



#### Key themes in the Telecom space

- Zain and STC towers sales.
- Enterprise business to show single digit growth rate.
- Higher cost of funding.

#### Our View:

Company	Rating	TP
STC	Neutral	SAR34/sh
Mobily	Overweight	SAR38/sh
Zain	Neutral	SAR10/sh

## The Telecom Sector

### Valuation outlook in the high-rate environment.

In the last few years, the telecom operators managed to deliver a strong growth across all segments backed by strong economy growth amid low interest rate levels. The business/enterprise segment shone recently, as it had the highest growth rate. The enterprise segment of STC recorded a 21% growth rate in 2021FY and 12.4% in 3Q (y-o-y), Etihad Etisalat (Mobily) recorded a growth of 28% in 2021FY, and 7% in 3Q (y-o-y). Zain does not disclose enterprise sales separately. These strong attractive growth levels were captured in a low interest rate environment, strong corporate investments, and solid economy position. However, as interest rates rose, many companies with modest growth expectations were discounted more severely. STC is now trading at roughly 4.4% vs. 3.6% last year (dividend yield), Mobily is at 2.5% yield vs similar yield last year (the unchanged yield was due to the strong growth in the profit of 32.5% YTD), while Zain doesn't pay out dividends due to the size of its leverage. If rates stay high for a long time, which we expect, that will impact earnings growth and keep the telecom sector under pressure. Thus, we change our rating to neutral for STC and revise TP to SAR34/sh based on an equal mix of DCF and EV/EBITDA approach. For Mobily, our TP is reduced to SAR38/sh based on an equal mix of DCF and EV/EBITDA approach. For Zain, the valuation is based solely on EV/EBITDA with a multiple of 6x, reaching to SAR10/sh with neutral rating.

### Market Key Trend:

#### Towers deal:

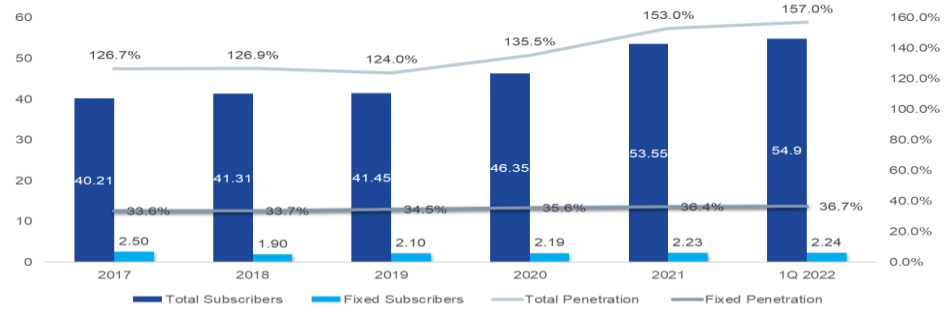
The concept of one large independent tower company emerging is not something new, as it took place across the world in many countries. The large independent tower can bring in many benefits to the telecom operator as they focus on improving their services and products offered, leaving the burden of developing the infrastructure to the independent tower company. Also, it adds value to operators, as they become more cost-efficient by simply renting the service instead of acquiring it. The recent tower deals for STC and Zain with the Public Investment Fund (PIF) are likely to improve the infrastructure of the telecom sector as one large tower operator emerges. Cost overlap typically occurs when two towers for different telecom operators are located close to each other. Thus, we believe that some cost efficiencies will take place in the future. In addition, the regulation passed by CITC in the past, which introduced the concept of tower sharing among telecom operators, also contributed positively to the growth of the industry.

#### Improvement in Penetration:

In the last couple of quarters, there has been a noticeable improvement in the penetration levels of both fixed and mobile subscribers. The number of mobile subscribers reached 55mn with a penetration level of around 157%, higher than the last four years' average of 135% and still below. The fixed broadband subscribers were mostly stable.



**Figure 1: Mobile Telecom Service & Fixed Broadband Penetration.**

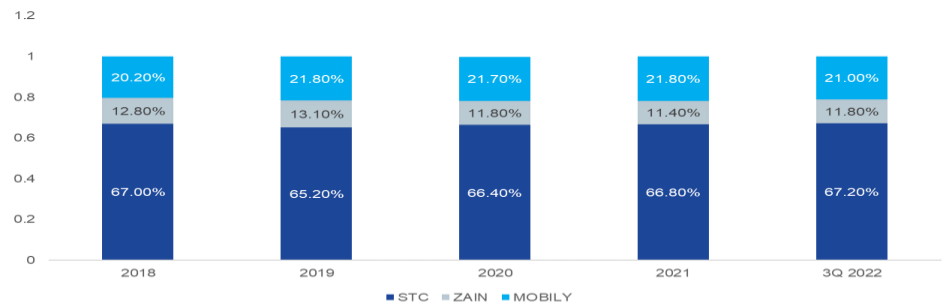


Source: CITC, Al Rajhi Capital.

### Market Share:

Over the past few years, Mobily was able to increase its market share to roughly 21% which might be credited to the management effort of restructuring Mobily and bringing back the company to profitability. Zain's market share saw a decline of 100bps, reaching 11.8%, while STC's share was mostly unchanged.

**Figure 2: Telecom market share.**

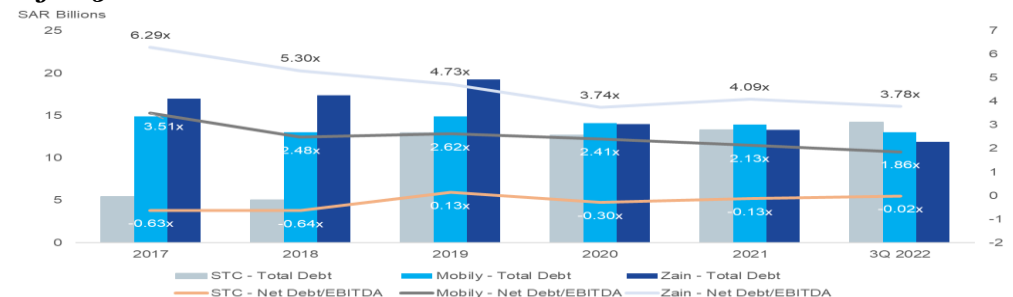


Source: Al Rajhi Capital.

### Debt in high interest rate era:

Companies especially those with high debt will be under stress as interest rate rises, cutting their future earnings. In the Telecom space, leverage is common and sizable. Zain is considered the most leveraged company with around 3.8x Net Debt/EBITDA. Zain's interest expense was 5.9%, 6.7% and 3.6% in 2019, 2020 and 2021 respectively. Although, the company managed to reduce one of the most expensive sources of financing (financing from related parties), the recent rise in SAIBOR will push financing expense to an expected range of SAR700mn – SAR750mn for 2023FY from SAR490mn in 2021FY. Mobily managed to lower debt to 1.9x Net Debt/EBITDA (~50% of the debt is fixed), the current debt level is somewhat manageable during high rate era. STC enjoys a low leverage number compared to other operators with around 0x Net Debt/EBITDA.

**Figure 3: Historical movements in Debt.**



Source: Al Rajhi Capital.



## Valuation

### STC.

We believe STC has a favourable financial position in this high-rate environment with a strong balance sheet. The only balance sheet concern is the high receivables, however, around 89% of the receivables are to the government. The last two payments from the government happened in 4Q18 for around SAR11.2bn and in 4Q20 for around SAR11.4bn. That being said, there might be a possibility of receivables settlement in 4Q22 for a similar amount, strengthening the financial position of STC. In addition, the Towers proceeds, for which we expect the deal to be completed in 1Q23 or 2Q23, will bring around ~SAR10bn cash to the company. If either of the two triggers happens, then there **could be a special dividend** of a similar amount distributed in 2018. All of these could improve STC's sentiment in the short term. However, with SAIBOR at 5.5%, which we expect to remain above 4% for at least the next two years, and as people shift money to fixed income or seek companies with strong growth prospects (STC's bottom line is expected to grow by 3.5 to 4% over the next four years), we revise our target price using an equal mix of DCF and dividend yield. Our DCF target price based on 9.5% WACC (STC has low levels of debt) and a 2% terminal growth rate is SAR38/sh. Our average dividend yield target price is SAR30/sh based on a 5% to 5.5% dividend yield. Our combined target price is SAR34/sh a -4.6% downside and a neutral rating.

### Mobily.

Over the last few years, the management was able to improve net income y-o-y and the company managed to lower its debt level while paying out dividends. We expect Mobily to grow its bottom line by 13% over the coming 3 years, which will give the company more room to increase its dividend from its current level of SAR0.85/sh if they decide to. Mobily pay-out in 2021 was 61%, up from 49% in 2020. This year, **we expect the dividend to be SAR1.2/sh** which is around 64% payout ratio similar to 2021 level (expected 3% dividend yield based on SAR32/sh). However, with SIBOR reaching 5.2% and expected to stay at an undesirable level for a longer period, this will increase the discount rate for Mobily. As a result, we revised our target price for Mobily from SAR45/sh to SAR38/sh based on an equal mix of DCF and EV/EBITDA. For the DCF, we used a WACC of 9.2% with a cost of equity of 10.5% and a cost of debt of around 5%, leading to SAR42/sh. while our EV/EBITDA gives us SAR33/sh based on multiples of 6.5x. Thus, our combined target price is SAR38/sh with an overweight rating and an upside of 12.4%.

### Zain KSA.

Zain seems to be our least favourable pick at this time. The company still has a considerable amount of leverage in which it pays high interest, which given the current level of SAIBOR could reflect negatively on P&L for the coming years. However, the Tower's deal with PIF could help the company reduce its debt to more favourable levels, which would change Zain's sentiment. The company will receive SAR2.4bn upon the completion of the deal and could use part of the proceeds to pay debt. Moreover, there are expectations that this interest rate cycle is different from its peers and might last longer than expected. Thus, we revise our target price for Zain KSA using EV/EBITDA, our TP is reduced from SAR12/sh to SAR10/sh from the current market price of SAR10.2/sh (downside of -1%) based only on 6x EV/EBITDA multiples and with a neutral rating.

Source: Al Rajhi Capital.

### Risk to our valuation:

Downside risk include 1) Delay in new projects will have a downside risk to our valuations. 2) SAIBOR staying at the high level for longer than expected. 3) If operating expenses increase more than what we expect then it will have a negative impact on our estimate.

Upside risks include 1) Maintaining higher margins than our expectations. 2) Favourable and strong positioning in e-commerce. 3) Lower Capex needs than our estimate resulting in a higher FCF. 4) New investments performance to be better than what we anticipate.



### Earnings graph:

Figure 4: P&L estimates for STC for FY2022 to FY2024.

(SAR bn)	2021	2022E	2023E	2024E
Revenue	63.4	67.1	69.9	72.2
Y-o-Y	7.6%	5.8%	4.1%	3.2%
Gross Profit	33.8	37.4	37.5	38.6
Gross margin	53%	56%	54%	54%
EBITDA	22.8	25.5	25.3	26.1
EBITDA margin	36%	38%	36%	36%
Net profit	11.3	12.2	12.6	13.1
EPS (SAR)	2.3	2.4	2.5	2.6
DPS (SAR)	1.6	1.6	1.6	1.6
EV/EBITDA	9.0	8.1	8.2	7.9
P/E	18.0	16.7	16.2	15.5

Source: Al Rajhi Capital.

Figure 5: P&L estimates for Mobily for FY2022 to FY2024.

(SAR bn)	2021	2022E	2023E	2024E
Revenue	14.8	15.5	16.1	16.6
Y-o-Y	6%	5%	4%	3%
Gross profit	8.7	9.2	9.5	9.7
Gross margin	58%	59%	59%	59%
EBITDA	5.6	6.0	6.2	6.4
EBITDA margin	38%	39%	39%	38%
Net profit	1.1	1.4	1.4	1.7
EPS (SAR)	1.4	1.9	1.9	2.2
DPS (SAR)	0.9	1.2	1.2	1.5
EV/EBITDA	7.8	7.2	7.0	6.9
P/E	23.0	17.1	17.2	14.3

Source: Al Rajhi Capital.

Figure 6: P&L estimates for Zain for FY2022 to FY2024.

(SARmn)	2021	2022E	2023E	2024E
Revenue	7.9	8.7	9.0	9.2
Y-o-Y	0%	10%	3%	3%
Gross profit	4.9	4.9	5.1	5.3
Gross margin	62%	57%	57%	57%
EBITDA	3.1	2.9	3.1	3.2
EBITDA margin	40%	34%	34%	35%
Net profit	0.2	0.3	0.2	0.5
EPS (SAR)	0.2	0.4	0.3	0.5
DPS (SAR)	0	0	0	0
EV/EBITDA	6.0x	6.4x	6.1x	5.9x
P/E	41.9x	28.4x	38.4x	20.2x

Source: Al Rajhi Capital.



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