend in the Kingdom. Mobile penetration has declined from a high of 188% in 2011 to 153% by Q3 2016. As seen from the chart below, prepaid subscribers have fallen sharply from 2014 onwards. The fall in prepaid subscribers began with the implementation of the Nitaqat system, which led to a large number of immigrant workers leaving the Kingdom. The new regulation, making it mandatory for all telecommunication subscribers to register their fingerprints has recently started impacting subscriber numbers. The cancellation of prepaid sim cards for subscribers unable to register their fingerprints started from early June, when CITC's grace period for taking fingerprints expired for prepaid customers. The grace period for postpaid subscribers ended in July-end. With already very high penetration, we believe subscriber numbers are likely to remain soft over the next few quarters.

Figure 2 Prepaid subscriptions declining



Source: CITC, Al Rajhi Capital

Other regulatory changes: The telecom sector has witnessed significant regulatory changes in the recent past. The cut in GCC roaming rates and interconnection rates only had a marginal impact on companies. Please see our report for more details. The fingerprint requirement also negatively impacted the sector's profitability. Recently the CITC has also ordered a halt on unlimited internet plans on prepaid lines (in the first phase) to reduce the pressure on networks.

Lower allowances/bonus to have marginal impact on the sector: The cut in salaries and allowances for Saudi public sector allowances will reduce disposable income in the Kingdom. However, being a defensive sector, the impact on the telecom sector would be much lesser than the impact on other consumer expenditure. Based on our understanding, most of the high ARPU customers have fixed monthly packages/bundles, and these are unlikely to change. More than the impact of lower disposable income, the cap applied on mobile telecom allowance could impact the telecom sector, in our view. According to the Saudi Gazette, the royal decree has capped telephone (mobile and landline) expenses for minister and similar ranked officials to SAR1,000 per month, above which the officials will need to pay the bills themselves. Thus, we expect some rationalization in usage. Though the overall impact of the decision will not be significant, STC will be affected the most from this move as most government and Saudi national's connections are likely to be on STC's network. Overall, we revise ARPUs lower for STC.

Tower deal: STC and Mobily have signed a deal to jointly explore options for tower network. All three network operators in the Kingdom are exploring options to either offload their tower assets into a separate firm and sell to an investor or save costs by merging their tower network. A decision in this regard will support the profitability of the overall sector, and reduce capex requirements, which would have the highest positive impact on the smaller players – Zain and Mobily. Please read our report for financial impact of tower sale. Zain group recently announced that the company expects to sell its Saudi tower business for US$500mn by H1 2017. As per the news source, the company was down to two bidders. The company has more than 7,700 towers and the proceeds of the sale are likely to be used to reduce its debt and fund its capex plans.

Arbitration between Zain and Mobily: The arbitration panel hearing the Mobily and Zain KSA dispute gave its decision, directing Zain to pay SAR219.5mn to Mobily, compared to Mobily's claim of SAR2.2bn. Based on our understanding, Mobily has already provisioned SAR2bn and is therefore unlikely to see any impact on its income statement in Q4. Zain has also reported that it has fully provisioned for the payment. Net-net the decision will not have a negative impact on either of the companies.

Valuation and risks: We have revised our estimates on the telecom companies to take into account the recent changes. Based on our new estimates, we arrive at a target price of SAR72 on STC and SAR27 on Mobily and are Neutral on both the stocks, while we keep Zain Under Review. We arrive at our targets based on an equal mix of relative and valuation methodologies. The near term direction of the stocks is likely to be based on Q4 results. As per our understanding there is unlikely to be any major deviation from our estimates in Q4.

STC financial estimates:

Income Statement (SARmn)	12/13A	12/14A	12/15A	12/16E	12/17E
Revenue	**45,605**	**45,826**	**50,651**	**53,328**	**54,098**
Access Charges	(18,191)	(17,670)	(20,306)	(24,641)	(24,652)
Employee Costs	-	-	-	-	-
Government Charges	-	-	-	-	-
S.G. & A. Costs	(8,943)	(9,095)	(11,051)	(10,542)	(10,904)
Repairs & Maintenance Costs	(1,104)	(399)	-	-	-
Operating EBIT	**10,989**	**11,632**	**11,859**	**10,189**	**11,052**
Cash Operating Costs	(28,238)	(27,164)	(31,357)	(35,183)	(35,556)
EBITDA	**17,367**	**18,661**	**19,294**	**18,144**	**18,542**
Depreciation and Amortisation	(6,378)	(7,030)	(7,434)	(7,955)	(7,490)
Operating Profit	**10,989**	**11,632**	**11,859**	**10,189**	**11,052**
Net financing income/(costs)	(1,083)	(496)	(1,023)	(463)	(64)
Forex and Related Gains					
Provisions					
Other Income	243	390	446	767	542
Other Expenses	897	638	(797)	(683)	(595)
Net Profit Before Taxes	**10,448**	**12,163**	**10,486**	**9,811**	**10,935**
Taxes	(230)	(775)	(697)	(742)	(820)
Minority Interests	(321)	(429)	(531)	(244)	(395)
Net profit	**9,897**	**10,959**	**9,258**	**8,825**	**9,720**
Dividends	(4,500)	(7,000)	(8,000)	(8,400)	(9,000)
Transfer to Capital Reserve					

	12/13A	12/14A	12/15A	12/16E	12/17E
Adjusted Shares Out (mn)	2,000	2,000	2,000	2,000	2,000
CFPS (SAR)	8.30	9.21	8.61	8.51	8.80
EPS (SAR)	4.95	5.48	4.63	4.41	4.86
DPS (SAR)	2.25	3.50	4.00	4.20	4.50

Growth	12/13A	12/14A	12/15A	12/16E	12/17E
Revenue Growth	1.9%	0.5%	10.5%	5.3%	1.4%
EBITDA Growth	8.0%	7.5%	3.4%	-6.0%	2.2%
Operating Profit Growth	12.8%	5.9%	2.0%	-14.1%	8.5%
Net Profit Growth	38.2%	10.7%	-15.5%	-4.7%	10.1%
EPS Growth	38.2%	10.7%	-15.5%	-4.7%	10.1%

Margins	12/13A	12/14A	12/15A	12/16E	12/17E
EBITDA margin	38.1%	40.7%	38.1%	34.0%	34.3%
Operating Margin	24.1%	25.4%	23.4%	19.1%	20.4%
Pretax profit margin	22.9%	26.5%	20.7%	18.4%	20.2%
Net profit margin	21.7%	23.9%	18.3%	16.5%	18.0%

Other Ratios	12/13A	12/14A	12/15A	12/16E	12/17E
ROCE	16.2%	15.5%	16.0%	13.7%	14.5%
ROIC	32.2%	31.4%	30.9%	27.8%	30.4%
ROE	18.9%	18.7%	15.2%	14.6%	16.0%
Effective Tax Rate	2.2%	6.4%	6.6%	7.6%	7.5%
Capex/Sales	16.3%	13.3%	18.3%	16.0%	18.0%
Dividend Payout Ratio	45.5%	63.9%	86.4%	95.2%	92.6%

Mobily financial estimates

Income Statement (SARmn)	12/13A	12/14A	12/15A	12/16E	12/17E
Revenue	**19,180**	**14,004**	**14,424**	**12,686**	**12,057**
Cost of Goods Sold	(6,987)	(7,225)	(6,466)	(5,141)	(4,765)
Gross Profit	**12,193**	**6,779**	**7,958**	**7,545**	**7,292**
Government Charges					
S.G. & A. Costs	(3,742)	(4,532)	(5,017)	(3,651)	(3,489)
Operating EBIT	**5,949**	**(1,287)**	**(684)**	**120**	**95**
Cash Operating Costs	(10,729)	(11,758)	(11,483)	(8,793)	(8,255)
EBITDA	**8,450**	**2,246**	**2,941**	**3,894**	**3,802**
Depreciation and Amortisation	(2,502)	(3,533)	(3,625)	(3,774)	(3,708)
Operating Profit	**5,949**	**(1,287)**	**(684)**	**120**	**95**
Net financing income/(costs)	(191)	(269)	(361)	(523)	(484)
Forex and Related Gains					
Provisions	-	(63)	-	-	-
Other Income	257	83	121	70	96
Other Expenses					
Net Profit Before Taxes	**6,015**	**(1,535)**	**(924)**	**(333)**	**(293)**
Taxes	(78)	(41)	(169)	41	(51)
Minority Interests					
Net profit	**5,937**	**(1,576)**	**(1,093)**	**(292)**	**(344)**
Dividends	(3,696)	(1,925)	-	-	-
Transfer to Capital Reserve					

	12/13A	12/14A	12/15A	12/16E	12/17E
Adjusted Shares Out (mn)	770.0	770.0	770.0	770.0	770.0
CFPS (SAR)		2.54	3.29	4.52	4.37
EPS (SAR)		(2.05)	(1.42)	(0.38)	(0.45)
DPS (SAR)	4.80	2.50	-	-	-

Growth	12/13A	12/14A	12/15A	12/16E	12/17E
Revenue Growth	-18.7%	-27.0%	3.0%	-12.0%	-5.0%
Gross Profit Growth	1.8%	-44.4%	17.4%	-5.2%	-3.4%
EBITDA Growth	-1.0%	-73.4%	30.9%	32.4%	-2.3%
Operating Profit Growth	-3.0%	-121.6%	-46.8%		-21.0%
Net Profit Growth	-1.3%	-126.5%	-30.6%	-73.2%	17.6%
EPS Growth			-30.6%	-73.2%	17.6%

Margins	12/13A	12/14A	12/15A	12/16E	12/17E
Gross profit margin	63.6%	48.4%	55.2%	59.5%	60.5%
EBITDA margin	44.1%	16.0%	20.4%	30.7%	31.5%
Operating Margin	31.0%	-9.2%	-4.7%	0.9%	0.8%
Pretax profit margin	31.4%	-11.0%	-6.4%	-2.6%	-2.4%
Net profit margin	31.0%	-11.3%	-7.6%	-2.3%	-2.9%

Other Ratios	12/13A	12/14A	12/15A	12/16E	12/17E
ROCE	18.8%	-7.7%	-2.9%	0.5%	0.4%
ROIC	21.1%	-4.0%	-2.6%	0.4%	0.4%
ROE	28.3%	-8.3%	-6.8%	-1.9%	-2.3%
Effective Tax Rate	1.3%	-2.6%	-18.3%	12.3%	-17.5%
Capex/Sales	29.9%	33.7%	23.6%	22.7%	18.0%
Dividend Payout Ratio	62.3%	-122.2%	0.0%	0.0%	0.0%

Zain KSA financial estimates

Income Statement (SARmn)	12/13A	12/14A	12/15A	12/16E	12/17E
Revenue	**6,523**	**6,170**	**6,741**	**6,819**	**7,239**
Cost of Goods Sold	(3,388)	(2,948)	(2,790)	(2,455)	(2,534)
Gross Profit	**3,135**	**3,223**	**3,951**	**4,364**	**4,705**
Government Charges					
S.G. & A. Costs	(2,244)	(2,123)	(2,322)	(2,561)	(2,643)
Operating EBIT	**(949)**	**(534)**	**(141)**	**(39)**	**451**
Cash Operating Costs	(5,632)	(5,071)	(5,113)	(5,016)	(5,177)
EBITDA	**890**	**1,100**	**1,629**	**1,803**	**2,062**
Depreciation and Amortisation	(1,840)	(1,633)	(1,770)	(1,842)	(1,611)
Operating Profit	**(949)**	**(534)**	**(141)**	**(39)**	**451**
Net financing income/(costs)	(702)	(736)	(831)	(977)	(919)
Forex and Related Gains	-	-	-	-	-
Provisions	-	-	-	-	-
Other Income	-	-	-	-	-
Other Expenses	-	-	-	-	-
Net Profit Before Taxes	**(1,651)**	**(1,270)**	**(972)**	**(1,016)**	**(467)**
Taxes	-	-	-	-	-
Minority Interests	-	-	-	-	-
Net profit	**(1,651)**	**(1,270)**	**(972)**	**(1,016)**	**(467)**
Dividends	-	-	-	-	-
Transfer to Capital Reserve	-	-	-	-	-

	12/13A	12/14A	12/15A	12/16E	12/17E
Adjusted Shares Out (mn)	1,080	1,080	584	584	584
CFPS (SAR)	0.17	0.34	0.96	1.41	1.96
EPS (SAR)	(1.53)	(1.18)	(1.17)	(1.74)	(0.80)
DPS (SAR)	-	-	-	-	-

Growth	12/13A	12/14A	12/15A	12/16E	12/17E
Revenue Growth		-5.4%	9.3%	1.1%	6.2%
Gross Profit Growth		2.8%	22.6%	10.4%	7.8%
EBITDA Growth		23.5%	48.1%	10.7%	14.4%
Operating Profit Growth		-43.8%	-73.5%	-72.4%	
Net Profit Growth		-23.1%	-23.4%	4.5%	-54.0%
EPS Growth		-23.1%	-0.6%	49.0%	-54.0%

Margins	12/13A	12/14A	12/15A	12/16E	12/17E
Gross profit margin	48.1%	52.2%	58.6%	64.0%	65.0%
EBITDA margin	13.7%	17.8%	24.2%	26.4%	28.5%
Operating Margin	-14.6%	-8.6%	-2.1%	-0.6%	6.2%
Pretax profit margin	-25.3%	-20.6%	-14.4%	-14.9%	-6.5%
Net profit margin	-25.3%	-20.6%	-14.4%	-14.9%	-6.5%

Other Ratios	12/13A	12/14A	12/15A	12/16E	12/17E
ROCE	-4.2%	-2.4%	-0.7%	-0.2%	2.6%
ROIC		-3.1%	-0.9%	-0.3%	3.5%
ROE	-48.9%	-20.8%	-19.4%	-25.1%	-14.2%
Effective Tax Rate	0.0%	0.0%	0.0%	0.0%	0.0%
Capex/Sales	11.3%	6.8%	18.4%	19.5%	10.5%
Dividend Payout Ratio	0.0%	0.0%	0.0%	0.0%	0.0%

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"Overweight": Our target price is more than 10% above the current share price, and we expect the share price to reach the target on a 12 month time horizon.

"Neutral": We expect the share price to settle at a level between 10% below the current share price and 10% above the current share price on a 12 month time horizon.

"Underweight": Our target price is more than 10% below the current share price, and we expect the share price to reach the target on a 12 month time horizon.

"Target price": We estimate target value per share for every stock we cover. This is normally based on widely accepted methods appropriate to the stock or sector under consideration, e.g. DCF (discounted cash flow) or SoTP (sum of the parts) analysis.

Please note that the achievement of any price target may be impeded by general market and economic trends and other external factors, or if a company's profits or operating performance exceed or fall short of our expectations.

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