

**Initiation Coverage**
**December 26, 2017**

| Recommendation      | Overweight |
|---------------------|------------|
| Current Price (SAR) | 68.50      |
| Target Price (SAR)  | 75.51      |
| Upside/Downside (%) | 10.2%      |

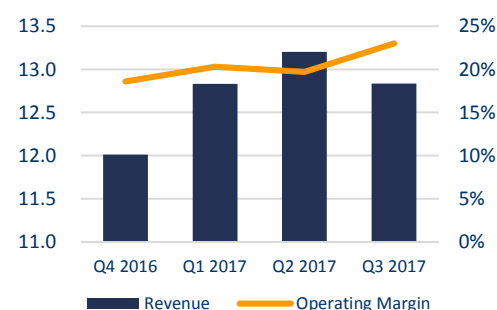
*As of December 26, 2017*
**Key Data (Source: Bloomberg)**

|                                  |       |
|----------------------------------|-------|
| Market Cap (SAR bn)              | 137.6 |
| 52 Wk High (SAR)                 | 78.9  |
| 52 Wk Low (SAR)                  | 64.5  |
| Total Outstanding Shares (in bn) | 2.0   |
| Free Float (%)                   | 16.2% |

**STC vs. TASI (Rebased)**


| Price Performance (%) | Absolute | Relative |
|-----------------------|----------|----------|
| 1m                    | -0.3     | 2.7      |
| 6m                    | 10.6     | 5.8      |
| 12m                   | 5.4      | 4.8      |

| Major Shareholders (%)           | %     |
|----------------------------------|-------|
| Public Investment Fund           | 70.0% |
| General Org For Social Insurance | 7.0%  |
| General Retirement Org           | 6.8%  |

**Quarterly Sales (SAR bn) and Operating Margin**


Source: Bloomberg, Company Financials, FALCOM Research; Data as of December 26, 2017

Saudi Telecom Company's (STC) 3Q17 earnings beat consensus with net income rising to SAR 2.62bn (+10% QoQ, +12% vs. consensus and +18% YoY). Lower operating costs and higher gross margins more than offset a decline in revenue (-3% QoQ and -9% YoY), resulting in higher operating profit. STC's margins improved sequentially, reflecting the positive impact of its cost-control initiatives to improve profitability.

STC faces intensifying competition and saturation in mobile penetration level in KSA. However, its leadership position, strong customer base, operational efficiency, and robust dividend yield are key positives outweighing the constraints. Based on STC's dominant position in the Saudi market and its focus on improving its revenue mix leads to our overweight stance on the stock.

**MTR cuts to affect top line**

Saudi Arabia's Communications and Information Technology Commission (CITC) approved reducing local voice call rates on mobile networks (MTRs) by 45% to SAR 0.055 from SAR 0.100 and local voice fixed termination rates (landline charges) to SAR 0.021 from SAR 0.045. The revision will come into effect from December 23, 2017, and will attract smaller players in the market, thus intensifying competition. For market leaders (including STC), this move would pressurize ARPU and increase operating costs as they would be compelled to pass on these low rates to customers while maintaining their market share.

**Operational efficiency program to boost margins**

STC's 9M17 improvement in the bottom line was led by a drop in operating costs, despite a decline in revenue. The company has benefitted from its strategy to focus on expansion in high-growth GCC markets and improving efficiency by adopting an operational efficiency program launched in late 2015. STC significantly cut its cost of services, thereby strengthening its margins in 3Q17, and is expected to continue to reduce costs.

**Well positioned to benefit from growth in enterprise and data segments**

STC has the largest market share in the mobile segment and a near monopoly in the fixed-line network segment. The company is well positioned to gain from increasing data usage. Internet penetration in Saudi Arabia rose to 75% in 2016 from 55% in 2013. Although the contribution of data services (16.3% in 2016) to STC's revenue mix remains low, the company has been focusing on capitalizing on the changing consumer trend. In addition, STC is targeting enterprises more than consumers, to improve its average margin per user.

**Strong balance sheet and high dividend yield to enhance shareholder value**

STC has a healthy balance sheet, with cash of SAR 3.1bn as of 3Q17. The company's net debt-to-EBITDA ratio declined to 0.1x in 2016 from 0.4x in 2013, well within its targeted limits. Consequently, STC has a high credit rating with 'Stable' outlook. Moreover, the company's high dividend payout ratio and increasing investments are supported by strong cash flows.

**Valuation:** We valued STC using the DCF approach to arrive at a fair value of SAR 75.5 per share. We considered WACC at 11.4%, with a terminal growth rate of 2.0%.

|                           | 2016A | 2017E | 2018E | 2019E |
|---------------------------|-------|-------|-------|-------|
| Revenue (SAR bn)          | 53.7  | 51.8  | 53.9  | 55.5  |
| Operating profit (SAR bn) | 10.0  | 11.2  | 12.3  | 13.6  |
| EPS (SAR)                 | 4.4   | 5.1   | 5.6   | 6.3   |
| Operating margin (%)      | 18.5% | 21.6% | 22.8% | 24.5% |
| RoE (%)                   | 14.5% | 16.2% | 16.8% | 17.6% |
| D/E (x)                   | 0.1   | 0.1   | 0.1   | 0.0   |
| P/E (x)                   | 16.3  | 13.5  | 12.4  | 11.1  |
| Price/BV (x)              | 2.4   | 2.2   | 2.1   | 2.0   |
| EV/EBITDA (x)             | 8.1   | 7.2   | 6.6   | 6.0   |

Source: Company Financials, FALCOM Research

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## Valuation Summary

### Explanation of valuation methodology and assumptions

We valued STC using the DCF approach to arrive at a fair value of SAR 75.5 per share. We considered WACC at 11.4%, with a terminal growth rate of 2.0%.

In relative terms, the company is trading at a one-year forward EV/EBITDA of 6.6x, at a premium of 0.8% from its sector peers, but trading at a discount of 34.7% from the Tadawul All Share Index.

| SAR Mn   | FY 2016A       | FY 2017E                              | FY 2018E      | FY 2019E      | FY 2020E       |
|--|----------------|---------------------------------------|---------------|---------------|----------------|
| EBIT   | 9,951          | 11,167                                | 12,298        | 13,604        | 14,842         |
| Taxes  | (751)          | (707)                                 | (773)         | (862)         | (951)          |
| Depreciation, amortization and impairment        | 8,078          | 8,099                                 | 8,187         | 7,795         | 7,521          |
| Changes in working capital                       | (3,502)        | (2,282)                               | (180)         | (63)          | (531)          |
| Net capital expenditure                          | (10,502)       | (7,979)                               | (6,309)       | (6,386)       | (6,579)        |
| <b>Free cash flow to firm</b>                    | <b>3,274</b>   | <b>8,298</b>                          | <b>13,222</b> | <b>14,087</b> | <b>14,302</b>  |
| Discount factor                                  |                | 1.0                                   | 0.9           | 0.8           | 0.7            |
| <b>PV of free cash flow to firm</b>              |                | <b>8,311</b>                          | <b>11,851</b> | <b>11,355</b> | <b>10,330</b>  |
| <b>Net Present Value (A)</b>                     |                |                                       |               |               | <b>41,827</b>  |
| <b>PV Terminal Value (B)</b>                     |                |                                       |               |               | <b>112,090</b> |
| <b>Assumed Terminal Growth Rate</b>              |                |                                       |               |               | <b>2.0%</b>    |
| <b>Discount Rate</b>                             |                |                                       |               |               | <b>11.4%</b>   |
| <b>Enterprise Value (A+B)</b>                    | <b>153,917</b> | <b>WACC Assumptions</b>               |               |               |                |
| <b>Total cash</b>                                | 3,068          | Risk-free rate                        |               |               |                |
| <b>Total debt</b>                                | 5,041          | Market returns                        |               |               |                |
| <b>Minority interest</b>                         | 933            | Beta                                  |               |               |                |
| <b>Equity value in SAR mn</b>                    | <b>151,011</b> | <b>Cost of equity</b>                 |               |               |                |
| <b>Number of shares in mn</b>                    | 2,000          | <b>Post tax cost of debt</b>          |               |               |                |
| <b>Target price in SAR per share</b>             | <b>75.5</b>    | Weight of equity in capital structure |               |               |                |
| <b>CMP in SAR as on December 26, 2017</b>        | <b>68.5</b>    | Weight of debt in capital structure   |               |               |                |
| <b>Upside/(downside) to current market price</b> | <b>10.2%</b>   | <b>WACC</b>                           |               |               |                |

Source: Company Financials, FALCOM Research Estimates

### Risks

#### Upside Risks:

- Diversifying income and bundling of services will increase the value proposition for STC while also mitigating it from the impact of pro-consumer regulatory reforms.
- Growing investments in joint ventures and subsidiaries will result in increasing capacity and thus, reach.
- Possible tower-sharing deals which are underway are likely to provide operational savings, in a capital-intensive industry.

#### Downside Risks:

- Revisions in the MTR by reducing prices of voice and landline calls would result in a more competitive market. This would lead to additional price cuts, higher attrition, and margin compression.
- The mobile and landline segment has neared saturation. Implementation of stricter regulations such as finger print initiative and cancelling of inactive SIMs limited growth in mobile segment while cannibalization in the landline segment, reduced subscriptions in 2016.

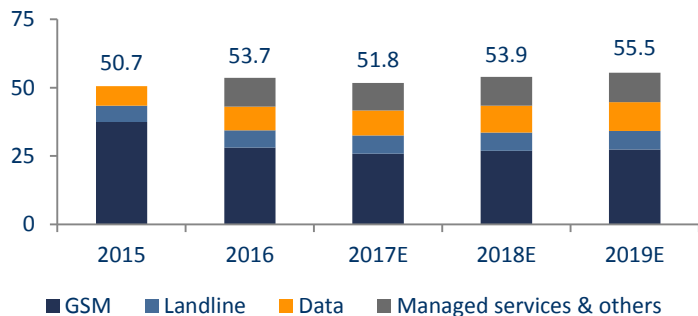


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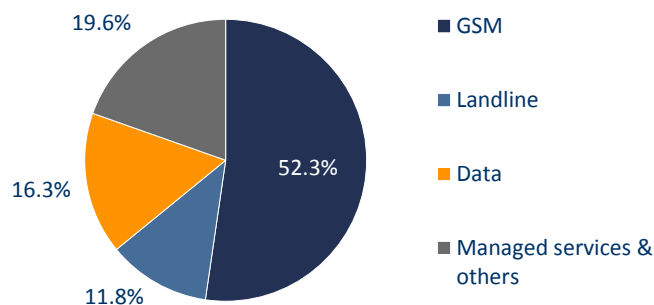
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## Key Charts

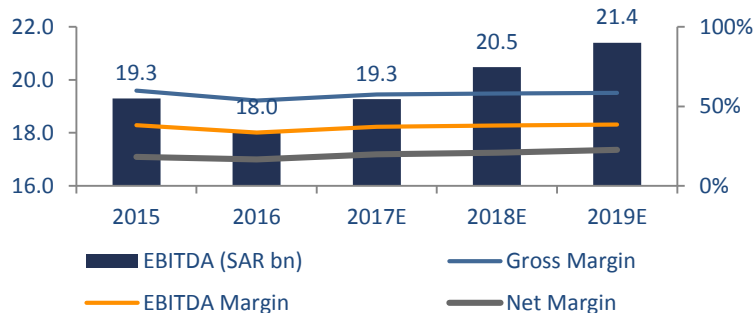
Revenue (SAR bn)



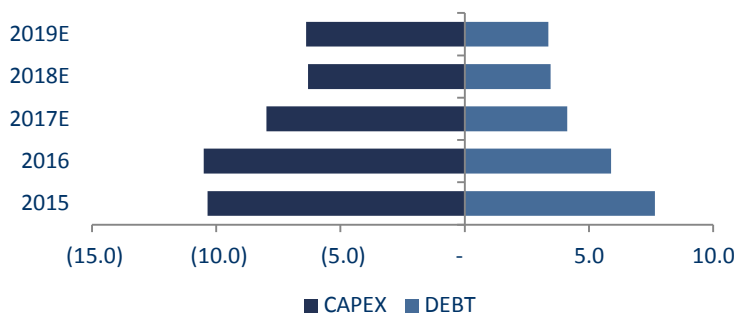
Revenue Split (2016)



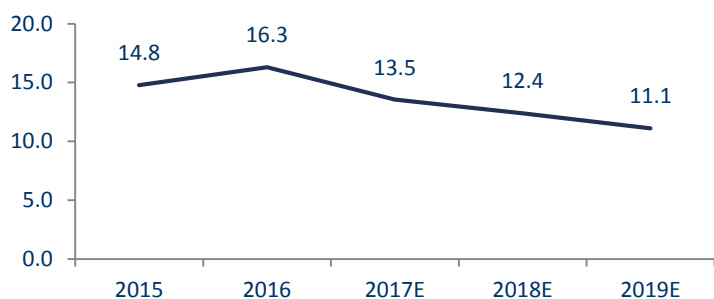
EBITDA &amp; Margins



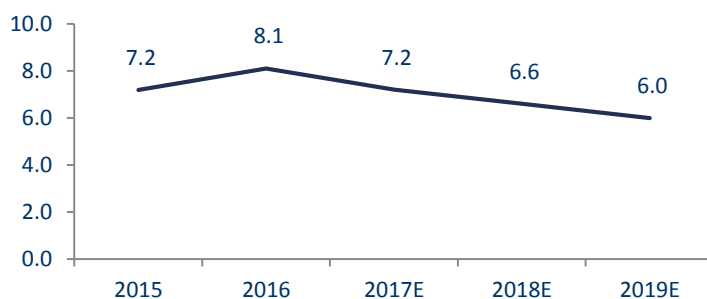
CAPEX and Total Debt



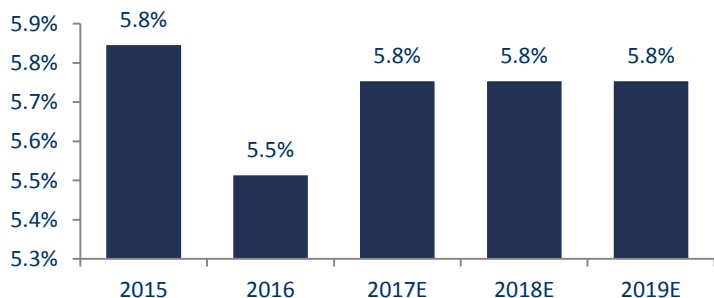
PE



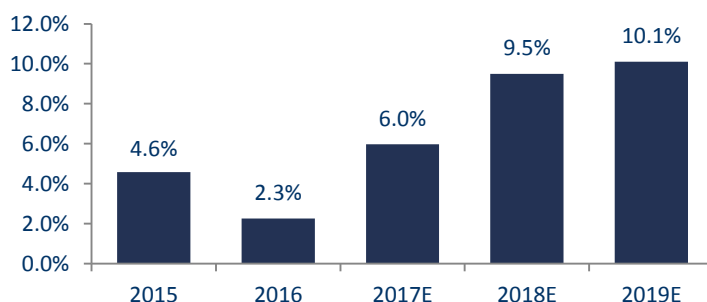
EV/EBITDA



Dividend Yield



Free Cash Flow Yield



Source: FALCOM Research Estimates

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## Summary Financials

| P&L (SAR mn)             | 2016   | 2017E  | 2018E  | 2019E  |
|--------------------------|--------|--------|--------|--------|
| Sales                    | 53,678 | 51,765 | 53,922 | 55,527 |
| Gross Profit             | 28,838 | 29,714 | 31,259 | 32,438 |
| EBITDA                   | 18,029 | 19,267 | 20,484 | 21,398 |
| EBIT                     | 9,951  | 11,167 | 12,298 | 13,604 |
| Earnings from Associates | 116    | 347    | 348    | 364    |
| Net Interest             | 344    | 357    | 351    | 475    |
| Other                    | (534)  | (650)  | (731)  | (752)  |
| PBT                      | 9,877  | 11,221 | 12,266 | 13,690 |
| Zakat                    | (751)  | (707)  | (773)  | (862)  |
| Minorities               | (228)  | (244)  | (267)  | (298)  |
| Net Income               | 8,898  | 10,269 | 11,226 | 12,529 |
| EPS                      | 4.4    | 5.1    | 5.6    | 6.3    |
| DPS                      | 4.0    | 4.0    | 4.0    | 4.0    |

| BS (SAR mn)                       | 2016    | 2017E   | 2018E   | 2019E   |
|-----------------------------------|---------|---------|---------|---------|
| Cash                              | 3,631   | 3,049   | 6,908   | 12,358  |
| Current Assets                    | 36,933  | 39,692  | 39,914  | 39,899  |
| Fixed Assets                      | 39,419  | 39,518  | 39,622  | 39,679  |
| Intangibles assets and goodwill   | 7,840   | 7,621   | 5,639   | 4,173   |
| Investments in associates and JVs | 6,302   | 6,333   | 6,618   | 6,916   |
| Total Assets                      | 101,777 | 104,719 | 107,207 | 111,531 |
| Current Liabilities               | 27,974  | 30,486  | 30,527  | 30,450  |
| Short Term Debt                   | 1,867   | 1,367   | 1,367   | 1,367   |
| Long Term Debt                    | 4,017   | 2,756   | 2,086   | 2,000   |
| Shareholders Equities             | 61,278  | 63,552  | 66,669  | 71,157  |
| Total Liabilities                 | 101,777 | 104,719 | 107,208 | 111,532 |

| CF (SAR mn)                         | 2016     | 2017E    | 2018E   | 2019E   |
|-------------------------------------|----------|----------|---------|---------|
| Operating Cash Flow                 | 24,137   | 21,006   | 19,107  | 19,931  |
| Working Capital Changes             | (5,561)  | (4,577)  | (180)   | (63)    |
| Cash Flow from Operating Activities | 18,576   | 16,430   | 18,926  | 19,868  |
| Capex                               | (9,555)  | (6,160)  | (6,309) | (6,386) |
| Cash Flow from Investing Activities | (7,975)  | (6,810)  | (6,021) | (5,992) |
| Changes in Debt                     | (1,712)  | (1,761)  | (670)   | (86)    |
| Dividends                           | (8,031)  | (8,000)  | (8,000) | (8,000) |
| Cash Flow from Financing Activities | (11,511) | (10,202) | (9,046) | (8,426) |

Source: Bloomberg, Company Financials, FALCOM Research

| Growth           | 2016   | 2017E | 2018E | 2019E |
|------------------|--------|-------|-------|-------|
| Revenue          | 6.0%   | -3.6% | 4.2%  | 3.0%  |
| EBITDA           | -6.6%  | 6.9%  | 6.3%  | 4.5%  |
| Operating profit | -16.1% | 12.2% | 10.1% | 10.6% |
| PBT              | -5.8%  | 13.6% | 9.3%  | 11.6% |
| Net Income       | -3.9%  | 15.4% | 9.3%  | 11.6% |

| Ratios (%)      | 2016  | 2017E | 2018E | 2019E |
|-----------------|-------|-------|-------|-------|
| Gross Margin    | 53.7% | 57.4% | 58.0% | 58.4% |
| EBITDA Margin   | 33.6% | 37.2% | 38.0% | 38.5% |
| EBIT Margin     | 18.5% | 21.6% | 22.8% | 24.5% |
| Net Margin      | 16.6% | 19.8% | 20.8% | 22.6% |
| ROE             | 14.5% | 16.2% | 16.8% | 17.6% |
| ROCE            | 12.4% | 14.1% | 14.9% | 15.7% |
| ROA             | 8.7%  | 9.8%  | 10.5% | 11.2% |
| Debt/Equity     | 0.1   | 0.1   | 0.1   | 0.0   |
| Net Debt/EBITDA | 0.1   | 0.1   | (0.2) | (0.4) |
| FCF Yield       | 2.3%  | 6.0%  | 9.5%  | 10.1% |
| Dividend Yield  | 5.5%  | 5.8%  | 5.8%  | 5.8%  |

| Valuation | 2016 | 2017E | 2018E | 2019E |
|-----------|------|-------|-------|-------|
| PE        | 16.3 | 13.5  | 12.4  | 11.1  |
| PB        | 2.4  | 2.2   | 2.1   | 2.0   |
| EV/EBITDA | 8.1  | 7.2   | 6.6   | 6.0   |
| EV/EBIT   | 14.7 | 12.4  | 10.9  | 9.5   |
| EV/Sales  | 2.7  | 2.7   | 2.5   | 2.3   |

| Peer Valuations          | 12M Fwd PE  | 12m Fwd EV/EBITDA |
|--------------------------|-------------|-------------------|
| Emirates Telecom Group   | 15.9        | 6.3               |
| Etihad Etisalat Co.      | NA          | 5.7               |
| Vodacom Group Ltd.       | 14.1        | 7.9               |
| MTN Group Ltd.           | 19.3        | 6.5               |
| Maroc Telecom            | 20.6        | 8.0               |
| Safaricom Ltd.           | 18.7        | 8.9               |
| Ooredoo Q.P.S.C          | 9.6         | 3.9               |
| <b>Saudi Telecom Co.</b> | <b>12.4</b> | <b>6.6</b>        |
| <b>Sector Median</b>     | <b>15.9</b> | <b>6.5</b>        |
| <b>TASI</b>              | <b>12.8</b> | <b>10.1</b>       |

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## FALCOM Rating Methodology

FALCOM Financial Services uses its own evaluation structure, and its recommendations are based on quantitative and qualitative data collected by the analysts. Moreover, the evaluation system places covered shares under one of the next recommendation areas based on the closing price of the market, the fair value that we set and the possibility of ascent/descent.

|                |  |
|----------------|--|
| Overweight:    | The Target share price exceeds the current share price by $\geq 10\%$ .  |
| Neutral:       | The Target share price is either more or less than the current share price by $10\%$ .   |
| Underweight:   | The Target share price is less than the current share price by $\geq 10\%$ .   |
| To be Revised: | No target price had been set for one or more of the following reasons: (1) waiting for more analysis, (2) waiting for detailed financials, (3) waiting for more data to be updated, (4) major change in company's performance, (5) change in market conditions or (6) any other reason from FALCOM Financial Services. |

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