Saudi Telecom

Telecom – Industrial
STC AB: Saudi Arabia
01 August 2018

Al Rajhi Capital الراجحي المالية

US$46.13bn	16%	US$6.04mn
Market cap	Free float	Avg. daily volume

Target price	78.50	-9.2% over current
Current price	86.50	as at 31/7/2018

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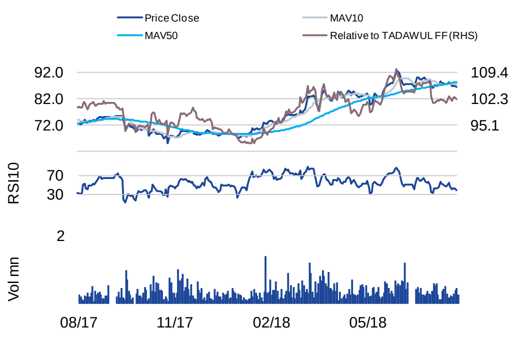
Existing rating

Underweight	Neutral	Overweight

Performance



Source: Bloomberg

Earnings

(SAR mn)	2017e	2018e	2019e
Revenue	51,362	50,712	51,219
Y-o-Y	-4.3%	-1.3%	1.0%
Gross Profit	29,555	27,892	28,683
Gross margin	57.5%	55.0%	56.0%
EBITDA	19,311	18,104	18,797
EBITDA margin	37.6%	35.7%	36.7%
Net profit	10,174	9,183	10,666
EPS (SAR)	5.09	4.59	5.33
DPS (SAR)	4.00	4.25	4.50
EV/EBITDA (Curr)	7.0	7.5	7.2
EV/EBITDA (Target)	6.7	7.1	6.9

Source: Company data, Al Rajhi Capital

Saudi Telecom Co. (STC AB)

Q2 miss, but immaterial to valuations. Maintain TP at SAR78.5/sh

STC reported overall Q2 results below our expectations with net income coming at ~SAR2.44bn vs our ~SAR2.7bn estimate. Given the uneven trends in historical revenue and costs, our focus is on EBITDA, which came slightly below our expectation but was in-line with historical average, implying steady performance despite weakness in consumer spending. Our higher expectation was hinged on higher data usage due to World cup football season. Based on flattish EBITDA forecasts for the year ahead and a gradual 2% improvement thereafter, we arrive at a target price of SAR78.5/sh (equal mix of EV/EBITDA and FCF). Upside risk factors are improved receivables position, higher than expected DPS, realized profits from investments and lower than expected capex while downside risks are related to weaker than expected consumer telecom spending, regulatory fines and price wars.

Q2 results miss. Overall in Q2, the numbers were slightly lower than what we expected across all line items (see table below). Given lack of sufficient disclosures, our main proxy for performance is average quarterly EBITDA (taken on a semi-annual basis). Q2 EBITDA at SAR4.7bn remained largely in-line with historical average EBITDA of ~SAR4.6bn per quarter. Despite some weakness in consumer segment, the company has largely maintained its margins steady via various cost initiatives, which has been a common theme among most Govt. controlled entities. We expect the company to clock an quarterly average EBITDA of ~SAR4.7bn in 2019 and gradually improve by 2% thereafter. There have been only 3 instances when EBITDA declined below ~SAR4.6bn in the past 14 quarters. While in Q1 the company reported no early retirement expenses, in Q2 the company reported SAR150mn expenses for early retirement. On the other hand, it had other income of SAR135mn in Q1, whereas this quarter had other expenses of ~SAR91mn, highlighting the volatility in net profit.

Working capital: We do not factor in any settlement from receivables (SAR20bn, but SAR7bn post offsetting payables, mostly from and to the Govt. respectively) and thereby expect no improvement in working capital in our FCF model. Prepaid expenses surged to ~SAR13bn from SAR8.2bn last quarter but we believe this is related to contractual costs for capex and could lower cash payments for expenses in the coming quarters.

Figure 1 STC Q2 2018 results

(SAR bn)	Q2 2017	Q1 2018	Q2 2018	Y-o-Y	Q-o-Q	ARC est
Revenue	**13,041**	**12,386**	**13,182**	**1.1%**	**6.4%**	**12,807**
Gross profit	6,911	6,997	7,112	2.9%	1.6%	7,300
Gross margin	53.0%	56.5%	54.0%			57.0%
Operating profit	2,584	2,632	2,901	12.3%	10.2%	2,761
Operating margin	19.8%	21.3%	22.0%			21.6%
Net profit	**2,356**	**2,588**	**2,444**	**3.7%**	**-5.5%**	**2,709**
Net margin	18.1%	20.9%	18.5%			21.1%

Source: Company data, Al Rajhi Capital

Tower company in the works: During Q1, STC established Etisalat Towers Company with a capital of SAR200mn. The company will be responsible for owning, constructing, operating, leasing and investing in land, as per 2017 Board report. The company is still under construction. This comes after early announcements between Mobily and STC in creating a company for tower management and is a positive step in our view.

Valuation: Overall, we value the company on an equal mix of FCF (SAR76/sh) and EV/EBITDA basis (7x, implying SAR81/sh) and arrive at a target price of SAR78.5/share. Currently the implied TTM EV/EBITDA is at ~8.4x as compared to global peers of ~7.1x, mainly as STC has been buoyed because of being one the key inclusions in MSCI, FTSE emerging market indices. We maintain our Neutral rating on the stock.

Upside risk factors are improved receivables position, higher than expected DPS, realized profits from investments and lower than expected capex while downside risks are related to weaker than expected consumer telecom spending, regulatory fines and price wars.

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"Neutral": We expect the share price to settle at a level between 10% below the current share price and 10% above the current share price on a 12 month time horizon.

"Underweight": Our target price is more than 10% below the current share price, and we expect the share price to reach the target on a 12 month time horizon.

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