November 2019

Saudi Telecom Co.

Investment Update

STC posted Q3-19 earnings broadly in line with our estimates. Revenue growth dependent on enterprise business solution, especially given the government's digitization drive. Moreover, increased focus on FTTH (Fiber optic), 5G roll out and increase in data consumption is expected to contribute to the rise in top-line. Maintaining "**Overweight**" recommendation and PT of **SAR 112.2/share**.

- **Enterprise solutions segment to drive revenues:** STC posted revenue of SAR 14.1bn in Q3-19, broadly in line with AJC's estimate of SAR 13.7bn. Revenue grew 6.0% Y/Y, majorly driven by a 71.8% Y/Y rise in STC channels segment, rise in contribution from consumer wholesale and retail business and increase in the share of profit from subsidiaries. As part of its growing enterprise business strategy (DARE), STC inked more than 25 agreements at GITEX 2019. Moreover, STC's tower management subsidiary is expected to start its commercial operations soon, thus adding value to the STC's business in the coming years, as there are great cooperation opportunities with other operators on tower management and telecom infrastructure.
- **STC set to capitalize on the data driven growth story:** KSA telecom sector is witnessing a growth story - primarily driven by increase in data usage. In Saudi Arabia, number of mobile broadband subscribers reached to 29.63mn as of June 2019; with a penetration rate of 88.7%, while the number of fixed broadband subscribers rose to 1.98mn, with a penetration rate of 33.1%. In Jun-19, STC became the first telecom operator to launch 5G services in the Kingdom. Moreover, STC has increased the number of sites equipped with 5G up to 1,000 sites in various KSA regions as the first operator to provide such service. It further announced 5G provided to corporate sector are expected to be launched early 2020. Though, the network expansion has improved the traffic volume growth as it improved up to 137% compared to last year; the 4G traffic volume (VoLTE) has grown at peak hours to more than 366% over last year. Though, STC has delivered highest average performance of 37.2 megabytes per second; a 51.0% Q/Q rise in Q2-19; the company is likely to face stiff competition as Zain has officially rolled out 5G services at competitive rates, thus leading to lower than expected ARPU's.
- **Margin improvement attributed to reversal of royalty fee and the expenditure efficiency program:** In Q3-19, the company's net profit increased 3.9% Y/Y to SAR 2.75bn. STC witnessed a rise in net margins in the last three quarters owing to its expenditure efficiency program. However, the margins witnessed a slight dip in the last quarter to 19.5% from 20.9% in Q2-19. Saudi telecom companies have reached an agreement with the Kingdom's ministries of finance, communications and information technology to change the calculation of their annual royalty fees. The agreement stipulates that each will pay annual royalty fee of 10.0% percent of net revenue from telecommunications services starting from Jan. 1, 2018, reduced from 15.0%. STC will pay 10.0% of net revenues from fixed line services and 8.0% percent of net revenues from data services. This development is expected to further boost STC's liquidity position and will allow company to expand and develop its 4G and 5G network and fiber extension to meet the growing demand for broadcast in the kingdom. Moreover, the fee provisioned from 2008 to 2017 is set to be reversed in the next three years.

Overweight

Target Price (SAR)	**112.2**
Upside / (Downside)*	**16.3%**

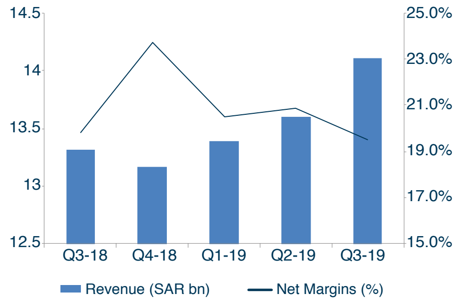
Source: Tadawul *prices as of 11th of November 2019

Key Financials

SARmn (unless specified)	FY17	FY18	FY19E
Revenue	50.7	52.0	53.5
Gross Profit	28.6	30.5	31.1
Net Profit	10.0	10.8	11.1
EPS	5.39	5.55	5.87

Source: Company reports, Aljazira Capital

Revenue (bn) vs Net Margin (%)



Source: Bloomberg, AlJazira Capital

Key Ratios

	FY17	FY18E	FY19E
Gross Margin	56.37%	58.78%	58.12%
Net Margin	19.77%	20.74%	20.77%
P/E	13.7x	17.0x	17.3x
P/B	2.2x	2.8x	2.8x
EV/EBITDA (x)	7.3x	9.5x	11.1x
Dividend Yield	5.84%	5.83%	6.54%

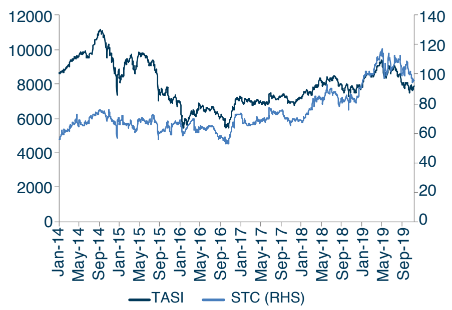
Source: Company reports, Aljazira Capital

Key Market Data

Market Cap (bn)	192.0
YTD %	4.5%
52 Week (High / Low)	117.4/80.0
Shares Outstanding (mn)	20.0

Source: Company reports, Aljazira Capital

Price Performance



Source: Tadawul, Aljazira Capital

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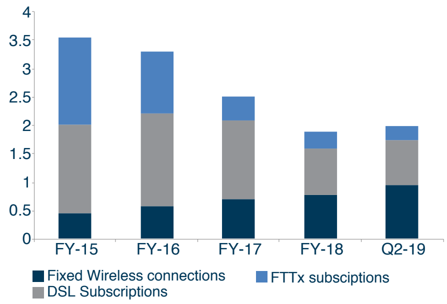
AJC View and Valuation: Saudi telecom sector has witnessed quite a few regulatory (reversal of royalty fee) and accounting changes (IFRS 9, 15, 16) that has led to revisions in EBITDA and Net Profit. STC has witnessed a growth of 6.0% Y/Y in the top line in Q3-19; while EBITDA and Net Profit have shown only a slight improvement of 2.1% and 3.9% Y/Y, respectively. Though, the company has been aggressive in expanding its enterprise business segment; the segment itself has its challenges such as receivables issues, high capex and low margins. With recent inclusions in MSCI EM and FTSE EM, STC has witnessed high foreign inflows that have led to surge in stock prices. The upcoming roll out of 5G services in the corporate sector and increase in contribution from FTTH segment is expected to contribute to the top-line; however, with increase in competition from other players in the data and retail segment, ARPU's are expected to remain under check.

We value STC on 100% weight for DCF (2.0% terminal growth and 9.3% average WACC). These yield a target price of SAR 112.2 per share, implying 16.3% upside from current levels. The stock is currently trading at a P/E of 16.3x as per our FY20 EPS. We recommend "**Overweight**" rating on STC with a positive outlook from a long-term perspective with a PT of **SAR 112.2/share.**

Total Subscriptions (in mn)



Source: Company reports, Aljazira Capital

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Income statement	2016	2017	2018	2019E
Revenues	53,678	50,661	51,963	53,481
Y/Y growth	*6.0%*	*-5.6%*	*2.6%*	*2.9%*
Cost of Services	(24,991)	(22,106)	(21,417)	(22,396)
Gross Profit	**28,688**	**28,555**	**30,546**	**31,085**
Y/Y growth	*-5.5%*	*-0.5%*	*7.0%*	*1.8%*
Selling & marketing	(6,327)	(5,609)	(5,463)	(5,509)
General & administrative	(4,331)	(4,516)	(5,247)	(4,819)
Impairment Provision	-	-	-	-
EBITDA	**18,029**	**18,431**	**19,836**	**20,758**
Depreciation and amortization	(8,078)	(7,445)	(7,591)	(8,614)
Operating Profit	**9,951**	**10,986**	**12,245**	**12,144**
Y/Y growth	*-16.1%*	*10.4%*	*11.5%*	*-0.8%*
Losses from investments accounted for under equity method	116	306	(11)	(11)
Finance Cost	(379)	(354)	(399)	(345)
Comissions/Finance Income	723	670	555	444
Others,net	(133)	(18)	(113)	(114)
Other Income and Expenses	**(74)**	**3**	**(417)**	**(126)**
Net Income before Zakat, Tax and Non-controlling interests	**9,877**	**10,989**	**11,828**	**12,018**
Provision for Zakat	(751)	(721)	(748)	(601)
Net Income before Non-controlling interests	**9,126**	**10,269**	**11,080**	**11,417**
Non-controlling interests	(227)	(253)	(301)	(310)
Net Income	**8,899**	**10,016**	**10,780**	**11,108**
Y/Y growth	*-3.9%*	*12.5%*	*7.6%*	*3.0%*

Balance sheet	2016	2017	2018	2019E
Current Assets				
Cash and cash equivalents	3,631	2,567	8,154	8,154
Short term investments	15,004	14,465	9,685	9,782
Accounts receivable, net	14,336	20,369	14,422	7,326
Prepayments and other current assets	936	1,006	1,953	3,029
Assets Held for Sales	-	-	-	-
Total Current Assets	**40,834**	**44,436**	**48,608**	**48,608**
Y/Y growth	*10.4%*	*8.8%*	*9.4%*	*9.4%*
Non Current Assets				
Investment Accounted for under equity Method	6,302	6,909	6,582	-
Property, plant and equipment, net	39,408	39,941	41,920	41,795
Y/Y growth	*-2.7%*	*1.4%*	*5.0%*	*-0.3%*
Intangible assets	7,259	7,175	9,560	7,774
Investments held to maturity	-	-	-	-
Other non-current assets	259	861	372	9,008
Total Non Current Assets	**61,825**	**64,046**	**63,341**	**58,577**
Y/Y growth	*3.6%*	*3.6%*	*-1.1%*	*-7.5%*
Total Assets	**102,658**	**108,482**	**111,949**	**111,949**
Y/Y growth	*6.2%*	*5.7%*	*3.2%*	*3.2%*
Current Liabilities				
Accounts payable	13,908	13,156	16,671	16,671
Other credit balances - current	4,126	7,281	4,078	7,487
Accrued expenses	-	-	-	7,612
Deferred revenues – current portion	82	96	41	2,957
Murabahas and loans – current portion	1,867	648	321	2,096
Liabilities related to assets held for sale	-	-	-	-
Total Current Liabilities	**30,055**	**33,639**	**32,035**	**32,035**
Y/Y growth	*32.3%*	*11.9%*	*-4.8%*	*-4.8%*
Non-Current Liabilities				
Murabahas and loans	4,017	4,006	3,965	5,391
Sukuk	-	-	-	-
Provisions for end of service benefits	3,776	3,922	3,919	3,919
Other credit balances - non-current	91	87	33	3,162
Total Non-Current Liabilities	**10,661**	**11,042**	**13,252**	**13,252**
Y/Y growth	*-11.0%*	*3.6%*	*20.0%*	*20.0%*
Shareholders' equity				
Share Capital	20,000	20,000	20,000	20,000
Statutory reserve	10,000	10,000	10,000	10,000
Retained earnings	32,622	34,638	37,418	39,780
Other reserves	(1,935)	(1,775)	(1,904)	(1,769)
Financial statements translation differences	-	-	-	-
Non-controlling interests	1,256	939	1,148	1,106
Total Equity	**61,942**	**63,802**	**66,662**	**69,117**
Y/Y growth	*0.0%*	*3.0%*	*4.5%*	*3.7%*
Total Liabilities and Equity	**102,658**	**108,482**	**111,949**	**111,949**

Source: Company financials, AlJazira research

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1. Overweight: This rating implies that the stock is currently trading at a discount to its 12 months price target. Stocks rated "Overweight" will typically provide an upside potential of over 10% from the current price levels over next twelve months.
2. Underweight: This rating implies that the stock is currently trading at a premium to its 12 months price target. Stocks rated "Underweight" would typically decline by over 10% from the current price levels over next twelve months.
3. Neutral: The rating implies that the stock is trading in the proximate range of its 12 months price target. Stocks rated "Neutral" is expected to stagnate within +/- 10% range from the current price levels over next twelve months.
4. Suspension of rating or rating on hold (SR/RH): This basically implies suspension of a rating pending further analysis of a material change in the fundamentals of the company.

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