Arabian Internet and Communications Services Co
Consumer – Software & Services
SOLUTION AB: Saudi Arabia
30 September 2021

الراجحي المالية
Al Rajhi Capital

US$4.832bn	20.00%	NA
Market cap	Free float	Avg. daily volume

Target price	200.0	+32.5% over offer price
Offer price	151.0	

Existing rating

Underweight	Neutral	**Overweight**

Earnings

(SARmn)	FY2020	FY2021E	FY2022E
Revenue	6,891	7,976	9,564
Revenue growth	31.1%	15.7%	19.9%
Gross profit	1,422	1,570	1,930
Gross margin	20.6%	19.7%	20.2%
EBITDA	912	1,056	1,392
EBITDA margin	13.2%	13.2%	14.6%
Net profit	702	792	1,061
Net margin	10.2%	9.9%	11.1%
EPS	5.8	6.6	8.8
DPS	0.0	1.6	2.2
Payout ratio	0.0%	25.0%	25.0%
RoE	36.5%	31.5%	32.0%

Source: Company data, Al Rajhi Capital

Valuation

Multiples	2020A	2021E	2022E
P/E	25.8x	22.9x	17.1x
EV/EBITDA	18.8x	15.8x	11.6x
P/B	9.4x	7.2x	5.5x
Target P/E	34.2x	30.3x	22.6x

Source: Company data, Al Rajhi Capital

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Arabian Internet and Communications Services Co (STCS)

Opportunities Abound; Initiating coverage with a TP of SAR200/sh.

Investment thesis: Strong branding, ability to attract talent (1,494 employees as of Dec 2020), a wide network of partnerships with more than 150 foreign and domestic players, diversity of revenue stream across almost all verticals and offerings (products, services, contracting), scale advantages (among top 20 listed companies by revenue in KSA, despite a fragmented IT landscape) are STCS's key strengths. Given its direct ownership by STC (79% post offering) and indirectly Govt., both being one of the largest capital spenders in the Kingdom, as well as key customers, STCS is bound to increase its market share in the Kingdom significantly.

Burgeoning Industry dynamics: ICT industry is taking off in KSA, with strong digital adoption across companies, structurally helped by the pandemic, creation of newer smart cities/infrastructure, need for cyber security, technological advances, 5G, housing demand etc. The Kingdom aspires to become the Middle East hub for technology and innovation. We expect KSA to follow global IT trends, led by data centre/cloud business, where growth rates are 25%. Such segments already contribute to 35% of revenue of traditional companies such as Microsoft, and growth is expected to continue at c.20% for the next three years (Bloomberg). Cloud business operating margins of Amazon and Microsoft are on an average 30-35%, higher than the current margins of 11-12% of STCS. Overall, we believe the sector has strong visibility for growth, with an average growth of c.40% during 2020 to 2023, with market share gains for STCS.

Key forecasts/financials: Total revenue of STCS increased 33% (on an average) during FY17-20 and we forecast an average revenue growth of 17% during FY20-23, while the net profit is expected to increase by 23%, helping the company to steadily improve its already high RoE (+37% in 2022e). The company's cash generation is solid with FCF yield at 3% in 2020, which is expected to increase to 5% in 2022. Additionally, the company's debt levels are low with a D/E of 2.5% in 2020.

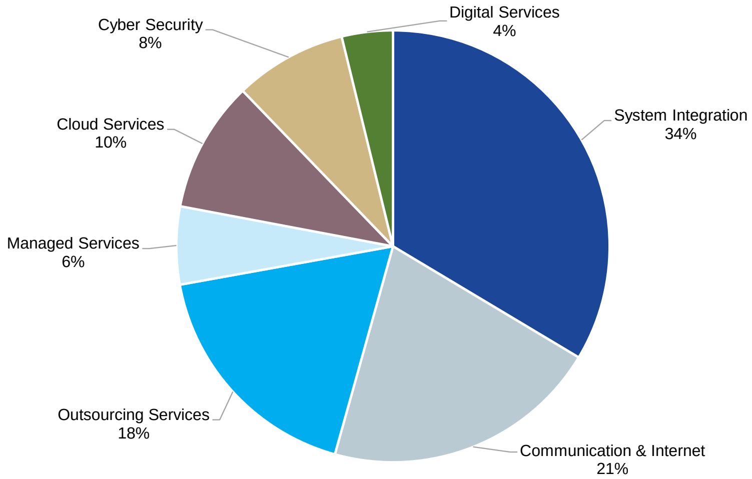
Valuation: We value STCS using an equal weight of DCF and relative valuation (P/E) methodologies. Our FCF based target price based on 2.5% terminal growth and 8.2% cost of capital comes to SAR203/sh, and P/E-based relative valuation based on 30x multiple gives us a target price of SAR198/sh. Thus, the target price stands at SAR200/sh. which implies an upside of 32.5% from the offer price of SAR151/sh.". The company is trading at 23x 2021e EPS. Thereby we initiate coverage on STCS with an ***"Overweight"*** rating. There is a strong case for higher multiples as valuation of peer companies show that - even with half STC's RoE metrics, peers trade at 26x, which is higher than STCS's average implied 2021E PE of 23x (Figure 35).

Challenges/Risks: Key downside risks are increase in cost of hiring due to employee churn, working capital delays due to receivables from key clients, unfavourable regulatory changes such as outsourcing of projects, project execution risks, increase in competition, especially via suppliers/foreign players, high dependence on Govt and hence oil prices.

Company Overview

Arabian Internet and Communications Services Co/Solutions by STC (STCS) is a leading IT service provider in the country and was incorporated as a Saudi limited liability company in Riyadh in 2003. The company commenced its operations as an internet service provider and later transformed into an ICT service provider and now provides a broad range of other IT-related services. Currently, STCS has a market share of 13% in the Kingdom's fragmented IT services market. The company caters to the requirements of Government, quasi-Government and private companies, across industries, including oil and gas, healthcare, banking, and government development sectors. In 2020, 50% of STCS revenue was from government and semi-government entities, 35% was from Saudi Telecom Company (STC) and 14% was from Private sector institutional customers. STCS operates in three main segments, core ICT services, which accounts for 54% of revenue, IT managed and operational services, which account for 24% of revenue and digital services, which account for 22% of revenue. Within core ICT services, the company operates under two divisions, system integration, which accounts for 34% of total revenue, and communication and internet, which accounts for 21% of revenue. In IT managed and operational services, the company operates in two divisions, outsourcing services (18%) and managed services (6%), while in digital services, it operates in three divisions, cloud services (10%), cyber security (8%) and digital services (4%).

Figure 1 Revenue breakup



Source: Company data and Al Rajhi Capital

Figure 2 Direct Ownership of the Company Pre- and Post-Offering

Shareholder	Pre-Offering			Post-Offering		
	No. of shares	Nominal Value (SAR)	Percentage	No. of shares	Nominal Value (SAR)	Percentage
stc	116,400,000	1,164,000,000	97%	94,800,000	948,000,000	79%
Telecom Commercial Investment Company Limited	3,600,000	36,000,000	3%	N/A	N/A	N/A
Public	N/A	N/A	N/A	24,000,000	240,000,000	20%
Treasury Shares	N/A	N/A	N/A	1,200,000	12,000,000	1%
Total	**120,000,000**	**1,200,000,000**	**100%**	**120,000,000**	**1,200,000,000**	**100%**

Source: IPO prospectus, Al Rajhi Capital

Investment Thesis

Figure 3 Market segment

Segments	2018 Market size and 2018-25 CAGR	Sub-segments	Drivers	Customers	Key players		
					Local SI	International Players	Communications
System Integration	SAR9,715mn (+4.4% CAGR)	IT Training, IT Consulting, Network, Application and Infrastructure	Mega-projects, Mega smart-city clusters (e.g. NEOM) and Digital Transformation	Government, Large enterprises	The Company, AEC, Ejada, SBM, MDS	TCS, Wipro,	
IoT and Digital	SAR2,270mn (+19.3% CAGR)	AI, Big Data and Analytics, IoT	Industrial robotics, smart energy management, Industrial, e-learning, eHealth	Industrails/manufacuring, Healthcare, Education, Utility	The Company, AEC, ICCES, DDIT	SecuTronic Infofont	Mobily, Zain
Application Services	SAR1,699mn (+8.9% CAGR)	Custom Application Development, Software Support & Deployment	Digitalization	Private & public enterprises	The Company, SBM, MIS, ACS, Jeraisy	Wipro, Emircom	
Data Centre and Cloud	SAR1,891mn (+20.4% CAGR)	Hosted Infrastructure, Data Centre Managed Services, Colocation, Private Cloud, Public Cloud	Cloud computing, Regulations	Banks, Government	The Company, DETESAD, AEC, MDS	Microsoft, SAP, Oracle	Mobily
Equipment Services	SAR1,756mn (+6.4% CAGR)	Hardware Deploy & Support, Managed Endpoint Services	Digitalization	SMEs	The Company, SM, ACS, MIS, MDS, AEC	DXC, Wipro	
Cybersecurity	SAR1,342mn (+7.7% CAGR)	Project-based cybersecurity, Managed Security, Managed Disaster Recovery.	Increased cyber threats, shift to digitalization	Private & public enterprises, Banks	The Company, AEC, SBM, Innovative solutions	Wipro, TCS, IBM	Saharanet, ITC, Mobily
Managed Networks	SAR1,122mn (+7.3% CAGR)	Office Network/Endpoint Service, Other Managed Services, Managed Wifi, Managed Area Network, Managed Router.	IT outsourcing, remote working	Government, Large enterprises	The Company, ACS, Jeraisy, Ebtikar		Mobily, ITC, BT, Al Saudia

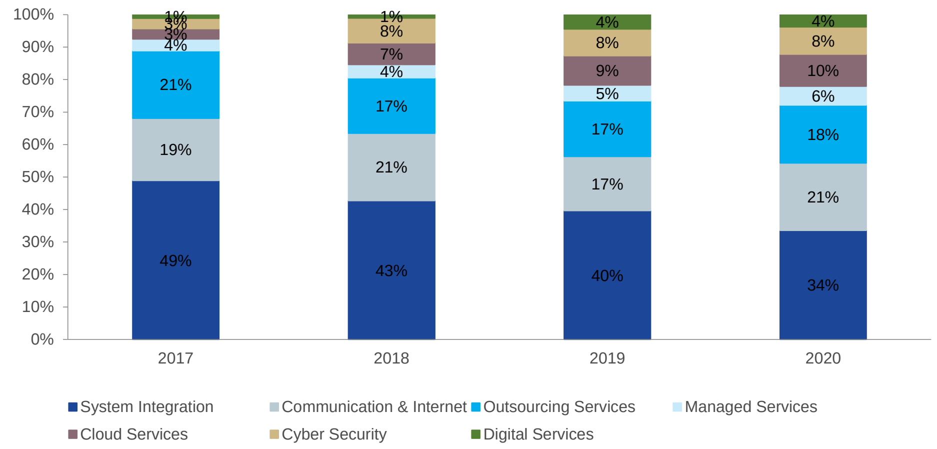
Source: Company data, Al Rajhi Capital

Strong revenue growth through strengthening market share: The revenue of STCS has grown at a CAGR of 33% between 2017 and 2020 and has been aided by strong growth across segments. The revenue of the largest segment of the company, core ICT services has grown at an average rate of 21%, during 2018 and 2020, outpacing the average growth of c.2% of the KSA B2B ICT services market. Within the core ICT services market, system integration revenue has grown at an average rate of 16% from 2018 to 2020, while the system integration market in the country fell at an average rate of c.1% for the same period. Going forward, we expect this trend to continue, as we expect revenue of the core ICT services segment of STCS to grow at an average rate of 15% for the next three years, while the KSA B2B ICT services market and the systems integration market is expected to grow at c.8%.

Overall, **we expect the revenue of STCS to grow at an average rate of over 15% for the next three years, a rate that will be higher than the average industry growth rate**. Over the period, the company has consistently managed to grow its revenue above the industry average, aided by its improved product portfolio and strong parentage. Going forward, we expect this trend to continue, as we **expect STCS to continue to strengthen its market position in the fragmented KSA IT services market**. Post-Covid, we expect the industry trend to shift in favour of the organized players, and STCS, with a strong track record, market presence, and brand name, through its parent STC, is likely to be a major gainer from this trend.

Diversification of its business profile: STCS has managed to diversify its revenue base in the past four years, by adding new products and services to its portfolio. Core ICT services, which in 2017 accounted for over 65% of revenue, accounted for c.55% of revenue in 2020, with the proportion of system integration segment falling from c.50% in 2017 to c.35% in 2020. The **proportion of digital services on the other hand has improved from c.5% in 2017 to c.20% in 2020**. Over the period, STCS has managed to improve its product and services offering through cross-selling and growing its offering along the various verticals of its customer's requirements. **We expect STCS, through its strong market position in ICT services verticals, to focus on growth areas, including data center, cloud, and managed services and digital transformation consultation**. The company is also looking to improve its presence with small and medium enterprises (SMEs), through new product offerings by focusing on standardized product and service offerings and developing off-the-shelf products. Given this, we expect the company to continue to diversify its revenue base; while we expect the core ICT service offerings of STCS to provide stability to its revenue, we expect new-age services in the digital segment to provide growth opportunities. Given this, we expect the revenue base of the company to further diversify in the medium term.

Figure 4 Revenue composition



Source: Company data and Al Rajhi Capital

Strong partnership relationship and ability to capitalize on relationship with STC: STC currently holds a 97% stake in STCS and post the IPO, will continue to hold a significant 79% stake in the company. In 2020, c.35% of STC's revenue was from sales to STC; while this has fallen from the earlier levels of c.45% in 2017, it continues to contribute to a significant proportion of the revenue. Apart from direct revenue, STCS has also been able to **capitalize on the large customer base of its parent**. Added to this, STCS also **leverages STC's customer reach, infrastructure, knowledge of institutions, and exhaustive sales force & customer base**. The company's relationship with STC has also helped it garner big orders, relative to its current size and also offer opportunities towards, joint product and services development and cross-training of employees.

STCS also has access to a **strong partnership base with more than 150 global and local partners.** It also generates the highest revenue for major technology providers such as DellEMC, PaloAlto, VMWare, Fortinet, IBM, Cisco, Microsoft, and Huawei. Through these partnerships, STCS can cater to the requirements of SMEs, by acting as resellers of off-the-counter products.

SMEs offer strong growth opportunities: The ICT services offered to various clients decrease with the size of a company. In general, large companies and entities require services that have to be tailored for their requirement. Similarly, the process of acquiring contracts from these companies too is procedural and stringent. On the other hand, the requirements of SMEs and small office, home office (SOHO) requirements could be standardized, based on the value proposition. As per The General Organization for Social Insurance, there are c.103k SMEs and c.445k SOHOs in Q3 2019 and offers a strong growth opportunity for growth. The position of STCS is further strengthened by its partnership with leading players in the industry and access to off-the-shelf products.

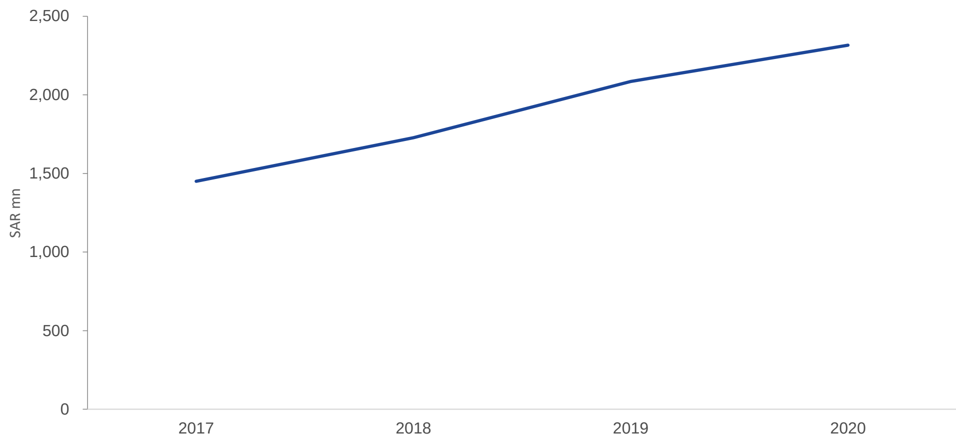
Segmental analysis

Core ICT services segment to offer stable growth

The ICT services segment is the largest segment of STCS, accounting for close to c.55% of 2020 revenue. This segment has two subdivisions, system integration and communication, and the internet.

System integration segment to provide stability: This vertical is the largest vertical for the company, accounting for 34% of the revenue. Though this vertical's share of revenue has fallen from nearly 50% in 2017, due to STCS' growth in other segments, at the back of steps taken by it to diversify its revenue base, it continues to be an important vertical for the company. The company also has a strong market position in this segment, with a market share of 13.7% and despite this, **has grown at an average rate of over 15% between 2017 and 2020.**

Figure 5 System Integration revenue trend



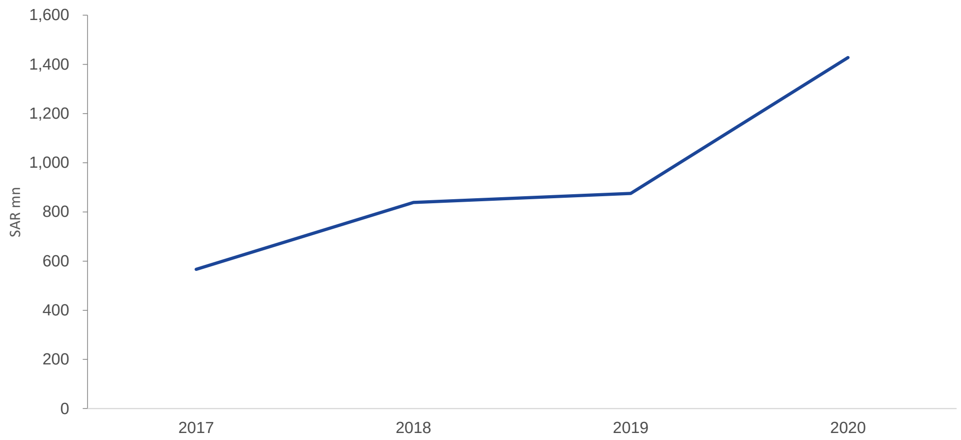
Source: Company data and Al Rajhi Capital

In this segment, **STCS develops the networks of customers and provides network integration, infrastructure integration, and advisory services, to aid in the improvement of the performance of their client's existing networks**. The product portfolio of the System Integration business line includes project system integration, licenses, and consulting services and over the period, the company has enhanced its offerings in this segment. This segment is benefited from the strong relationship with STC, through joint development of applications. STCS also has strong partnerships with global vendors, including Microsoft, VMWare, Oracle Systems, Red Hat, HPE, DellEMC, Cisco, Huawei, IBM, Ericsson AB, and Juniper Networks. Key customers of these verticals, apart from various ministries, include Saudi National Bank, Saudi Network Information Centre, and Saudi Basic Industries Corporation. The company has also worked with Saudi Aramco to build a supercomputer data center, which is among the top ten data centers in the world.

Going forward, **we expect revenue from this segment to grow at c.8-10%,** slightly **higher than the average industry growth.** Though this segment growth is relatively low, as compared to some of the company's other verticals, given the size of the vertical, we expect this segment to provide stability and being one of the established verticals of the company, it also provides opportunities in cross-selling.

Communication and internet: This segment is the second vertical in the ICT services provided by the company and accounts for 21% of 2020 revenue and its proportion has increased from 19% in 2017. Revenue from this segment has grown at an average rate of c.35%, between 2017 and 2020. In this segment, the company links the client's systems and devices to the information network and sells dedicated internet access (DIA), VSAT services, and enterprise mobility management.

Figure 6 Communication and Internet revenue trend



Source: Company data and Al Rajhi Capital

The predominant portion of revenue from this segment is generated through B2B channel and the company is currently focusing on diversifying its revenue base to private and SMEs. Some of the key clients in this segment include Saudi Arabia's 2020 G20 Presidency, High Commission for the Development of Arriyadh, Ministry of Health, Al Jaber Group, Ministerial Agency of Civil Affairs, Princess Nora Bint Abdulrahman University, Saudi Ground Group, and Alyusar Company.

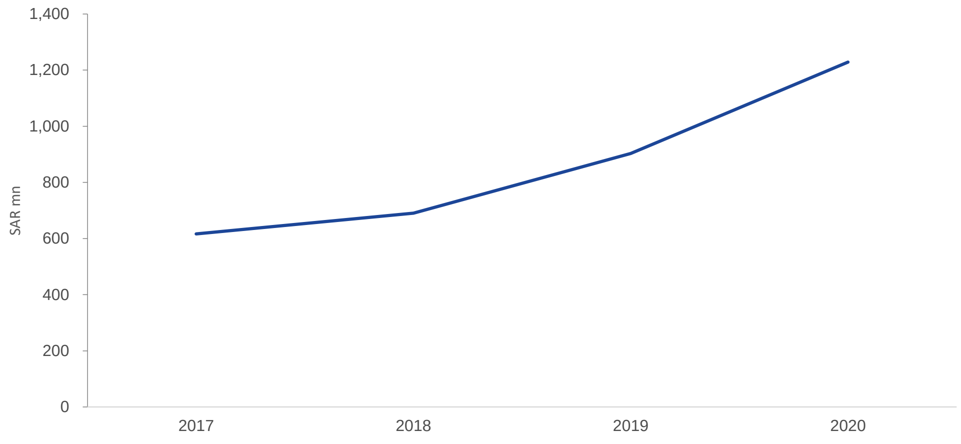
This segment is expected to aid STCS by providing recurring revenue through existing long-term contracts, providing visibility for future growth. The segment is also able to utilize its extensive resources, like STC's fiber optics network, which has the highest national coverage in the country. Given this, **we expect the revenue of this segment to grow at an average rate of more than 25% in the next three years**.

IT managed and operational services offer growth opportunities

This is the second largest segment of STCS, accounting for close to 25% of 2020 revenue. This segment has two subdivisions, outsourcing services, and managed services.

Outsourcing services: This segment accounts for 18% of 2020 revenue and its proportion has increased from 17% in 2018. **Revenue from this segment has grown at an average rate of c.25%, between 2017 and 2020**. In this segment, **the company offers outsourcing services, including technical support, outsourcing operational resources, consultation, and administrative support services.** It also offers skilled resources for technical and administrative functions to its clients. STCS is a preferred outsourcing provider to STC and has recently won contracts from government agencies. Key clients of the companies in this segment, include, STC, CISCO, Huawei, and various government agencies and ministries.

Figure 7 Outsourcing Service revenue trend

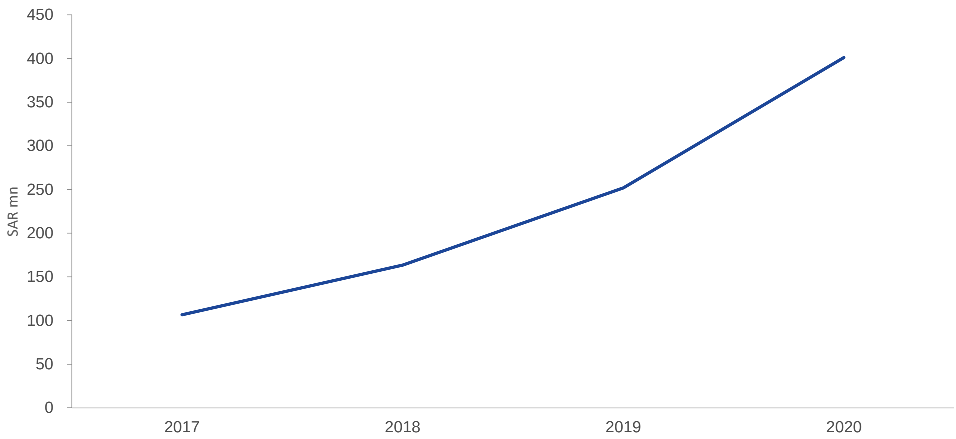


Source: Company data and Al Rajhi Capital

Though 2020 revenue from this division was driven mainly by STC and government agencies, the company is looking to **leverage its existing capabilities to tap emerging opportunities from SMEs**. The company is also looking to leverage its skillset in other divisions, including digital services and cyber security, and also utilize its existing customer base to drive revenue from this segment. **The segment is likely to benefit from the company's exhaustive pool of human resource services, a strong pool of local talent, strong capabilities in cyber security, a strong presence in automation, and a strong relationship with existing government clients are expected to drive growth**. Going forward, we expect revenue from this segment to grow at an average rate of c.15% for the next three years.

Managed services: This segment accounts for 6% of 2020 revenue and its proportion has increased from 4% in 2017. **Revenue from this segment has grown at an average rate of c.55%, between 2017 and 2020**. In this segment, the company offers upgraded products of its traditional connectivity products and offers end-to-end management of business networks, through managed projects, managed LAN, and managed router services.

Figure 8 Managed Services revenue trend



Source: Company data and Al Rajhi Capital

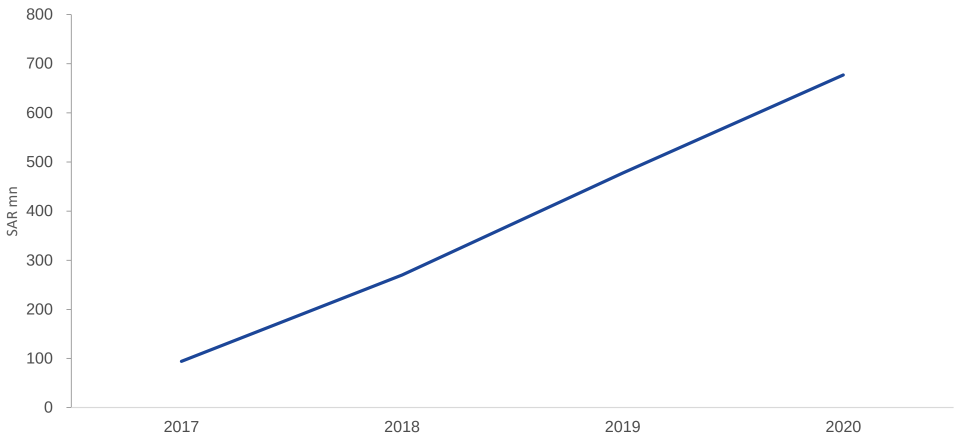
Apart from this, the company looks to keep adding new products to its portfolio in this segment. Sales in this segment are mainly B2B and are currently driven mainly by STC's customers in the government sector, though the company is looking to diversify its presence to the private sector and SMEs. This segment benefits from **STCS's wide network of partners, across cities and products, strong team, and access to state-of-the-art technology**. Given these, we expect revenue from this segment to grow at c.25% for the next three years.

Digital services offer strong growth opportunities

Revenue from this segment accounted for 22% of total revenue in 2020 and has grown from 7% in 2017. This segment is the fastest-growing segment for the company and between 2017 and 2020, it has registered an average growth of 90%. This segment has three subdivisions, cloud services, cyber security, and digital services.

Cloud services: In the digital services vertical, **cloud services is the largest vertical and accounted for 10% of revenue in 2020** and has grown from 3% in 2017. Revenue from this segment has grown by more than 90%, between 2017 and 2020. In this segment, the company generates **revenue from selling cloud and data center products**. These products enable customers to store and access large amounts of data and STCS has the capability to build and maintain large data centers. The company offers its customers, high standard infrastructure, with services hosted on highly secured Tier 3 and Tier 4 datacenters. The company **provides a full array of data center and cloud services, cloud connectivity services, cloud data center services, cloud core services, cloud partner services, and cloud projects services**. STCS also provides certain new products, including backup as a service, and disaster recovery as a service.

Figure 9 Cloud Services revenue trend

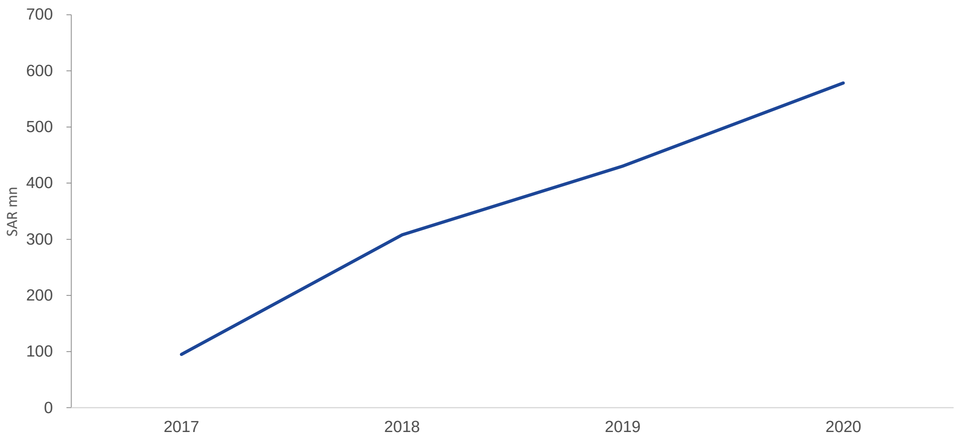


Source: Company data and Al Rajhi Capital

STCS has partnership arrangements with companies including VMWare, Dell, Microsoft, and Oracle. Added to this, key revenue drivers in this segment are its strong presence in the Kingdom, cross-selling, and customer reach. The company derives revenue in this segment through its off-the-shelf products and by acting as agents to third-party technology providers. The main channel of sales in this segment is B2B and the revenue from government agencies is the main driver. The company has also been awarded a multi-year project with the STC towards a delivery platform for data production and monetization. Key customers in this segment include Bank Al Jazira and various government agencies. Going forward, we expect this segment to continue to remain the main growth driver for the company and we expect revenue from this segment to grow at an average rate of c.40% between 2020 to 2023.

Cyber security: This vertical accounted **for 8% of 2020 revenue** and has increased from 3% in 2017 and revenue from this segment has increased at an average rate of c.80% between 2017 and 2020. In this segment, STCS offers planning, design, implementation, and project management to cater to the customer's requirement towards cyber security. The company has strengthened its position in the segment through partnerships with more than 75 security vendors and by maintaining regulation compliance with the National Cybersecurity Authority (NCA). Its key partners in this segment include Cisco, Fortinet, IBM, and PaloAlto Networks, and key customers in this segment include National Commercial Bank, Jeddah Municipality, Alqassim University, the Zakat, Tax, and Customs Authority, and Tatweer Educational Technologies Company. Overall, we expect the revenue from this segment to **continue to grow at a rate higher than the industry average**.

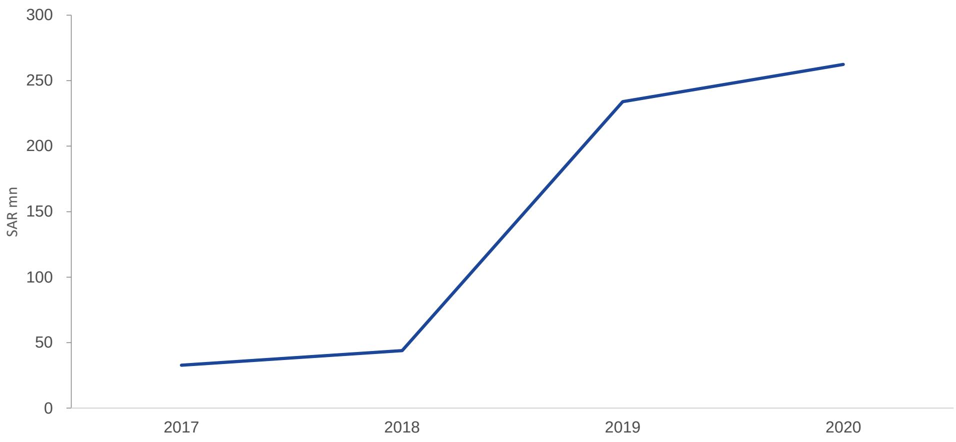
Figure 10 Cyber Security revenue trend



Source: Company data and Al Rajhi Capital

Digital services: This vertical accounted for 4% of 2020 revenue and has increased from 1% in 2017 and revenue from this segment has increased at an average rate of c.100% between 2017 and 2020. In this segment, STCS offers solutions that enables **customers to connect, monitor, and analyze machines and devices to enable them to make informed decisions**.

Figure 11 Digital Services revenue trend



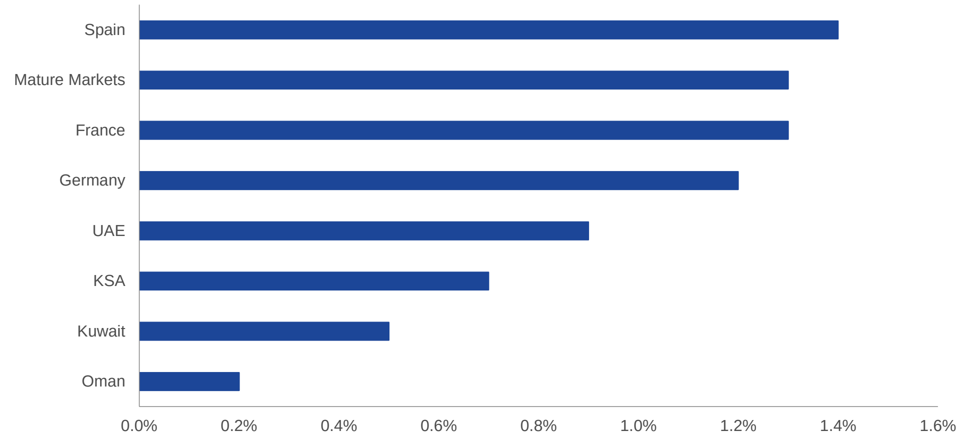
Source: Company data and Al Rajhi Capital

The company provides these services in three categories cloud services, data center services, and PaaS, and the key services provided by the company are digital service projects, fleet control, ISPAN, asset management, and RAQIB. In this segment, **the company benefits from the fact that it is the only cloud service provider in the country and its relationship with STC**. The company has historically benefitted from the marketing and sales team of STC and the investments of STC in certain large projects. Apart from government agencies, the key clients for this segment include KFSH Hospital, King Abdullah Bin Abdulaziz University Hospital. Overall, we expect the revenue from this segment to continue to grow at a rate higher than the industry average.

Industry Overview

IT market in the Kingdom under-penetrated, the growth potential is high: As per data from International Data Centre (IDC), IT services spending in the Kingdom in 2019 stood at SAR19.8 bn or **0.7% of the country's GDP**. Apart from this being lower than the **average of 1.3% of the mature markets,** it was lower than even some of its peers, like UAE (0.9%). This offers substantial room for future growth, considering that KSA also has a significantly higher proportion of the younger population. In line with this, the IT services market has been estimated to have grown to SAR37.7 bn in 2020, compared to SAR19.8 bn in 2018. Growth in spending has been aided by strong growth recorded in data center & cloud, IoT & digital, and application services.

Figure 12 IT spending to GDP

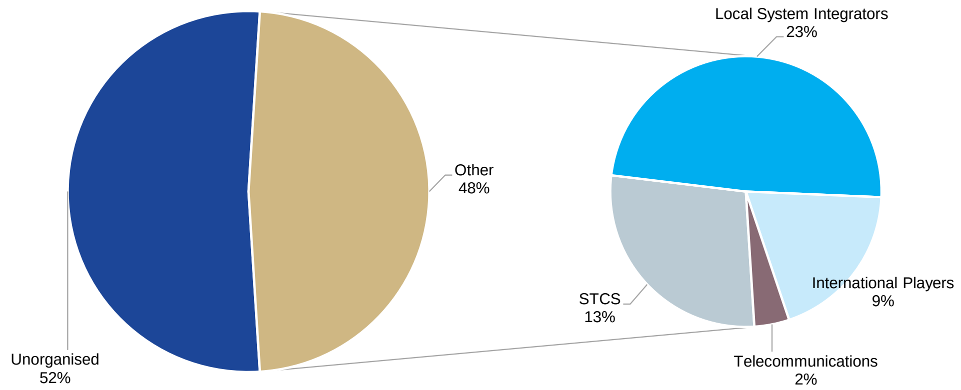


Source: Company data, IDC and Al Rajhi Capital

Despite the impact of Covid, IT spending in the Kingdom has shown resilience in most sectors, except in retail, which was one of the worst affected sectors during the crisis. IT outlay during the period has been driven mainly by digital transformation, cloud computing, security software, collaboration software, and AMP (artificial intelligence, machine learning, and process automation). Going forward, it has been estimated that most industries are likely to increase their IT investments in the next three years, with growth being led by services, healthcare, consumer goods, and communications.

IT services market in KSA highly fragmented: The IT services market in KSA is highly fragmented, with **STCS being the largest player with a market share of 13%** (2018), more than two times the market share of the second-largest player. The major competitors of STCS are local system integrators, which together account for c.23% of the IT services market share, and are largely fragmented. Advanced Electronics Company (AEC) and Saudi Business Machines (SBM) are the other major players in the local market. International players combined account for 9% of the market share and this share is expected to increase in the coming years. The international players offer the biggest threat to local players, given their mature product and services portfolio and business model. However, the competition is restricted to clients requiring standard solutions, like SMEs, and is a lesser threat in government projects where relationships, local presence, and credibility are important. However, this provides an opportunity to local companies, since Hyperscalers, companies like AWS and Microsoft, usually sell through partners, rather than selling directly. Telecommunication players like Integrated Telecom (ITC), Sahara Net, BT AI Saudia, NourNet, account for less than 2% market share. As **the market grows and the IT requirements increase, we expect bigger companies, which can offer reliable services and are capable of providing the latest technology, to be likely to garner higher market share**.

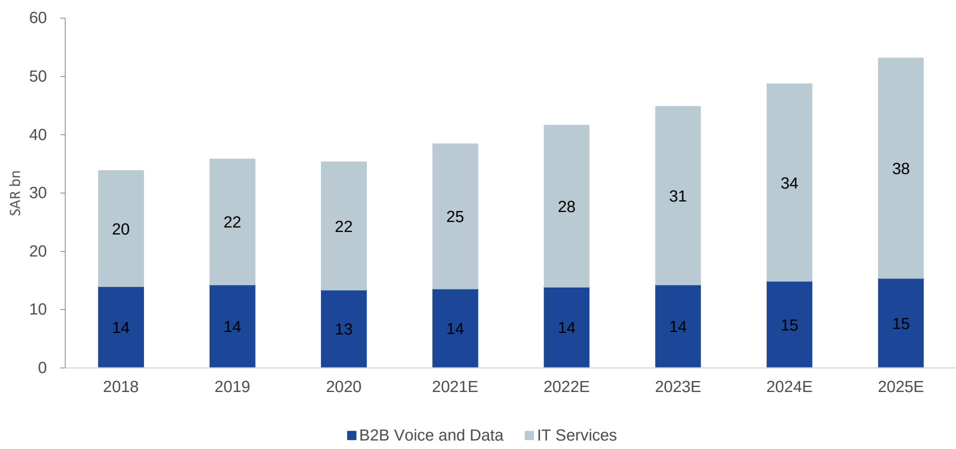
Figure 13 Fragmented IT Services Market



Source: Company data, IDC and Al Rajhi Capital

ICT services market pegged to grow at a stable pace: The ICT services market in the Kingdom has been projected at SAR35 bn in 2020 and it has been estimated to have grown at a CAGR of 2% between 2018 and 2020. KSA is also the largest market for ICT services, being 4-8x larger than peers in the region, as per market data in 2018. The ICT services market is subdivided into two segments. IT services, which is the largest, accounting for 62% of the total market in 2020, while B2B voice and data accounts for the balance 38%. In the past two years, the IT services segment has registered an average growth of 5%, while B2B voice and data has fallen at an average rate of 2% in the past two years. Growth in both segments was impacted by Covid in 2020 and **the market is expected to recover in the current year**. Going forward, growth in IT services is expected to be higher, relative to B2B voice and data segment.

Figure 14 ICT Services Market trend

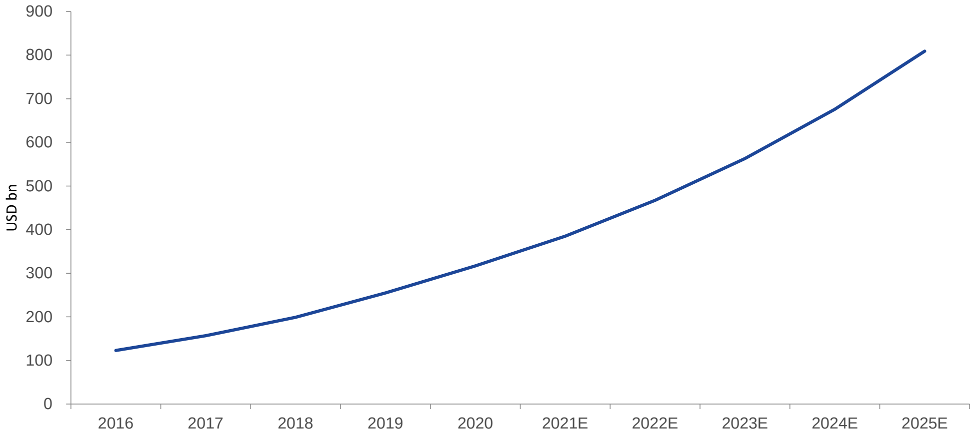


Source: Company data, IDC and Al Rajhi Capital

Apart from the organic historical growth trend, growth in IT services is also expected to be driven by increased spending in digitalization, in line with Saudi Vision 2030 and higher spending in information technology in the Kingdom. The largest consumers of IT services have been the public sector, financial services, and media & telecommunications; while we expect consistent growth from these segments, the fastest growing sectors in the Kingdom are manufacturing, transportation, retail, and healthcare. **Future growth in this segment is expected to be driven by the internet of things (IoT), cloud services, and managed networks.** Investment in B2B voice and data is likely to be beneficial in the short run, by increased spending in business continuity measures due to Covid. Overall, KSA's ICT services market is expected to grow at an average rate of c.8% for the next three years, driven mainly by c.10% average growth in the IT services segment. Given that the expected growth rate in the Kingdom is one of the highest in the region, there is an opportunity for the country to be a digital hub in the GCC.

Datacenter and cloud global trend:

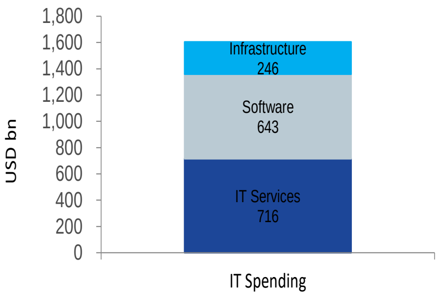
Figure 15 Global Cloud Market Spending



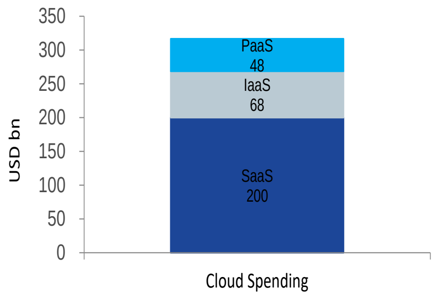
Source: IDC, Bloomberg Intelligence, and Al Rajhi Capital

Total global cloud market spending is **estimated by IDC at USD317bn and has grown at an average rate of over 25% between 2018 and 2020, with Amazon and Microsoft being the leaders, with a market share of 13% each**.

Figure 16 Global IT Spending



Global Spending on Cloud



Source: IDC, Bloomberg Intelligence, and Al Rajhi Capital

Despite the strong growth, spending on cloud is just 20% of total enterprise tech spending, this, in turn, provides opportunities for future growth. The next level of growth is expected to come from the transfer of IT infrastructure from on-premises to the cloud. Given that movement to cloud offers better scalability and lower cost, cloud infrastructure is an attractive proposition to companies. Overall, as per IDC estimates, spending on the cloud is expected to grow at an average rate of more than 20%.

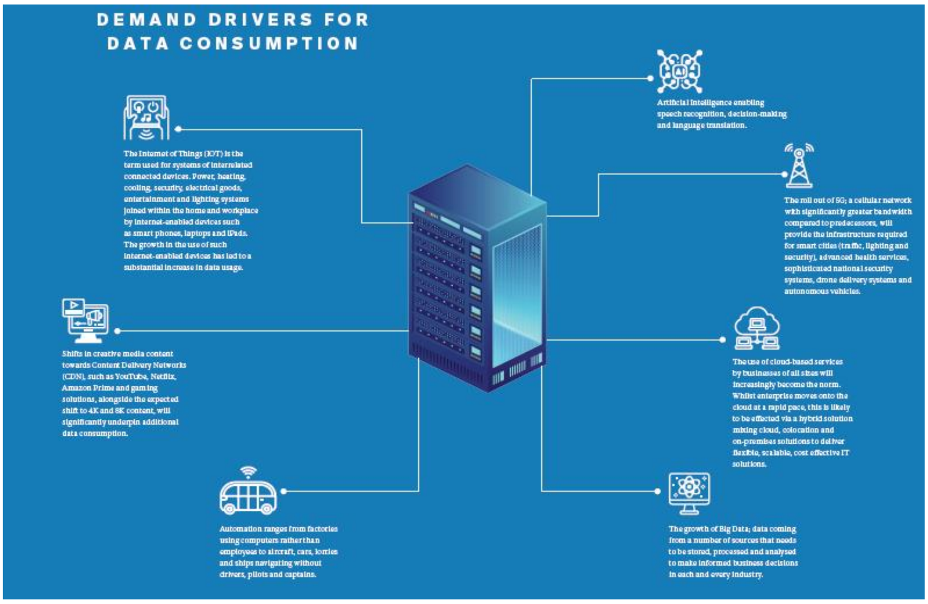
The global cloud market is currently dominated by Amazon and Microsoft, which together account for around 26% of the market share. The other large players Salesforce.com (6%), Google (4%) and Oracle (3%) account for significantly lesser market share. Overall, the sector is currently fragmented, with the top five players accounting for less than 40% of the market share, based on data from IDC and Bloomberg intelligence.

Figure 17 Profitability of Leading Cloud Providers

USD mn			
Amazon Web Services (Year ending 31-Dec)	**2018**	**2019**	**2020**
Revenue	25,655	35,026	45,370
Operating Income	7,296	9,201	13,531
margins	28%	26%	30%
Microsoft - Intelligent Cloud (Year ending 30-June)	**2019**	**2020**	**2021**
Revenue	38,985	48,366	60,080
Operating income	13,920	18,324	26,126
margins	36%	38%	43%

Source: SEC filings, Al Rajhi Capital

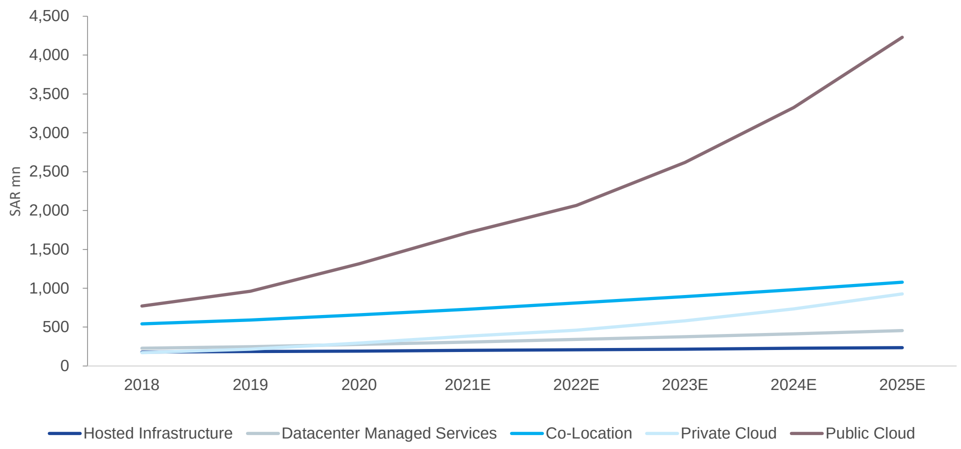
Figure 18 Demand driver for data consumption



Source: Knight Frank

Data centre and cloud offer strong growth opportunities in KSA

Figure 19 Data Centre and Cloud Market in KSA



Source: Company data, IDC and Al Rajhi Capital

This is one of the **fastest-growing segments in the IT services market in KSA** and has grown by c.20% between 2018 and 2020, with growth being driven by public cloud (31%) and private cloud (31%). Going forward, this segment is expected to continue to grow at a strong rate and is expected to register an average growth of 20%, for the next three years and will be continued to be driven by the public (26%) and private (25%).

Figure 20 Global distribution of hyper-scale data centers

Source: Knight Frank

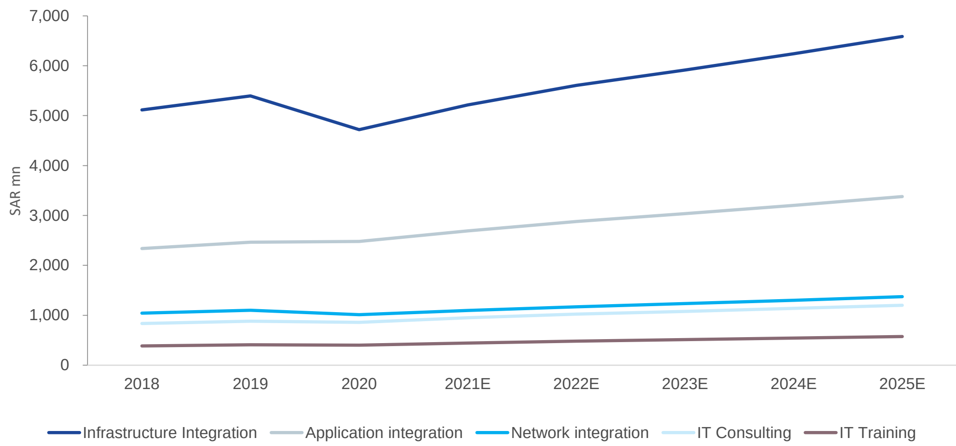
Figure 21 Mega Watts per million consumed (Estimates by Knight Frank)

Major Asia Pacific Markets				
Asia Pacific	**Population**	**DC Market**		**MW PER POP**
Singapore	5,600,000	450	MW	80.36
Hong Kong	7,392,000	320	MW	43.29
Tokyo	9,273,000	220	MW	23.72
Sydney	4,600,000	220	MW	47.83
Totals	**26,865,000**	**1,210**	**MW**	**45.05**
Major European Markets				
Europe	**Population**	**DC Market**		**MW PER POP**
London	8,900,000	700	MW	78.65
Amsterdam	2,800,000	550	MW	196.43
Frankfurt	5,500,000	450	MW	81.82
Paris	2,141,000	350	MW	163.48
Totals	**19,341,000**	**2,050**	**MW**	**105.99**
GCC Markets				
GCC	**Population**	**DC Market**		**MW PER POP**
Dubai	3,200,000	60	MW	18.75
Abu Dhabi	1,300,000	20	MW	15.38
UAE	9,400,000	90	MW	9.57
Saudi Arabia	35,000,000	60	MW	1.71
Bahrain	1,600,000	12	MW	7.5
Kuwait	4,100,000	10	MW	2.44
Oman	4,700,000	15	MW	3.19
Totals	**54,800,000**	**187**	**MW**	**3.41**
Middle East (& Africa) Markets				
MEA	**Population**	**DC Market**		**MW PER POP**
Egypt	98,000,000	25	MW	0.26
Jordan	9,800,000	12	MW	1.22
Pakistan	200,000,000	50	MW	0.25
India	1,400,000,000	350	MW	0.25
Kenya	50,000,000	15	MW	0.3
Ethiopia	112,000,000	15	MW	0.13
Morocco	36,000,000	35	MW	0.97
Totals	**1,905,800,000**	**502**	**MW**	**0.26**

Source: Knight Frank and Al Rajhi Capital

Systems integration market: The Systems integration market in KSA has been estimated at SAR9.5 bn and has fallen at an average of 1% between 2018 and 2020. The fall in the systems integration market was at the back of a fall in infrastructure integration and network integration segments. The fall is attributed to Covid and this impact is expected to be temporary and activity is expected to pick up from 2021.

Figure 22 System Integration Market

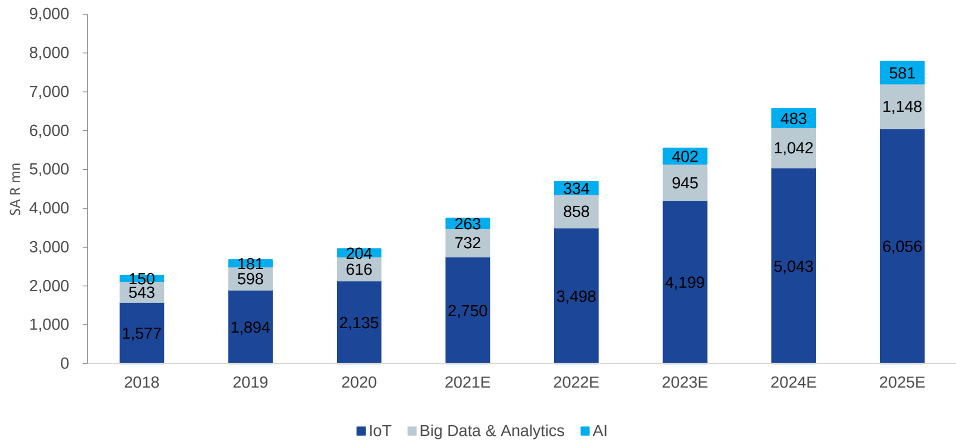


Source: Company data, IDC and Al Rajhi Capital

Going forward, the systems integration market is estimated to grow at an average rate of 8% for the next three years and will be aided by a recovery in growth in the infrastructure integration segment (8% average growth) and network integration segment (7%). Other segments in the market too are expected to grow at a steady rate, IT consulting (8%), IT training (8%), and application integration (7%).

IoT and digital market: This has been one of the fastest-growing markets in IT services and has grown at an average of 14% between 2018 and 2020 and has been aided by strong growth in IoT (16%) and artificial intelligence (17%) (AI). Big data and analytics on the other hand grew by 7% for the same period. Going forward, this segment is expected to continue to register strong growth and average more than 20% between 2020 and 2023. Growth is expected to be driven by strong growth in IoT (25%) and AI (25%), while big data and analytics are expected to grow by 15%.

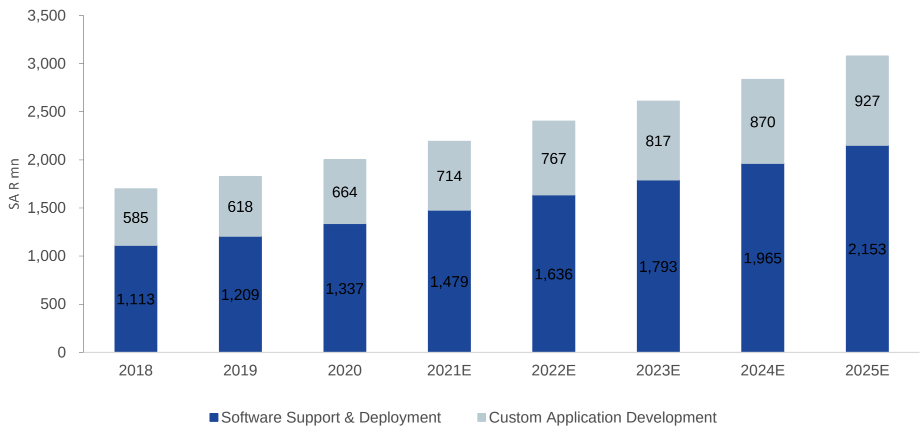
Figure 23 IoT and Digital Market



Source: Company data, IDC and Al Rajhi Capital

Application services market: This market has grown at an average rate of 9% between 2018 and 2020 and has been driven by software support and deployment (10%), while custom application development has grown at 7% for the same period. Going forward, the segment has been projected to grow in line with the historical trend (9%) for the next three years, with software support & deployment and custom application development segments likely to replicate historical growth.

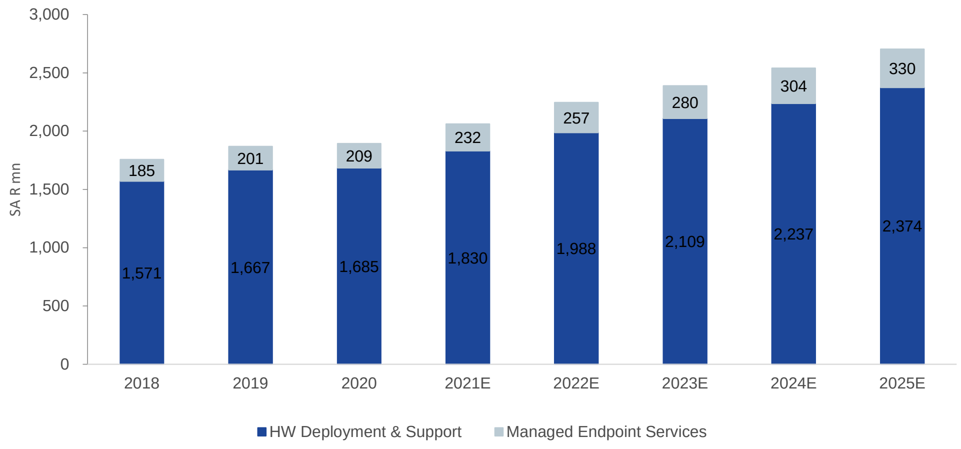
Figure 24 Application and Services market



Source: Company data, IDC and Al Rajhi Capital

Equipment and services market: This segment has grown at an average rate of 4% between 2018 and 2020, with the largest HW deployment & support, growing in line with the overall market. Managed endpoint services on the other hand grew by 6% for the same period. Growth rates are expected to recover post-2020, registering an average growth of 8% for the next three years, with HW deployment & support expected to grow at 8%, and managed endpoint services are likely to grow by 10%.

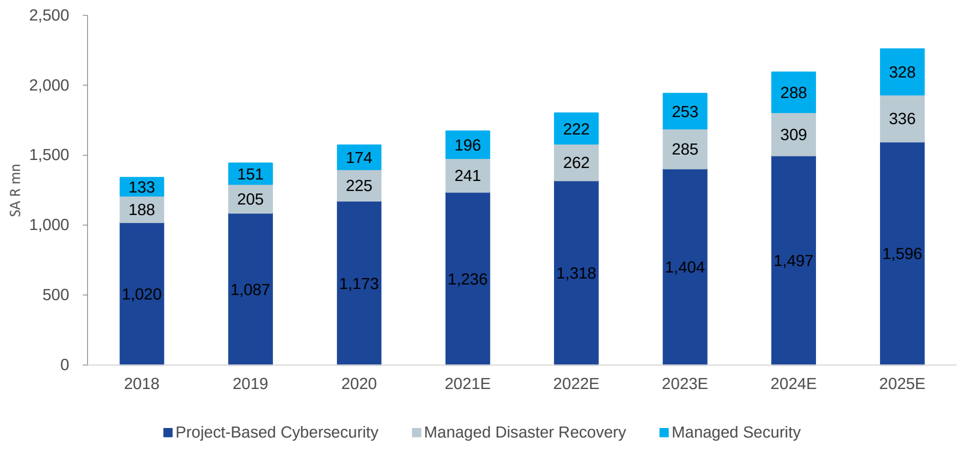
Figure 25 Equipment and Services Market



Source: Company data, IDC and Al Rajhi Capital

Cyber security market: This segment has grown at an average rate of 8% between 2018 and 2020, with the largest project-based cybersecurity, growing by 7%. Growth of the segment was driven by managed security, which grew by 14%, and managed disaster recovery growing by 9%. Going forward, the cyber security market is expected to grow by 7% for the next three years, with growth being driven by managed security (13%), while managed disaster recovery is expected to grow by 8% and project-based cybersecurity growing by 6%.

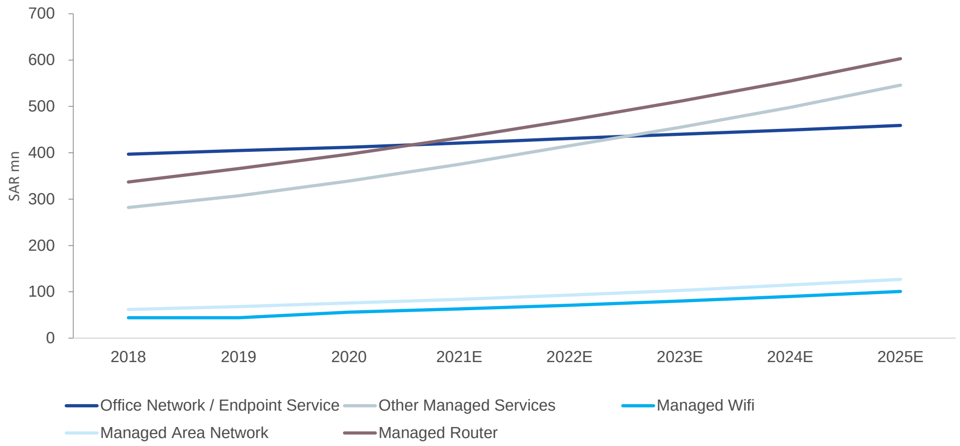
Figure 26 Cyber Security Market



Source: Company data, IDC and Al Rajhi Capital

Managed networks market: This segment has grown at an average rate of 7% between 2018 and 2020 and was driven by growth in most segments. The three largest verticals in this segment, managed routers grew by 9% between 2018 and 2020, while other managed service and office networks grew by 10% and 2% respectively. Going forward, we expect the segment to continue to grow at around 7% for the next three years, with most of the vertical growing at the average historical rates.

Figure 27 Managed Networks Market

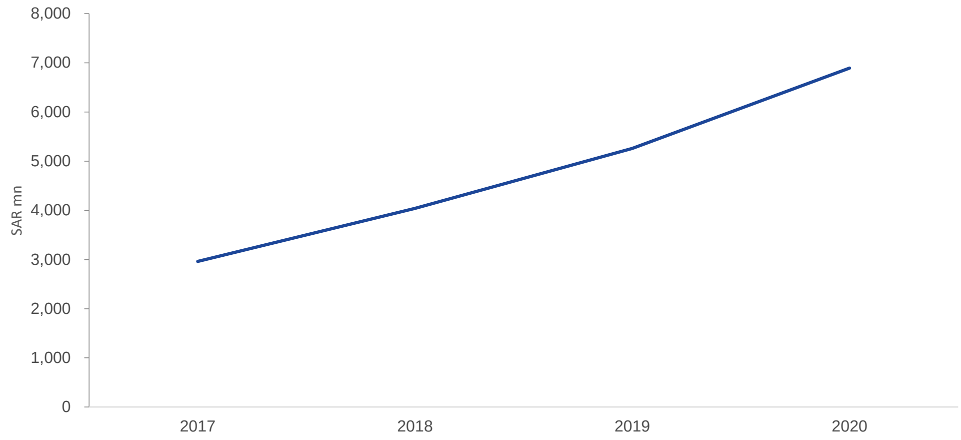


Source: Company data, IDC and Al Rajhi Capital

Key Financials

Total revenue of STCS on an average increased 33% between FY17-20 aided by growth across business verticals, core ICT services, IT managed and operational services, and digital services. FY 2020 turnover growth was higher at 31% y-o-y, despite the challenges posed by COVID and was aided by growth in demand in certain business verticals due to the pandemic. Going forward, we expect revenue growth to remain strong, aided by strong performance across the segment, especially cloud services. Given this, we expect the company to register an average revenue growth of 17% between FY20-23.

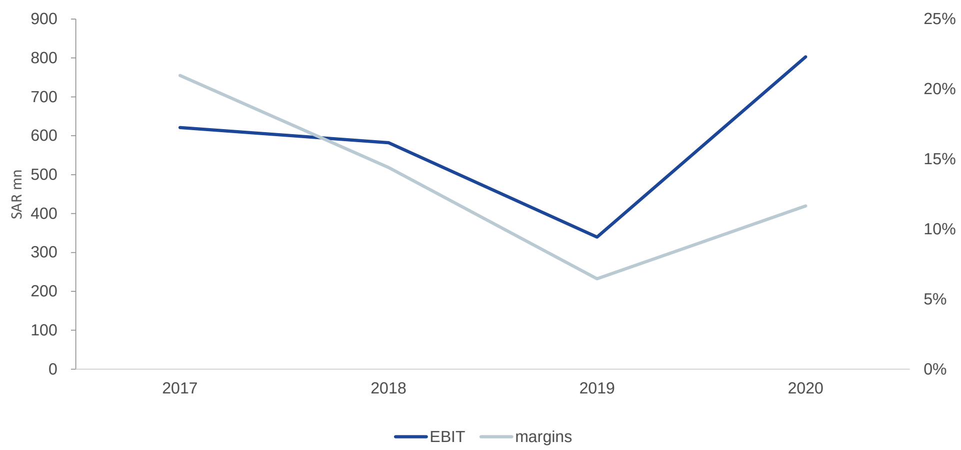
Figure 28 Trend in Revenue



Source: Company data, Al Rajhi Capital

Operating profits (EBIT) increased by a relatively lower 9% between FY17-20; despite higher revenue, profitability has come under pressure during the period. EBIT for 2020 more than doubled y-o-y, aided by an improvement in revenue and gross margins. We expect the performance of the company to stabilise, as scale improves through higher revenue. Given this, we expect EBIT to increase at an average rate of over 20% for the next three years.

Figure 29 Trend in Profitability



Source: Company data, Al Rajhi Capital

Figure 30 Income Statement

in SAR mn	2019	2020	2021E	2022E
Sales	5,257	6,891	7,976	9,564
y-o-y growth	*30.1%*	*31.1%*	*15.7%*	*19.9%*
Cost of Sales	(4,410)	(5,469)	(6,406)	(7,634)
Gross profit	**847**	**1,422**	**1,570**	**1,930**
margins	*16.1%*	*20.6%*	*19.7%*	*20.2%*
Operating cost				
Employee costs	(200)	(208)	(219)	(230)
Selling and distribution expenses	(158)	(159)	(184)	(221)
Administrative expenses	(150)	(251)	(264)	(277)
Others				
Total operating costs	**(508)**	**(619)**	**(667)**	**(728)**
Operating profit (before impairments)	**340**	**803**	**903**	**1,202**
margins	*6.5%*	*11.7%*	*11.3%*	*12.6%*
Other income	18	(1)	0	0
Financing Expense	(3)	(3)	(3)	(3)
Earnings before tax pre EOI	**354**	**800**	**900**	**1,200**
Extraordinary income/expense	81	(46)	(50)	(60)
Earnings before tax	**435**	**754**	**851**	**1,140**
Zakat & Tax	(41)	(52)	(59)	(79)
effective tax rate	*9.4%*	*6.9%*	*6.9%*	*6.9%*
Net income	**394**	**702**	**792**	**1,061**
margins	*7.5%*	*10.2%*	*9.9%*	*11.1%*
EPS	3.28	5.85	6.60	8.85
DPS	6.67	0.00	1.65	2.21

Source: Company data, Al Rajhi Capital

Figure 31 Balance Sheet

in SAR mn	2019	2020	2021E	2022E
Assets				
Cash and cash equivalents	414	993	1,459	2,052
Accounts receivable	2,635	2,804	3,245	3,891
Prepayments and other assets	157	157	157	157
Contract assets	1,166	1,505	1,741	2,088
Inventories	151	112	132	157
Total Current Assets	**4,523**	**5,571**	**6,733**	**8,346**
Contract costs	6	7	7	7
Intangible assets	104	91	137	186
Right-of-use assets	77	72	69	70
Property and equipment	167	594	692	807
Total non-current assets	**354**	**764**	**905**	**1,069**
Total assets	**4,877**	**6,335**	**7,639**	**9,415**
Liabilities				
Accounts payable and accruals	1,458	1,974	2,312	2,755
Deferred revenue	1,427	1,705	1,973	2,366
Contract liabilities	452	336	394	469
Zakat payable	40	53	53	53
Total current liabilities	**3,377**	**4,068**	**4,732**	**5,644**
Lease liabilities	54	48	48	48
End of service indemnities	189	295	341	409
Total non-current liabilities	**243**	**343**	**389**	**457**
Total liabilites	**3,621**	**4,411**	**5,121**	**6,101**
Share capital	100	1,200	1,200	1,200
Statutory reserve	50	120	120	120
Other reserves	28	(7)	(7)	(7)
Retained earnings	1,079	610	1,204	2,000
Total Shareholders' Equity	**1,257**	**1,924**	**2,518**	**3,314**
Total liabilites and equity	**4,877**	**6,335**	**7,639**	**9,415**

Source: Company data, Al Rajhi Capital

Figure 32 Cash Flow

in SAR mn	2019	2020	2021E	2022E
Cash flows from operating activities	183	1,119	958	1,212
Cash flow from investment	151	(536)	(295)	(353)
Cash flows from financing activities	(813)	(4)	(198)	(265)
Net change cash & cash equivalents	**(478)**	**579**	**465**	**594**

Source: Company data, Al Rajhi Capital

Valuation

We value STCS using an equal weight of DCF and relative valuation methodologies (P/E). Our DCF based target price based on 2.5% terminal growth and 8.2% cost of capital comes to SAR203/sh, and P/E-based relative valuation based on 30x multiple gives us a target price of SAR198/sh. Thus, the target price stands at SAR200/sh which implies an upside of 32.5% from the offer price of SAR151/sh". The company is trading at 23x 2021e eps. We initiate coverage on STCS with an "Overweight" rating.

There is a strong case for higher multiples as the valuation of peer companies show that - even with half STC's RoE metrics, peers trade at 26x, which is higher than STCS's average implied 2021E PE of 23x (Figure 35).

Figure 33 DCF Summary

(SAR mn)	31-Dec-21	31-Dec-22	31-Dec-23	31-Dec-24	31-Dec-25	Terminal
EBITDA	1,056	1,392	1,722	2,026	2,296	
Finance expenses	(3)	(3)	(3)	(3)	(3)	
Others	(50)	(60)	(70)	(78)	(86)	
Tax	(59)	(79)	(98)	(115)	(128)	
Net changes in working capital	13	(39)	(36)	(30)	(22)	
Net capex	(295)	(353)	(411)	(464)	(579)	
Net changes in cash	**663**	**859**	**1,106**	**1,336**	**1,478**	
Discounted net changes in cash	650	778	925	1,033	1,056	18,895
Net value	**23,337**					
Cash	993					
Net investments	0					
Total value	**24,331**					
Shares O/s	120					
Value per share	***203***					

Source: Company data, Al Rajhi Capital

Figure 34 Scenario Analysis – SAR/sh

		Terminal growth				
		0.0%	**1.5%**	**2.5%**	**3.5%**	**4.0%**
	6.2%	199	225	253	303	345
	7.2%	185	203	221	249	270
WACC	**8.2%**	175	188	**200**	218	230
	9.2%	167	177	186	198	205
	10.2%	161	168	175	183	189

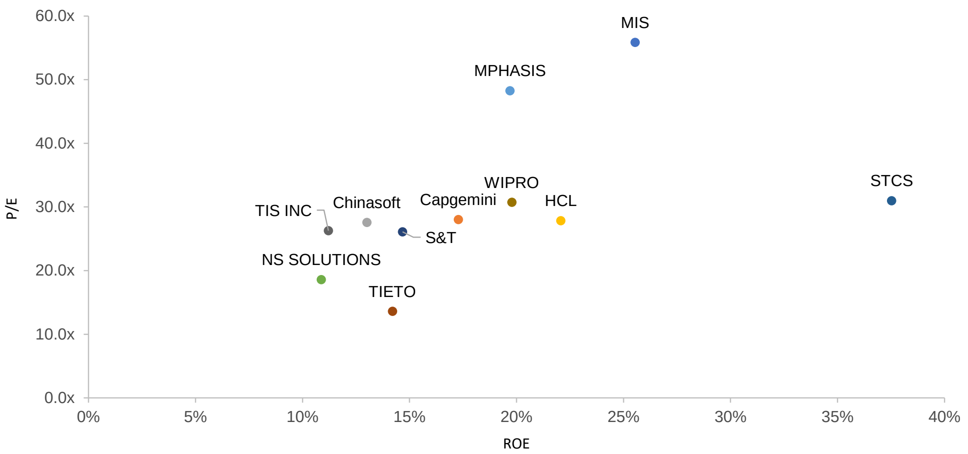
Source: Company data, Al Rajhi Capital

Figure 35 Global Peer Comparison

Name	Country	Market Cap (US$mn)	EV (US$mn)	P/E			EV/EBITDA		
				TTM	2021E	2022E	TTM	2021E	2022E
MIS	Saudi Arabia	1,126	1,220	55.9x	31.9x	20.6x	NA	28.3x	18.8x
Capgemini	France	35,650	42,432	28.0x	22.1x	19.4x	13.6x	13.2x	12.4x
Chinasoft	China	5,009	4,920	27.6x	25.7x	19.6x	21.2x	20.7x	15.5x
HCL	India	46,775	45,141	27.8x	25.7x	22.6x	13.5x	15.9x	14.2x
MPHASIS	India	7,920	7,727	48.3x	40.3x	34.1x	17.5x	27.0x	22.9x
NNIT	Denmark	481	549	112.0x	30.6x	20.3x	12.0x	10.2x	8.7x
NS SOLUTIONS	Japan	3,072	3,093	18.6x	17.9x	16.9x	NA	10.0x	9.5x
S&T	Austria	1,748	2,105	26.1x	24.5x	18.3x	11.5x	12.9x	10.8x
TIETO	Finland	3,594	4,547	13.6x	11.4x	10.5x	8.0x	7.4x	7.5x
TIS INC	Japan	6,872	6,637	26.3x	22.6x	20.7x	11.0x	11.6x	10.6x
WIPRO	India	47,238	45,000	30.7x	29.3x	26.3x	17.9x	19.9x	17.8x
Average				**37.7x**	**25.6x**	**20.8x**	**14.0x**	**16.1x**	**13.5x**
Median				**27.8x**	**25.7x**	**20.3x**	**13.5x**	**13.2x**	**12.4x**

Source: Bloomberg, Al Rajhi Capital

Figure 36 STCS target P/E against global peers



Source: Bloomberg, Company data, Al Rajhi Capital

Risks

Key downside risks are increase in cost of hiring due to employee churn, working capital delays due to receivables from key clients, unfavourable regulatory changes such as outsourcing of projects, project execution risks, increase in competition, especially via suppliers/foreign players, high dependence on Govt and hence oil prices. Further, its dependency on STC to generate revenue may act as a downside risk in case STC's business is impacted negatively amid the weak economic activities.

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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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