


US\$58.45bn

Market cap

16%

Free float

US\$41.63mn

Avg. daily volume

Target price
97.0

-9.5% over current

Current price
107.2

as at 4/8/2019

Research Department

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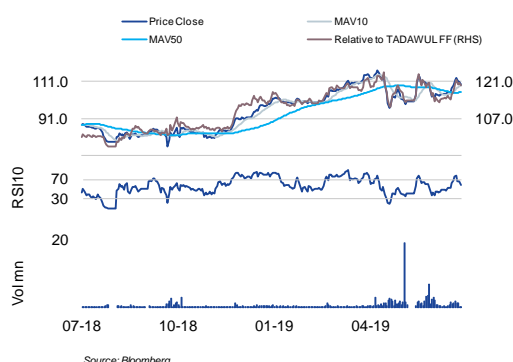
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Existing rating

Underweight

Neutral

Overweight

Performance

Earnings

(SAR mn)	2018	2019e	2020e
Revenue	52,068	54,255	56,479
Y-o-Y	2.7%	4.2%	4.1%
Gross Profit	30,565	32,282	33,436
Gross margin	58.7%	59.5%	59.2%
EBITDA	19,857	21,865	22,535
EBITDA margin	38.1%	40.3%	39.9%
Net profit	10,790	11,255	12,039
EPS (SAR)	5.40	5.63	6.02
DPS (SAR)	6.00	5.00	5.00
EV/EBITDA (Curr)	10.3	9.4	9.1
EV/EBITDA (Target)	9.9	9.0	8.8

Source: Company data, Al Rajhi Capital

STC

Improved metrics but expensive valuations

In Q2 19, STC reported revenue and profit that came 3% and 6% above our estimates. Even after no major benefit from change in royalty fees, the company reported improved gross profit margins, due to IFRS 16 where leasing costs have moved below cost of sales. Nonetheless, the company reported SAR2.8bn net profit, which was up 17% y-o-y and 4% q-o-q even with impairment loss (receivables) of SAR225mn and higher than usual cost of early retirement of SAR216mn. These extraordinary costs give the company ability to offset lower gross margin in weak quarters as we have seen in the past. Moreover after reporting losses from equity investment in the last two quarters, the company has seen SAR79mn profits, boosting bottom line. We continue valuing the company based on average of EV/EBITDA (at 7.5x, higher than peers, on account of STC being included in MSCI EM index) and DCF based valuations and arrive at a TP of SAR97/sh. (up from SAR93/sh.) with Neutral rating.

Q2 telecom sector round up: Telecom sector revenues in Q2 have improved on a q-o-q basis despite Ramadan seasonality. ARPU has also been improving gradually. Zain and Mobily attribute this improvement to improved performance across all segments. We believe one of the key reasons for this could be pickup in post-paid subscriptions which generally are of higher value. Data from CITC shows that while prepaid subscribers have declined slightly in Q1 (vs. 2018), postpaid has seen a 10% increase during the same period. Moreover, for the first time in many quarters we have seen number of expats increase in Q1, which bodes well for the sector. Overall the sentiments are positive than before in our view.

Figure 1 STC Q2 2019 results

	2Q19	1Q19	2Q18	y-o-y	q-o-q	ARC	vs ARC
Revenue	13,604	13,386	13,079	4%	2%	13,182	3%
COGS	5,397	5,483	5,912	-9%	-2%	5,470	-1%
Gross Profit	8,207	7,903	7,167	15%	4%	7,712	6%
G. Margin	60%	59%	55%			59%	
Op. costs	4,730	4,628	4,266	11%	2%	4,437	7%
Op. profit	3,477	3,275	2,901	20%	6%	3,275	6%
Op. margin	26%	24%	22%			25%	
Interest, tax	629	525	457	38%	20%	579	9%
Net profit	2,848	2,750	2,444	17%	4%	2,696	6%

Source: Company data, Al Rajhi Capital

Valuation and risks: Given improved metrics, we raise our revenue estimates upward. Our DCF model based on 2% terminal growth rate, 11.25% cost of equity gives us a fair value of SAR98.6/share and EV/EBITDA valuation method gives us SAR95.2/share, based on 7.5x multiple. We take an average of this to arrive at our target price of SAR97/share.

Upside risks to our valuation are, increase in data prices, more benign competition, lower capex spends, meaningful contributions from other investments. **Downside risks** are impairment of receivables, higher than expected capex, further decline in prices, write down of goodwill, unfavourable decision on pending litigations and increase in SAIBOR. Once MSCI EM inclusion factor is off the table, we could see downward revision in EV/EBITDA multiple used by the market (may reduce to 6x from currently 7.5x). Based on this, our fair valuation could drop significantly.



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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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