



## Key themes

In a nutshell, Saudi Telecoms witnessed weak performance in 2017. 2018 is likely to remain challenging as well unless data prices increase. Earnings growth otherwise is likely to mainly come from lower interest expense and depreciation, for the smaller players.

## What do we think?

Stock	Rating	Price Target
STC	Neutral	SAR78.5
Mobily	Neutral	SAR13.4
Zain	Neutral	SAR7.3

# Saudi Arabian Telecom Sector

## Exceptionally soft Q4. Uptick in data prices is key.

*Q4 was a bit more challenging than usual for the telecom sector in Saudi Arabia. On the ground, we had witnessed significant promotions resulting in weak top-line. It was noticeable in SAMA's monthly statistics as well, with a sharp drop in Telecom PoS data on a y-o-y basis. However, in Q1 so far, we have not seen as many special promotional offers as we saw in Q4 17. Average data prices have also increased starting January. On the other hand, decline in number of subscribers may continue as expat population continues to decline and consumers are likely to be more cautious in their spending. Increase in data prices and revenues will be the main driver (and a must) for recovery of the sector as benefit from cost savings could be limited. If data prices do not improve, bottomline improvement is likely to come mainly from lower financing expenses, as companies deleverage and lower depreciation expenses, as capex declines. Given the sensitivity to an increase in data prices in the Kingdom we believe hikes could be gradual and more indirect unless the regulator intervenes. STC beat our estimates in the last two quarters while Mobily has showed resilience in its top-line performance in the last few quarters and Zain KSA reported weak Q4 numbers. See left pane for new TPs and ratings.*

**A challenging year ahead:** Towards the end of the last year, we saw heightened promotional activity by all the three telecom companies. While competition has moderated a bit, in general, all telecom operators expect a challenging year ahead with more VoIP based calling, impact from general lower consumer spending, and implementation of consumer protection rights etc. As per GOSI, the number of expat employees have declined by ~400k in a year. The impact of an expat moving out is unlikely to be offset by a Saudi national (~10k increase in 1 year) getting employed in the case of the telecom sector because irrespective of employment, Saudi nationals most likely already have an active mobile connection. Q1 and Q2 numbers could see a bit more stability in expat telecom subscribers given that schools close by mid-year.

**Pricing:** An increase in pricing is one of the only triggers that can change the sector's outlook. However, given the sensitivity of an increase in the Kingdom, companies would need to boost prices indirectly by providing higher value based services or through newer bundles/packages etc. For example, Zain KSA was able to increase its ARPU significantly in 2017 by providing value-based offers to help migrate customers from prepaid to post-paid. It thus witnessed more than a 100% growth in post-paid revenues in 2017, which was instrumental in driving up EBITDA by 40%.

**Cost savings/ Margins:** 2017 saw improvement in margins due to a) increasing contribution from data and b) focus on cost optimization. Cost savings areas have included G&A and S&M expenses. However as mentioned by the companies in their analyst conf. calls, as major cost reduction has already likely taken place, there could be lower potential for further cost cutting. The



companies are also witnessing a decline in high margin international calls (~10% of topline). As consumers are getting more and more acquainted with unencrypted VoIP services (which continue to substitute network international calls), we could expect international segment to continue witness erosion in revenues. Moreover, we believe the MTR cuts, which have been in place from Jan 1 (or even if they become nil) are unlikely to cause any material change in the numbers. MTRs, which generally are glided downwards to help the smaller players gain market share, came late into existence when the structure of calling had already become more on-net based.

**Capex:** We believe Zain and Mobily are likely to keep capex at around 15-18% of revenue while their main priorities will be lowering debt. STC on the other hand will look to continue investing at its past rate of capex, at around SAR8.7bn/year, substantially more than its peers and gaining further network advantage. All the three companies have bought spectrum to boost capacity which will increase amortization costs slightly. As we have said in the past, a tower sale depends on the pricing and we do not yet see a lucrative pricing for a sale to take place yet. In the long term, given that Mobily and Zain are trying to deleverage, these two companies may be unable to compete with STC on the onset of a new technological adoption etc. and hence may get preferential regulatory treatment in the future.

**Key drivers of net profit:** Assuming no increase in data prices, operating metrics are mostly likely to remain the same and improvement in net profit will be mainly led by reduction in interest expenses as companies de-lever and reduction in depreciation as capex normalizes. For example, for Mobily, the depreciation in 2017 was around SAR3.2bn while capex was lower at SAR2.1bn, not fully offsetting depreciation. Thus going forward we could see depreciation lower driving up profits.

## Company updates:

**STC:** We find it interesting that STC has been able to increase its EBITDA consistently in the recent few quarters despite a challenging macro, especially considering performance of its peers (beating our and consensus estimates). When we correlate the recent growth achieved with the trend in accounts receivables, we see that both have moved inline, implying that this growth could be related to an increase in allowance for Govt. employees or an increase in enterprise segment revenues – either way STC appears to be the only beneficiary. One of the other reasons for the recent stock rally has been the steady improvement in EBITDA margin. The company has been able to sustain gross margin at ~60% in the past two quarters.

STC also acquired exclusive rights to broadcast Saudi professional soccer matches over 10 years for a SAR6.6bn deal. While details are not available on the financials, we believe it would be reasonable to expect higher return than was being generated previously by investing in marketable securities (we still value it as cash till we get more details).

The company is also actively looking to invest its cash to generate higher return. While it will not affect dividends, these investments could be in start-ups which may not generate cash flows yet and may not benefit our valuations immediately or the near term.



Figure 1 STC Q4 results

(SAR bn)	Q4 2016	Q3 2017	Q4 2017	Y-o-Y	Q-o-Q	ARC est	Comments
Revenue	13,011	12,835	12,494	-4.0%	-2.7%	12,874	Revenue declined sequentially on impact of VoIP, declining subscriber base in the Kingdom and intense competition
Gross profit	7,023.0	7,650	7,588	8.0%	-0.8%	7,660	Gross profit margin improved on cost optimization
Gross margin	54.0%	59.6%	60.7%			59.5%	
Operating profit	1,829	2,954	2,942	60.9%	-0.4%	2,571	Improved gross profit margin led to higher operating profit margin as well
Operating margin	14.1%	23.0%	23.5%			20.0%	
Net profit	2,083	2,621	2,649	27.2%	1.1%	2,352.6	Net profit grew sequentially due to lower other expenses during the quarter
Net margin	16.0%	20.4%	21.2%			18.3%	

Source: Company data, Al Rajhi Capital

**Valuation:** As for valuation metrics, we use a mix of DCF (FCF) and relative valuation (7x EV/EBITDA inline with global avg., revised upwards from 6.5x, historical average). Given stable capital structure and stability in financial performance along with modest growth rates, both valuation methods yield similar valuation estimates. For FCF, we use risk free rate of 3.4% (10 year US Govt. bond yield of 2.8% and 0.6% KSA default spread). Our cost of equity is 11.05% and WACC is 10.56%. Our target price is SAR78.5/sh, average of DCF (SAR74.2/sh) and relative valuation methods (SAR82.7/sh).

**Upside risks:** Inclusion in MSCI EM Index, uptick in data prices, increase in Govt. mobile allowances, gaining more projects in ICT/corporate segment, reduction in cost of early retirement expenses, higher than expected benefit from its new investments, meaningful contribution from FTTH and broadcasting rights of soccer matches, higher than expected dividends.

**Downside risks:** Unfavourable regulations, inability to maintain market share, further price war, inability or long delay to collect its Govt. receivables.



## STC:

Income statement (SARmn)	12/16A	12/17A	12/18E	12/19E	12/20E
Revenue	53,678	51,362	51,485	52,000	52,520
Cost of services	-24,991	-21,807	-22,138	-22,360	-22,583
Gross profit	28,688	29,555	29,346	29,640	29,936
SG&A	-10,659	-10,244	-9,937	-10,036	-10,136
EBITDA	18,029	19,311	19,410	19,604	19,800
D&A	-8,078	-8,207	-8,325	-8,338	-8,522
Operating profit	9,951	11,104	11,085	11,266	11,278
Finance cost	-379	-354	-235	-213	-213
Other expenses (net)	305	382	993	1,408	1,609
Profit before tax	9,877	11,132	11,843	12,460	12,673
Tax	-751	-721	-758	-797	-811
Minority interest	-226	-237	-225	-239	-254
Net profit	8,900	10,174	10,860	11,424	11,608
	12/16A	12/17A	12/18E	12/19E	12/20E
Adjusted Shares Out (mn)	2,000	2,000	2,000	2,000	2,000
CFPS (SAR)	8.80	9.61	9.94	10.19	10.35
EPS (SAR)	4.65	5.39	5.67	5.90	5.96
DPS (SAR)	4.00	4.00	4.25	4.50	4.50
	12/16A	12/17A	12/18E	12/19E	12/20E
<b>Growth</b>					
Revenue Growth	6.0%	-4.3%	0.2%	1.0%	1.0%
EBITDA Growth	-6.6%	7.1%	0.5%	1.0%	1.0%
Operating Profit Growth	-16.1%	11.6%	-0.2%	1.6%	0.1%
Net Profit Growth	0.5%	15.8%	5.3%	4.1%	0.9%
EPS Growth	0.5%	15.8%	5.3%	4.1%	0.9%
	12/16A	12/17A	12/18E	12/19E	12/20E
<b>Margins</b>					
EBITDA margin	33.6%	37.6%	37.7%	37.7%	37.7%
Operating Margin	18.5%	21.6%	21.5%	21.7%	21.5%
Pretax profit margin	19.1%	22.8%	23.9%	24.7%	24.7%
Net profit margin	17.3%	21.0%	22.0%	22.7%	22.7%
	12/16A	12/17A	12/18E	12/19E	12/20E
<b>Other Ratios</b>					
ROCE	14.3%	15.6%	15.4%	15.1%	14.6%
ROIC	27.2%	30.1%	29.5%	29.5%	28.6%
ROE	15.4%	17.6%	17.9%	17.9%	17.4%
Effective Tax Rate	7.3%	6.1%	6.2%	6.2%	6.2%
Capex/Sales	14.2%	13.2%	17.0%	16.0%	15.8%
Dividend Payout Ratio	86.0%	74.3%	75.0%	76.2%	75.5%
	12/16A	12/17A	12/18E	12/19E	12/20E
<b>Valuation Measures</b>					
P/E (x)	16.4	14.2	13.5	12.9	12.8
P/CF (x)	8.7	7.9	7.7	7.5	7.4
P/B (x)	2.5	2.5	2.4	2.3	2.2
EV/Sales (x)	2.5	2.6	2.5	2.5	2.4
EV/EBITDA (x)	7.4	6.9	6.8	6.6	6.4
EV/EBIT (x)	13.4	12.0	11.8	11.5	11.3
EV/IC (x)	3.9	3.8	3.7	3.5	3.4
Dividend Yield	5.2%	5.2%	5.6%	5.9%	5.9%

Source: Company data, Al Rajhi Capital



**Mobily:** Mobily has witnessed some stability in its customer base, which is positive. Not only in customer base, the company has seen relatively stable revenues and EBITDA margins in the past 4 quarters. Given this stability, we now revise our top-line growth for 2018 upwards slightly (from 1% decline in top-line previously) and with most other assumptions remaining unchanged, we slightly increase our TP to SAR13.4/share.

We believe there are some investors finding value in Mobily given that it is trading at book value of 0.77x, which could be one of the reasons why the stock rallied from SAR13 to SAR16, till before the announcement of results. However, if we are to eliminate the goodwill of SAR1.46bn in its Balance sheet (non-existent in other two companies) and factor in recurring losses of around SAR180mn (quarterly) to continue, within a year at the same share price, the Price to adjusted Book would become 0.91x.

**Figure 2 Mobily Q4 results**

(SARmn)	Q4 2016	Q3 2017	Q4 2017	y-o-y	q-o-q	Our est.	Comments
<b>Revenue</b>	<b>2,908</b>	<b>2,806</b>	<b>2,827</b>	<b>-2.8%</b>	<b>0.7%</b>	<b>2,777</b>	Revenue grew despite challenges, supported by stabilization of customer base
Gross Profit	1,671	1,672	1,560	-6.7%	-6.7%	1,650	Margins were likely under pressure on lower international calls and aggressive promotions
Gross margin (%)	57.5%	59.6%	55.2%			59.4%	
<b>EBITDA</b>	<b>954</b>	<b>896</b>	<b>907</b>	<b>-4.9%</b>	<b>1.2%</b>	<b>886</b>	EBITDA margin improved sequentially on cost saving initiatives
EBITDA margin (%)	32.8%	31.9%	32.1%			31.9%	
Interest exp	(162)	(159)	(163)	0.6%	2.6%	(158)	
<b>Net profit</b>	<b>(65)</b>	<b>(174)</b>	<b>(182)</b>	<b>nm</b>	<b>nm</b>	<b>(163)</b>	Net profit was below estimate on lower than expected gross margin
Capex	(1,080)	(426)	(658)	-39.1%	54.3%	(472)	
Zakat	(18)	(15)	(15)	-13.9%	-0.6%	(16)	

Source: Company data, Al Rajhi Capital

**Valuation:** Though key financials could be relatively easy to forecast, valuation is extremely sensitive to WACC estimates which depends on capital structure in the future years as we use dynamic weights for debt and equity. As for valuation metrics, we use a mix of DCF (FCF) and relative valuation (7x EV/EBITDA). For FCF, we use risk free rate of 3.4% (10 year US Govt. bond yield of 2.8% and 0.6% KSA default spread). Our cost of equity is 12.35% while current WACC is 8.4%, which increases to 10.2% as weight of debt decreases. Our target price is SAR13.4/sh, average of DCF (SAR13.6/sh) and relative valuation methods (SAR13.3/sh).

**Upside risks:** Merger with other players, uptick in data prices, stability in consumer base, a value accretive tower sale, favourable regulatory changes.

**Downside risks:** Inability to invest in capex, inability to maintain market share, further price war, inability to extend debt, lower than expected cost savings, writing off of its goodwill or accounts receivables.



## Mobily:

Income statement (SARmn)	12/16A	12/17A	12/18E	12/19E	12/20E
Revenue	12,569	11,351	11,351	11,465	11,694
Cost of services	-5,144	-4,821	-4,745	-4,758	-4,795
Gross profit	7,425	6,530	6,606	6,707	6,900
SG&A	-3,416	-2,918	-2,917	-2,866	-2,924
EBITDA	4,009	3,612	3,689	3,841	3,976
D&A	-3,775	-3,626	-3,514	-3,502	-3,266
Operating profit	235	-14	175	339	710
Finance cost	-556	-678	-677	-635	-590
Other expenses (net)	75	45	65	57	60
Profit before tax	-246	-648	-436	-240	180
Tax	43	-61	-25	-25	-25
Minority interest	-	-	-	-	-
Net profit	-203	-709	-461	-265	155
	12/16A	12/17A	12/18E	12/19E	12/20E
Adjusted Shares Out (mn)	770.0	770.0	770.0	770.0	770.0
CFPS (SAR)	4.64	3.79	3.96	4.20	4.44
EPS (SAR)	(0.26)	(0.92)	(0.60)	(0.34)	0.20
DPS (SAR)	-	-	-	-	-
Growth	12/16A	12/17A	12/18E	12/19E	12/20E
Revenue growth	-12.9%	-9.7%	0.0%	1.0%	2.0%
EBITDA growth	87.2%	-9.9%	2.1%	4.1%	3.5%
Operating profit growth	NA	NA	NA	93.1%	109.6%
Net profit growth	NA	NA	NA	NA	NA
EPS growth	NA	NA	NA	NA	NA
Margins	12/16A	12/17A	12/18E	12/19E	12/20E
Gross profit margin	59.1%	57.5%	58.2%	58.5%	59.0%
EBITDA margin	31.9%	31.8%	32.5%	33.5%	34.0%
Operating Margin	1.9%	-0.1%	1.5%	3.0%	6.1%
Pretax profit margin	-2.0%	-5.7%	-3.8%	-2.1%	1.5%
Net profit margin	-1.6%	-6.2%	-4.1%	-2.3%	1.3%
Other Ratios	12/16A	12/17A	12/18E	12/19E	12/20E
ROCE	1.0%	0.0%	0.7%	1.3%	2.8%
ROIC	0.7%	-0.1%	0.7%	1.5%	2.5%
ROE	-1.3%	-4.9%	-3.3%	-1.9%	1.1%
Effective Tax Rate	17.6%	-9.5%	-5.6%	-10.2%	13.7%
Capex/Sales	44.3%	19.2%	18.0%	17.0%	16.0%
Dividend Payout Ratio	0.0%	0.0%	0.0%	0.0%	0.0%
Valuation Measures	12/16A	12/17A	12/18E	12/19E	12/20E
P/E (x)	na	na	na	na	72.9
P/CF (x)	3.2	3.9	3.7	3.5	3.3
P/B (x)	0.8	0.8	0.8	0.8	0.8
EV/Sales (x)	2.0	2.1	2.1	2.0	1.9
EV/EBITDA (x)	6.3	6.6	6.4	5.9	5.5
EV/EBIT (x)	107.7	na	133.8	67.0	30.6
EV/IC (x)	0.9	0.9	0.9	0.9	0.9
Dividend Yield	0.0%	0.0%	0.0%	0.0%	0.0%

Source: Company data, Al Rajhi Capital



**Zain:** After steadily improving its profits for many quarters, ZainKSA reported weak Q4 earnings despite making its first set of annual profits. The investment rationale for Zain does not differ materially from that of Mobily. The key driver for profits will be increase in data prices. ZainKSA expects its EBITDA margins to be stable in the near-term at current prices. We believe that growth is likely to be similar to that of Mobily's.

Figure 3 Zain Q4 results

(SAR mn)	Q4 2016	Q3 2017	Q4 2017	Y-o-Y	Q-o-Q	ARC est	Comments
Revenue	1,801	1,807	1,716	-4.7%	-5.0%	1,825	Topline declined due to lower subscriber base, and VoIP calls, leading to lower international voice call revenues
Gross profit	1,142	1,231	1,133	-0.8%	-8.0%	1,259	Gross profit margin slipped due to lower international voice calls, which are higher margin
Gross margin	63.4%	68.1%	66.0%			69.0%	
Operating profit	87	229	167	90.5%	-27.2%	237	The decline in operating profit was constrained by lower general & administrative and distribution & marketing expenses
Operating margin	4.9%	12.7%	9.7%			13.0%	
Net profit	(135)	3	(45)	NM	NM	16	Lower operating profit resulted in a net loss for the quarter
Net margin	-7.5%	0.2%	-2.6%			0.9%	

Source: Company data, Al Rajhi Capital

**Valuation:** ZainKSA is more sensitive to changes in WACC than Mobily given its low equity base. For relative valuation, we use 7x EV/EBITDA and for DCF, we use risk free rate of 3.4% (10 year US Govt. bond yield of 2.8% and 0.6% KSA default spread). Our cost of equity is 12.20% while current WACC is 9.36%, which increases to 10.65% as weight of debt decreases. For our WACC calculations, we use the Zain management payables at around SAR1bn as equity. Our target price is SAR7.3/sh, average of DCF (SAR9.3/sh) and relative valuation methods (SAR5.3/sh).

**Upside risks:** Merger with other players, uptick in data prices, stability in consumer base.

**Downside risks:** Inability to invest in capex, inability to maintain market share, further price war, inability to extend debt, lower than expected cost savings.



## Zain:

Income statement (SARmn)	12/16A	12/17A	12/18E	12/19E	12/20E
Revenue	6,927	7,306	7,303	7,376	7,523
Cost of services	-2,526	-2,393	-2,373	-2,360	-2,370
Gross profit	4,401	4,913	4,929	5,015	5,153
SG&A	-2,605	-2,396	-2,403	-2,427	-2,475
EBITDA	1,795	2,517	2,527	2,589	2,678
D&A	-1,850	-1,614	-1,669	-1,667	-1,658
Operating profit	-54	903	858	922	1,020
Finance cost	-953	-910	-890	-865	-842
Other expenses (net)	28	18	17	11	11
Profit before tax	-980	12	-15	69	189
Tax	0	0	0	-2	-5
Minority interest	0	0	0	0	0
Net profit	-980	12	-15	67	184

	12/16A	12/17A	12/18E	12/19E	12/20E
Adjusted Shares Out (mn)	583.7	583.7	583.7	583.7	583.7
CFPS (SAR)	1.49	2.78	2.83	2.97	3.16
EPS (SAR)	(1.68)	0.02	(0.03)	0.12	0.31
DPS (SAR)	-	-	-	-	-

Growth	12/16A	12/17A	12/18E	12/19E	12/20E
Revenue growth	2.7%	5.5%	0.0%	1.0%	2.0%
EBITDA growth	10.2%	40.2%	0.4%	2.5%	3.5%
Operating profit growth	NA	-5.0%	7.5%	10.6%	5.5%
Net profit growth	NA	NA	NA	NA	46.7%

Margins	12/16A	12/17A	12/18E	12/19E	12/20E
Gross profit margin	63.5%	67.2%	67.5%	68.0%	68.5%
EBITDA margin	25.9%	34.5%	34.6%	35.1%	35.6%
Operating Margin	-0.8%	12.4%	11.8%	12.5%	13.6%
Pretax profit margin	-14.1%	0.2%	-0.2%	0.9%	2.5%
Net profit margin	-14.1%	0.2%	-0.2%	0.9%	2.4%

Other Ratios	12/16A	12/17A	12/18E	12/19E	12/20E
ROCE	-0.3%	6.3%	6.1%	5.0%	5.7%
ROIC	-0.4%	6.2%	6.5%	6.9%	8.0%
ROE	-24.1%	0.3%	-0.4%	1.9%	5.0%
Effective Tax Rate	0.0%	0.0%	0.0%	2.5%	2.5%
Capex/Sales	29.0%	21.3%	18.0%	17.0%	16.0%
Dividend Payout Ratio	0.0%	0.0%	0.0%	0.0%	0.0%

Valuation Measures	12/16A	12/17A	12/18E	12/19E	12/20E
P/E (x)	na	351.6	na	60.4	22.1
P/CF (x)	4.7	2.5	2.5	2.3	2.2
P/B (x)	1.1	1.1	1.1	1.1	1.1
EV/Sales (x)	2.2	1.9	1.8	1.8	1.6
EV/EBITDA (x)	8.4	5.5	5.3	5.0	4.6
EV/EBIT (x)	na	15.3	15.7	14.0	12.0
EV/IC (x)	1.0	1.0	1.0	1.0	1.0
Dividend Yield	0.0%	0.0%	0.0%	0.0%	0.0%

Source: Company data, Al Rajhi Capital





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### Contact us

**Mazen AlSudairi**  
Head of Research  
Tel : +966 1 211 9449  
Email: [alsudairim@alrajhi-capital.com](mailto:alsudairim@alrajhi-capital.com)

**Al Rajhi Capital**  
Research Department  
Head Office, King Fahad Road  
P.O. Box 5561, Riyadh 11432  
Kingdom of Saudi Arabia  
Email: [research@alrajhi-capital.com](mailto:research@alrajhi-capital.com)

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