Arabian Internet and Communications Services Co
Consumer – Software & Services
SOLUTION AB: Saudi Arabia
17 August 2022

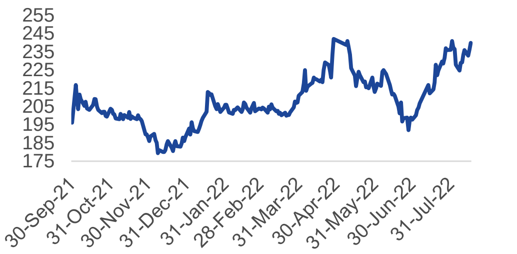
US$7.891bn	20%	US$12.64mn
Market cap	Free float	Avg. daily volume

Target price	242.00	-1.9% over current
Current price	246.60	as at 17/08/2022

Existing rating

Underweight	Neutral	Overweight

Performance



Earnings

(SARmn)	2021A	2022E	2023E
Revenue	7,816	8,832	9,937
Revenue growth	13.4%	13.0%	12.5%
Gross profit	1,708	1,887	2,114
Gross margin	21.9%	21.4%	21.3%
EBITDA	1,108	1,305	1,466
EBITDA margin	14.2%	14.8%	14.8%
Net profit	833	985	1,101
Net margin	10.7%	11.2%	11.1%
EPS	6.9	8.2	9.2
DPS	4.0	5.0	5.5
Payout ratio	57.6%	60.9%	59.9%
P/E	35.5x	30.0x	26.9x
RoE	36.7%	37.1%	35.6%

Source: Company data, Al Rajhi Capital

الراجحي المالية
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Arabian Internet and Communications Services Co (STCS)

Reduce the TP to SAR242/sh on margin concerns

Post the strong topline growth in Q2 2022, STCS raised its FY 2022 topline growth guidance to 9-11% (from its previous guideline of mid to single-digit growth). However, the company kept its EBITDA margin guidance unchanged at 13-15%. As we were already forecasting double-digit growth for FY 2022, we are upgrading our growth estimate only slightly to 13.0% from 12.5%. However, we are concerned about the mix of growth. In Q2 2022, the revenue growth of 16% was led by IT Managed and Operational Services (c.22%). Given that the IT managed and operational services business is a relatively low margin business, the Q2 operating margin was a miss versus our estimate. Further, we were also disappointed with the digital services business, which was flat y-o-y and has grown only 4% y-o-y in H1 2022. Given that the company's long-term growth story is dependent on the performance of its digital services business, any weakness on that front is a matter of concern. We continue to forecast mid to high single-digit growth for this business in the medium term, however, we trim our growth estimates for this business for FY 2022 and FY 2023 to 4.5% and 6.0%, respectively. And at the same time, we expect higher contribution from IT managed and operating services to weigh on the margins. We remain positive on the medium to long-term story, given that the company has strong exposure to government, has a solid balance sheet, and is a key player in terms of KSA's digital growth story. However, as we trim our near-term operating and net profit estimates for FY 2022 and FY 2023, we reduce our target price to SAR 242/share from SAR 260/share. We have not incorporated the impact of the Giza acquisition in our estimates, as we await further details around the revenue and profitability of Giza.

Recap of Q2 2022 results

- STC solutions' revenues of SAR 2.25 bn grew by 16% y-o-y, 7% above our estimates, while gross margins were largely in line with our estimates at 22.4%. The stronger than expected revenue growth was primarily driven by solid growth in core ICT services (+20.8% y-o-y), and IT Managed and Operational Services (+21.8% y-o-y). However, digital services grew only 0.1% y-o-y.

- Operating profit margins were slightly lower than our expectations at 13.0% versus ARC's 13.5%, due to which the beat on operating profits was just 3%. The key reason could be higher than expected growth in IT-managed business that has lower margins than the core ICT business. Net profit of SAR 273 mn grew almost 7% y-o-y and was a modest beat compared to our estimates.

Figure 1 STCS Q2 2022 results

(SAR mn)	Q2 2022	Q1 2022	Q2 2021	*ARC Est.*	*Cons Est.*	*y-o-y*	*q-o-q*	*vs ARC*	*vs Cons*
Revenue	2,254	2,418	1,937	2,111	2,115	*16.4%*	*-6.8%*	*6.8%*	*6.6%*
Gross Profit	505	494	432	471		*16.9%*	*2.3%*	*7.2%*	
G. margin	*22.4%*	*20.4%*	*22.3%*	*22.3%*					
Op. profit	294	313	271	285		*8.5%*	*-6.2%*	*3.0%*	
Op. margin	*13.0%*	*12.9%*	*14.0%*	*13.5%*					
Net profit	273	283	256	270	273	*6.6%*	*-3.5%*	*1.0%*	*0.2%*
Net margin	*12.1%*	*11.7%*	*13.2%*	*12.8%*	*12.9%*				

Source: Company data, Al Rajhi Capital

Valuation and risks: STCS is quoting at 32x its LTM eps, a slight discount to its key peer, ELM (34x based on LTM EPS), while it trades at 30x on our 2022e EPS. We continue to value STCS using an equal weight of DCF and relative valuation (P/E) methodologies. Our DCF-derived value per share is SAR 253. The key inputs for the DCF are 10% CAGR in free cash flows during 2022-2028, a slightly higher cost of equity 8.3%, and also a higher terminal growth rate of 3.0% (as we expect digital services growth to be back-end loaded). Our relative valuation methodology yields a value per share of SAR 230 (rounded up), derived through a multiple of 25x (unchanged) on our 2023e EPS of SAR9.2. Our new target price is SAR 242/share, which yields a limited upside from the current market price. Thus, we assign a neutral rating to the stock. Key risks: Better than expected growth in digital services business in H2 2022 and FY 2023, strong contribution from Giza acquisition, strong order inflow from government, etc.

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"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.

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