

# Solutions by STC

## Mixed 2Q. We remain cautious

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### SOLUTION AB

Maintain Rating	Price	Price Objective	Upside	Market Cap	Average Daily Value
UNDERPERFORM	363.00	314.00	-13.5%	43,560	19.48
	SAR	SAR		SAR(mn)	USD(mn)

all data as of 31 July 2023

## Key takeaways

- Solid margins drive EBITDA / Net income 9% / 6% above consensus...
- ... yet rev 3% miss (and only 4% LFL Y/Y) & FCF pressured by working capital
- Maintain Underperform with SAR314 PO and 10% downside potential

COGS - cost of goods sold

CCC: Contact Center Company

## Maintain Underperform post 2Q results

4 key takeaways from Solutions 2Q23 results (based on the company's release as full financials not yet available): i) revenue 30% Y/Y, 6% below BofAe and 3% below company-compiled consensus ii) EBITDA 30% Y/Y, 3% above BofAe and 9% above consensus. iii) net income 24% Y/Y, 3% below BofAe and 6% above consensus. iv) 2Q23 FCF loss 14% wider than BofAe. We maintain our Underperform rating with 10% downside to our SAR314 PO; the stock trades on 32x P/E for 2023E while the company has delivered only 4% organic top-line growth in 2Q23.

## Revenue growth has been weak

2Q23 revenue was 29.5% Y/Y to SAR2,701m vs +19.3% in 1Q23. However, organic growth has decelerated to 3.6% from 6.4% in 1Q23, or from 16.8% in 1Q23 ex-stc data centre project in 1Q22. Segment wise: (i) core ICT services were 5.9% below BofAe and 28.9% Y/Y vs 17.7% in 1Q23. Assuming 100% of Giza is booked there, organic revenue growth was -7.0% Y/Y vs -4.9% in 1Q. (ii) IT managed and operational services were 9.2% below BofAe and 40.8% Y/Y vs 27.4% in 1Q23. Assuming 100% of CCC is booked there, organic revenue growth was 2.8% vs 28.1% in 1Q23 (iii) Digital services were 0.7% above BofAe and 15.8% Y/Y vs 13.6% in 1Q23 and 8.4% in 4Q22.

## EBITDA margin stronger

EBITDA margin was 16.9%, 1.9pp above consensus and 1.5pp above BofAe. Gross margin was 27.1%, 4.9pp above consensus and 4.6pp above BofAe despite bigger than expected share of lower-margin digital business (18.5% of total vs 17.3% BofAe), however this has been largely offset by OpEx 29% above BofAe due to "increased provision for bad debt".

## EPS growth below EBITDA, pressured by Giza

Net income was SAR340m, 24% Y/Y. The company has mentioned two non-operational factors negatively impacting profitability: (i) 'FX translation losses due to Egyptian Pound depreciation' (not disclosed, was SAR29m in 1Q23) and (ii) 'higher Zakat related to the ccc acquisition'.

## FCF generation muted

Solutions has reported -SAR355m FCF (vs -SAR311m BofAe), which compares with SAR392m in 2Q22 and SAR319m in 1Q23. Excluding investments (capex + the ccc acquisition), FCF was SAR107m vs SAR235m BofAe due to "increased investments in working capital mostly due to higher contract assets related to overall business growth as well as acquisition of Giza and ccc". As SAR595m dividends were also paid in the quarter, net cash position has reduced to -SAR1.9bn from -SAR2.8bn in 1Q23.

### Stock Data

Price	363.00 SAR
Price Objective	314.00 SAR
Date Established	31-May-2023
Investment Opinion	B-3-7
52-Week Range	216.80 SAR- 392.20 SAR
Mrkt Val / Shares Out (mn)	43,560 SAR / 120.0
Average Daily Value (mn)	19.48 USD
Free Float	20.0%
BofA Ticker / Exchange	XMETF / SAU
Bloomberg / Reuters	SOLUTION AB / 7202.SE
ROE (2023E)	42.4%
Net Dbt to Eqty (Dec2022A)	-95.6%

SAR m	2Q23A	2Q23E	A vs E	2Q22A	Y/Y	1Q23A	Q/Q	2Q23C	A vs C
<b>Revenue</b>	<b>2,701</b>	<b>2,867</b>	<b>-5.8%</b>	<b>2,085</b>	<b>29.5%</b>	<b>2,676</b>	<b>0.9%</b>	<b>2,788</b>	<b>-3.1%</b>
Core ICT Services	1,377	1,464	-5.9%	1,068	28.9%	1,559	-11.7%		
IT Managed and Operational Services	825	909	-9.2%	586	40.8%	674	22.4%		
Digital Services	499	495	0.7%	431	15.8%	443	12.6%		
Cost of revenue	(1,969)	(2,222)	-11.4%	(1,580)	24.6%	(2,070)	-4.9%		
<b>Gross profit</b>	<b>732</b>	<b>645</b>	<b>13.5%</b>	<b>505</b>	<b>44.9%</b>	<b>606</b>	<b>20.8%</b>	<b>620</b>	<b>18.1%</b>
Gross margin	27.1%	22.5%	4.6pp	24.2%	2.9pp	22.6%	4.5pp	22.2%	4.9pp
OpEx incl. D&A	(345)	(267)	29.4%	(212)	63.1%	(249)	38.4%		
<b>Operating Profit (EBIT)</b>	<b>387</b>	<b>379</b>	<b>2.2%</b>	<b>294</b>	<b>31.8%</b>	<b>357</b>	<b>8.4%</b>		
D&A	(69)	(64)	8.3%	(56)	23.2%	(62)	11.7%		
<b>EBITDA</b>	<b>456</b>	<b>442</b>	<b>3.1%</b>	<b>350</b>	<b>30.5%</b>	<b>419</b>	<b>8.9%</b>	<b>419</b>	<b>8.8%</b>
EBITDA margin	16.9%	15.4%	1.5pp	16.8%	0.1pp	15.6%	1.2pp	15.0%	1.9pp
<b>Net profit</b>	<b>340</b>	<b>349</b>	<b>-2.6%</b>	<b>273</b>	<b>24.5%</b>	<b>303</b>	<b>12.2%</b>	<b>321</b>	<b>5.9%</b>
Net margin	12.6%	12.2%	0.4pp	13.1%	-0.5pp	11.3%	1.3pp	11.5%	1.1pp
Capex	(21)	(46)	-54.2%	(25)	-14.6%	(26)	-20.7%		
As % of revenue	<b>0.8%</b>	<b>1.6%</b>	-0.8pp	1.2%	-0.4pp	1.0%	-0.2pp		
<b>FCF (Co definition)</b>	<b>(355)</b>	<b>(311)</b>	<b>14.2%</b>	<b>392</b>	<b>-190.5%</b>	<b>319</b>	<b>-211.4%</b>		
FCF margin	-13.1%	-10.8%	-2.3pp	18.8%	-32.0pp	11.9%	-25.1pp		
<b>Net debt/(cash) - Co definition (ex-leases)</b>	<b>(1,898)</b>	<b>(2,428)</b>	<b>-21.8%</b>	<b>(1,721)</b>	<b>10.3%</b>	<b>(3,334)</b>	<b>-43.1%</b>		

Source: Company report, BofA Global Research estimates, Company for consensus

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### Solutions by STC (XMETF)

Our discounted cash flow (DCF)-based price objective (PO) is SAR314. We assume a terminal growth of 4.0% and weighted-average cost of capital (WACC) of 9.4%. We see the following upside risks to our PO: (i) Saudi digitalization spending (including in the public sector) growing faster than expected, (ii) wider than forecasted margin expansion driven by operating leverage and revenue mix, (iii) the cloud business tracking ahead of expectations that might warrant higher stock multiples, (iv) better working capital trends, so FCF generation. Downside risks are: (i) faster transition to the cloud pressuring core ICT and managed services, (ii) volatile Saudi and Egypt macro, (iii) intensifying competition with local and international players, (iv) more competition could mean higher employee attrition and so pressure on personnel expenses, (v) execution risks related to the acquisition of Giza Systems.

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### Solutions by STC (XMETF) Price Chart



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Coverage Universe	Count	Percent	Inv. Banking Relationships	Count	Percent
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R1

Buy	212	53.13%	Buy	103	48.58%
Hold	89	22.31%	Hold	45	50.56%
Sell	98	24.56%	Sell	30	30.61%

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Coverage Universe	Count	Percent	Inv. Banking Relationships	Count	Percent
Buy	1877	53.28%	Buy	1040	55.41%
Hold	815	23.13%	Hold	464	56.93%
Sell	831	23.59%	Sell	385	46.33%

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Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

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