



Theme

The report contains key takeaways from results of the three listed Saudi telecom companies as well as our latest target prices

What do we think?

| Stock | Rating | Price Target |
|----------|---------|--------------|
| STC | Neutral | SAR80.0 |
| Mobily | Neutral | SAR17.5 |
| Zain KSA | Neutral | SAR6.8 |

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Saudi Arabian Telecom Sector

Q3 2018 key takeaways

The Saudi Arabian telecom firms reported healthy Q3 revenue and gross profit growth numbers, which were better than expected despite a decline in expats population, no material increase in data prices and a likely pick up in VoIP calling. What drove better numbers was mainly a combination of 1) healthy handset sales (in-line with commentary on electronics sales by Jarir and Extra), 2) higher than expected increase in foreign visitors, led by Hajj season (1.76mn foreign visitors in 9M18 compared to the same number for whole of 2017), 3) contribution from Govt. related contracts / business contracts. All the three firms reported healthy clean EBITDA margins (36-39%). However, looking closer into revenue mix, core telecom consumer spending weakened in this quarter for STC and Mobily. Zain delivered better performance though they might have benefitted from aggressive promotions of handset sales and partly from IFRS 15 application. On the whole, while there were positives (unwillingness to go for pricing competition and trends of gradual stabilization in revenues), the core performance appears broadly in-line with expectations. There are no changes to our views in the sector from an investment standpoint. Our target prices/ratings are STC: SAR80/ Neutral (up from SAR78.5), Mobily: SAR17.5/Neutral (unchanged) and Zain KSA: SAR6.8/Neutral (up from SAR6.6).

STC:

- Top-line for STC grew 5.6% y-o-y as compared to Mobily's 6% and 8% for Zain KSA. The company reported KSA data transmission growth of 34% y-o-y in Q3 2018 highlighting the increase in the data traffic due to Hajj pilgrimage season. However what drove revenues growth was an increase in Govt. related transactions which doubled from SAR961mn in Q3 2017 to SAR1.82bn in Q3 2018, without which revenues would have declined 1.3% y-o-y.
- The sequential decrease in accounts receivables despite increase in Govt. revenues implies some cash could have been paid for settling receivables.
- EBITDA trend has been uneven in the past as part of operating costs remains lumpy. Hence, we rely on average quarterly EBITDA levels, which is around SAR4.75bn in the 12 months before Q3. At SAR5.1bn, Q3 EBITDA was a surprise growing by 8% y-o-y, this was also led by Govt. related transactions as expenses pertaining to Govt./related contracts increased by a smaller amount as compared to revenues.
- Forecasting expenses below EBITDA line is challenging given lack of much information on early retirement (key item) and miscellaneous expenses, which is why we rely on Ev/EBITDA metrics for relative valuation. In Q3, other expenses grew to SAR291mn (vs. SAR107mn in Q3 2017), largely on the back of higher cost of early retirement program and finance cost offsetting the beat till EBITDA line.



- As a result, despite the EBITDA beat, STC's net profit of SAR2,643mn(+2.9% y-o-y) came in-line with our and consensus estimates of SAR2,600mn and SAR2,504mn, respectively. Though results were better than expectations, the underlying core telecom expenditure trends indicated a moderate decline.
- Having likely shelved international expansion plans in telecommunications, STC is planning to grow by investing in newer segments. Notably it has investments in Careem (10% stake valued at \$100mn in end of 2016, which now has more than doubled based on recent plans of Uber to acquire Careem) and signed an MoU for TV broadcasting. SAR660mn is the annual investment required (10 year contract, ~10% of existing capex) and we are yet to understand the benefits from this but believe it could be more of a strategic investment. STC can leverage these services by providing them as a part of bundled package and gain ad revenues. The company has also launched STC Pay, an investment arm specialized in digital payments and the financial technology services for individuals and institutes.
- Given these investments STC may not increase its dividend pay-out, despite the capability to pay higher dividends. The last dividend policy that had a pay-out of at least SAR1/share per quarter has ended but we are likely to continue seeing similar levels in the future.

Valuation: We use a mix of DCF (FCF) and relative valuation (7x EV/EBITDA in-line with global avg., higher than 6.5x historical average). For FCF, we use risk free rate of 3.9% (10 year US Govt. bond yield of 3.2% and 0.7% KSA default spread). Our cost of equity is 11.4% and WACC is 10.9%. Our revised target price is SAR80/sh (up from SAR78.5/sh), average of FCF (SAR76/sh) and relative valuation methods (SAR84/sh).

Risks: Upside risks to our estimates are from higher than expected revenues from its newer investments, tower sale/sharing, lower than expected cost of early retirement, hike in quarterly dividends, improvement in valuation of subsidiaries and more transparency in reporting. Downside risks are from unfavourable regulatory changes, aggressive competition leading to lower than expected ARPUs and acquisitions at expensive valuations.



Figure 1 STC Q3 results

| (SAR mn) | Q3 2017 | Q2 2018 | Q3 2018 | % chg y-o-y | % chg q-o-q | ARC est |
|---------------------|---------|---------|---------|-------------|-------------|---------|
| Revenue | 12,621 | 13,182 | 13,333 | 5.6% | 1.1% | 12,861 |
| Gross profit | 7,401 | 7,112 | 7,805 | 5.5% | 9.7% | 7,459 |
| Gross profit margin | 58.6% | 54.0% | 58.5% | | | 58.0% |
| Operating profit | 2,907 | 2,901 | 3,236 | 11.3% | 11.5% | 2,860 |
| Net profit | 2,569 | 2,444 | 2,643 | 2.9% | 8.1% | 2,600 |

Source: Company data, Al Rajhi Capital

Figure 2 Income statement

| Income statement (SARmn) | 12/16A | 12/17A | 12/18E | 12/19E | 12/20E |
|--------------------------|---------|---------|---------|---------|---------|
| Revenue | 53,678 | 51,362 | 52,600 | 53,652 | 54,725 |
| Cost of services | -24,991 | -21,807 | -23,249 | -23,607 | -23,969 |
| Gross profit | 28,688 | 29,555 | 29,351 | 30,045 | 30,755 |
| SG&A | -10,659 | -10,244 | -9,731 | -10,194 | -10,398 |
| EBITDA | 18,029 | 19,311 | 19,620 | 19,851 | 20,358 |
| D&A | -8,078 | -8,207 | -8,324 | -8,286 | -8,478 |
| Operating profit | 9,951 | 11,104 | 11,295 | 11,565 | 11,880 |
| Finance cost | -379 | -354 | -363 | -330 | -330 |
| Other expenses (net) | 305 | 382 | 484 | 802 | 916 |
| Profit before tax | 9,877 | 11,132 | 11,417 | 12,037 | 12,466 |
| Tax | -751 | -721 | -731 | -770 | -798 |
| Minority interest | -226 | -237 | -250 | -266 | -282 |
| Net profit | 8,900 | 10,174 | 10,436 | 11,001 | 11,386 |

Source: Company data, Al Rajhi Capital



Mobily

- Top-line at SAR2,976mn grew +6.1% y-o-y driven by multiple factors such as Hajj seasonality, handset sales and improvement in business segment. However in terms of segmental contribution, consumer revenues remained flat on 9M y-o-y basis while business & wholesale segment grew 11%. Had it not been for the strong growth in handset sales and Hajj season, revenue could have probably declined. Overall this performance is in-line with STC's core telecom revenue trend.
- As per the company's presentation, there was a contract worth SAR300mn signed with Arriyadh Development Authority. Most of these revenues are likely accounted as receivables given that the increase in accounts receivables was SAR150mn on a q-o-q basis.
- Gross profit at 5.2% y-o-y tracked top-line growth. There were two impairments recorded in Q3. One, SAR83mn from property and equipment and other is SAR78mn on accounts receivables. Despite this, operating profit came at SAR108mn.
- The "other income" (in turn composed of many items and not one, as per the management), whose details are not clear, keeps varying by a good margin over the quarters. This quarter it dipped by SAR23mn sequentially.
- Finance charges grew to SAR206mn (+29.6% y-o-y), reflecting impact of higher SAIBOR and ceasing of capitalization of expenses related to debt, whose details are not clear. The increase was higher than the special interest income increase seen by banks, of 6-8% y-o-y owing to mainly SAIBOR increase.
- Overall without Zakat reversal of SAR70mn, net profit would have worsened to SAR100mn exactly in line with our estimate. Notably, the usual run-rate for Zakat per quarter is ~SAR20mn.

Figure 3 Mobily Q3 results

| (SAR mn) | Q3 2017 | Q2 2018 | Q3 2018 | % chg y-o-y | % chg q-o-q | ARC est |
|---------------------|---------|---------|---------|-------------|-------------|---------|
| Revenue | 2,805.7 | 2,894.7 | 2,976.1 | 6.1% | 2.8% | 2,822.6 |
| Gross profit | 1,672.0 | 1,774.8 | 1,758.3 | 5.2% | -0.9% | 1,693.6 |
| Gross profit margin | 59.6% | 61.3% | 59.1% | | | 60.0% |
| Operating profit | (3.6) | 127.0 | 108.1 | NM | -14.9% | 82.4 |
| Net profit | (174.5) | (78.6) | (30.9) | -82.3% | -60.7% | (99.3) |

Source: Company data, Al Rajhi Capital

Valuation: For our price target, we use an equal mix of DCF and EV/EBITDA, based on 7x multiple) methods and arrive at a target price of SAR17.5/share with a Neutral rating. In a nutshell, we believe the company is improving but overall the company has a visibility of top line growth of <3% y-o-y for the next 2 years and EBITDA margin is mostly stabilized. The debt is high and the operating cash flows (without any benefit from accounts payables) are only marginally higher than capex required and pays no dividends. If one were to value it purely on EV/FCF basis, i.e., applying 17x multiple, which is the average multiple for telecom firms, and deducting the debt & liabilities, the range of implied value of the company would be significantly lesser.

Risks: Upside risks to our valuation are improved gross margins, improving receivables and no bad debts, faster than expected top-line growth. Downside risks are due to further impairments in receivables and further price competition in the sector.



Figure 4 Income statement

| Income statement (SARmn) | 12/16A | 12/17A | 12/18E | 12/19E | 12/20E |
|--------------------------|--------|--------|--------|--------|--------|
| Revenue | 12,569 | 11,351 | 11,692 | 11,926 | 12,164 |
| Cost of services | -5,144 | -4,821 | -4,735 | -4,890 | -4,987 |
| Gross profit | 7,425 | 6,530 | 6,957 | 7,036 | 7,177 |
| SG&A | -3,416 | -2,918 | -2,806 | -2,981 | -3,041 |
| EBITDA | 4,009 | 3,612 | 4,151 | 4,055 | 4,136 |
| D&A | -3,775 | -3,626 | -3,791 | -3,559 | -3,488 |
| Operating profit | 235 | -14 | 360 | 496 | 648 |
| Finance cost | -556 | -678 | -797 | -742 | -682 |
| Other expenses (net) | 75 | 45 | 150 | 58 | 61 |
| Profit before tax | -246 | -648 | -287 | -188 | 27 |
| Tax | 43 | -61 | 7 | -60 | -60 |
| Minority interest | - | - | - | - | - |
| Net profit | -203 | -709 | -280 | -248 | -33 |

Source: Company data, Al Rajhi Capital



Zain KSA

- Top-line grew 8.0% y-o-y to SAR1,952mn on the back of higher demand for company's products and services, handset sales and an accounting change (IFRS15). The company mentioned a SAR90mn impact on revenue (9M) because of IFRS15 accounting change, which we believe is mainly attributed to revenue from contract handsets. In our view, the company likely used to record equipment revenue excluding subsidies before and now it records revenue including subsidies. The company mentioned 3-4x sale of devices more than last year and hence the change had a noticeable impact. Without the IFRS 15 change, the top-line would have grown by 5% y-o-y in Q3, which is better than its peers in our view.
- Hajj seasonality as well as aggressive promotions on the ground have also contributed partly to the growth. The company recently launched FTTH services which are still not contributing meaningfully. Data revenues contributed 52% of total revenues.
- Gross profit tracked top-line to rise 8.6% y-o-y. The company indicated SAR126mn reversal of provisions, which we believe is at the cost of goods level and thereby gross profits could have declined by 1.5% y-o-y excluding the same. The reversal of provisions is not clear but the company mentioned it be a one-off item. Telecom sales are mostly B2C and thereby are small ticket items. Hence a large reversal in receivables is unlikely and the revision may have been necessitated because of change in some estimates.
- EBITDA improved to SAR728mn (+15.4% y-o-y) as growth in operating expenses (+1.4% y-o-y) lagged top-line growth, implying EBITDA margin of 37%. The company has been able to gradually lower operating expenses over the quarters.
- Interest expenses grew to SAR246mn (+8.7% y-o-y) despite de-levering the balance sheet through a repayment of Murabaha financing (SAR600mn). The total debt including that owed to shareholders amount to SAR16.7bn.
- Zain's Q3 2018 bottom-line of SAR48mn, up from SAR3mn in Q3 2017, came in higher than our and consensus estimated loss of SAR57mn and SAR47mn, respectively. However, excluding the impact of release of certain provisions (SAR126mn), net loss came in higher than our estimate. Bottom-line also benefitted from higher commission income and other income (finalization of the Universal Service Fund granted from the government), which is one –off in nature. As per the management in the analyst conference call, Zain concluded the USF project at a lower cost than the subsidies from Government, resulting in a positive impact of SAR18mn in Q3.
- The company's accumulated losses stand at 38% of equity and the company is working on a capital rights issue of SAR6bn which will be used to reduce debt of the company.
- Last 12 months net debt/ EBITDA is at 5.2x and in case the rights issue goes through along with the 38% capital reduction, net debt / EBITDA could become 3.2x.

Valuation: The company trades at forward EV/EBITDA of 7.2x as compared to local peers of 6.6x (2019e) and median regional peers of 6.1x (Bloomberg). We value Zain at 7x 12 month forward EBITDA. For DCF, we use risk free rate of 3.9% (10 year US Govt. Bond yield of 3.2% and 0.7% KSA default spread). Our cost of equity is 13.6% while current WACC is 7.2%, which increases to 8.7% as weight of debt decreases during the forecasted period. For our WACC calculations, we have included Zain management payables at around SAR1bn as equity. Our target price is SAR6.8/sh(revised upwards from SAR6.6), average of DCF and relative valuation methods .

Risks: Key upside risks to our estimates would successful rights issue, hike in data prices provided all the three players increase prices, no meaningful reduction in overall market size, a value accretive tower sale and higher than expected shift to post-paid subscribers which could improve ARPU. Faster than expected reduction in debt levels could also lead to improvement in profitability. Key downside risks are related to further pricing competition, continued erosion of subscribers, further erosion in market share, higher capex needs, lower than expected cost savings.



Figure 5 Zain Q3 results

| (SAR mn) | Q3 2017 | Q2 2018 | Q3 2018 | % chg y-o-y | % chg q-o-q | ARC est |
|---------------------|---------|---------|---------|-------------|-------------|---------|
| Revenue | 1,807 | 1,846 | 1,952 | 8.0% | 5.7% | 1,815 |
| Gross profit | 1,231 | 1,193 | 1,336 | 8.5% | 12.0% | 1,236 |
| Gross profit margin | 68.1% | 64.6% | 68.4% | | | 68.1% |
| Operating profit | 229 | 179 | 268 | 17.0% | 49.7% | 166 |
| Net profit | 3 | (38) | 48 | NM | NM | (57.3) |

Source: Company data, Al Rajhi Capital

Figure 6 Income statement

| Income statement (SARmn) | 12/16A | 12/17A | 12/18E | 12/19E | 12/20E |
|--------------------------|--------|--------|--------|--------|--------|
| Revenue | 6,927 | 7,306 | 7,436 | 7,659 | 7,736 |
| Cost of services | -2,526 | -2,393 | -2,424 | -2,474 | -2,499 |
| Gross profit | 4,401 | 4,913 | 5,012 | 5,185 | 5,237 |
| SG&A | -2,605 | -2,396 | -2,443 | -2,520 | -2,545 |
| EBITDA | 1,795 | 2,517 | 2,569 | 2,665 | 2,692 |
| D&A | -1,850 | -1,614 | -1,773 | -1,783 | -1,791 |
| Operating profit | -54 | 903 | 796 | 882 | 901 |
| Finance cost | -953 | -910 | -890 | -856 | -817 |
| Other expenses (net) | 26 | 20 | 43 | 43 | 32 |
| Profit before tax | -981 | 13 | -51 | 70 | 116 |
| Tax | 0 | 0 | 0 | 0 | 0 |
| Minority interest | 0 | 0 | 0 | 0 | 0 |
| Net profit | -981 | 13 | -51 | 70 | 116 |

Source: Company data, Al Rajhi Capital



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