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Al Rajhi Capital

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KSA Telecoms

Valuation factors in optimistic outlook

Key themes

Growth higher than expected previously while margins may be marginally lower

Fintech and initiatives to increase costs

5G investments to increase capex. We expect no special dividends for STC in 2019 & 2020

What do we think?

Stock	Rating	Price Target
STC	Underweight	SAR91.0
Mobily	Neutral	SAR24.0
ZainKSA	Neutral	SAR13.0

The telecom sector in Saudi Arabia witnessed a healthy performance in 2019 so far. In terms of revenue YTD, STC was up 6% y-o-y while Mobily was up 14% y-o-y and Zain KSA up 12% y-o-y, mainly led by low base, improved ICT/business segment and improvement in ARPU. Going into Q4 2019 and 2020, there are reasons to be optimistic as there is now stability in number of expats, higher number of business/tourist visitors expected, increased business activities locally, further growth expected in business segment and increase in prices. On the other hand, investment in 5G in 2020 could mean higher costs & capex. This implies STC is unlikely to pay special dividends in 2019/2020 if it does not receive payment for receivables. While Zain is aggressive on 5G, we believe Mobily is likely to focus on debt repayments. We present the key trends in the space. Our target price for STC is SAR91/share based on equal mix of DCF and 7.5x EV/EBITDA multiple. For Mobily and Zain based on valuation multiple of 6x and 6.3x respectively, we arrive at target prices of SAR24/sh and SAR13/sh respectively.

Key trends in the Saudi telecom space

1. In 2018, after declining by 1.3mn, expat population stabilized in 2019 (till Sep) with a decline of only ~90k. This bodes well for Mobily and Zain as we believe they were the ones most impacted by declining expat population in the past.

2. Not only the expat subscribers, we are seeing increased local market activity and tourism as well. There was a 5% y-o-y increase in hajj pilgrims in 2019 and we expect this to continue to grow by high single digits in 2020.

3. There are reasons for us to believe that ARPU could improve as we see introduction of a host of new dynamic plans and newer packages with higher value/prices. For example, STC's Sawa Flex at SAR90 (8GB) is a significantly better value proposition than Sawa Like at SAR65 (2GB). Prices of multiple post-paid packages have increased too. There is also a trend of pre-paid to post-paid migration which would boost ARPU.

4. FTTX is picking up, though it may not be material to the sector as a whole because a large part of FTTX is replacing ADSL + Fixed Wireless subscriptions. In 1H 2019, the number of FTTX subscribers have increased by 170k subs while ADSL+Fixed wireless declined by 90k subs. However, with new mortgage/homes demand pick up, this could further have impetus. We expect around 0.19mn homes to be constructed in the next three years annually.

5. Users are migrating from dedicated data devices to data packages on smartphones which could incentivize increased calling.

6. 5G is in the very early stages with increased investment to be seen in 2020. At the moment, given improving 4G data download speeds, there may not be a pressing need for 5G. The focus will be more on corporate than retail segment for 5G.

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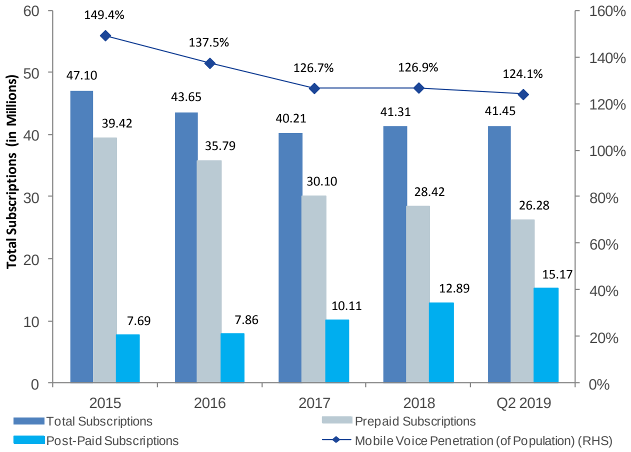
7. As per our discussions with companies, there is a minor royalty fee benefit post the revised calculation for STC and Zain (we have quantified it at around SAR115mn/quarter as per our assumptions for Zain) while Mobily's costs have increased but mitigated through better top-line performance.

8. ICT services (cloud, security etc.) are driving the majority of growth for STC in our view. Mobily has outperformed the rest which could be attributed to this and strong consumer segment performance in Hajj. Mobile/broadband penetration remains stable which is broadly as expected given the saturated state of market. Fintech and other initiatives are being pursued by all the companies though we do not believe that it could materially change the outlook at least in the near to medium term. At the moment we believe STC Pay could be burning cash to increase its subscriber base.

9. Pre-paid to post –paid migration may mean higher receivables/provisions going forward but the net effect should be offset by higher ARPU.

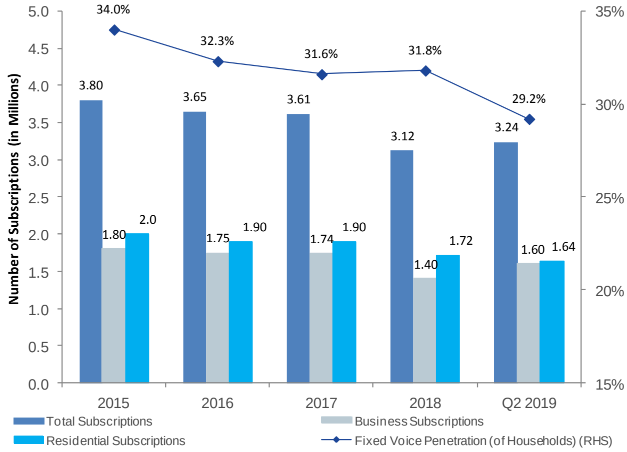
10. We believe the tower deal is not completely off the table. As per our understanding CITC is reviewing its policies currently, post which we could again see some developments.

Figure 1 Mobile Voice Telecommunications Services



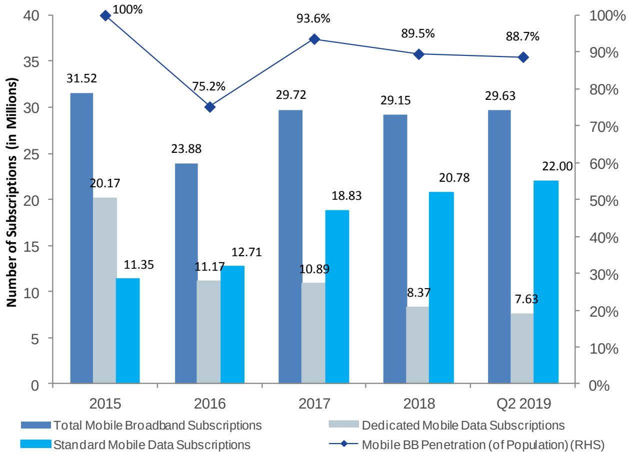
Source: CITC, Al Rajhi Capital

Figure 2 Fixed Voice Telecommunications Services



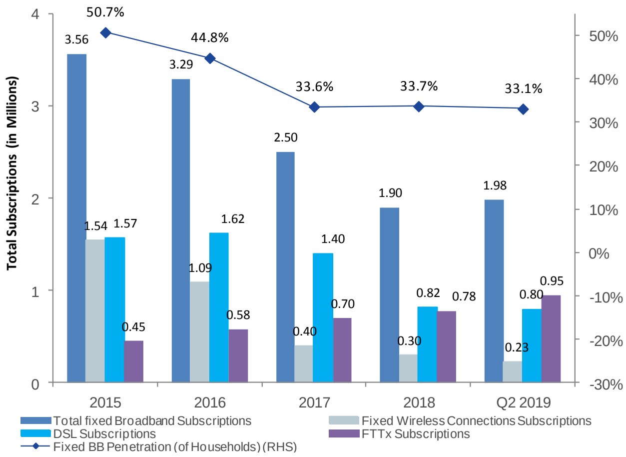
Source: CITC, Al Rajhi Capital

Figure 3 Mobile Broadband Services



Source: CITC, Al Rajhi Capital

Figure 4 Fixed Broadband Services



Source: CITC, Al Rajhi Capital

STC

Special dividends unlikely in 2019/20

(SAR mn)	2018	2019e	2020e	2021e
Revenue	52,068	55,505	58,280	60,028
Y-o-Y	2.7%	6.6%	5.0%	3.0%
Gross Profit	30,565	32,193	32,928	34,816
Gross margin	58.7%	58.0%	56.5%	58.0%
EBITDA	19,857	21,647	21,738	23,291
EBITDA margin	38.1%	39.0%	37.3%	38.8%
Net profit	10,790	11,082	11,855	12,685
EPS (SAR)	5.40	5.54	5.93	6.34
DPS (SAR)	6.00	4.00	4.00	5.00
EV/EBITDA	9.4	8.6	8.6	8.0
P/E	17.2	16.8	15.7	14.7

We factor increased ARPU given newer packages and marginal improvement in subscribers in 2020. There is likely to be continued support from STC solutions and enterprise segment which have performed well. 5G will be in focus in 2020 as per the company by tapping into corporate segment.

There has been some **shuffling in reporting costs due to IFRS16** in Q3 because we saw increase in cogs offset by decrease in depreciation and finance costs (part reversal of that we saw in Q1). Excluding the impact of this, the margins (gross and operating) were in-line with our expectations and the previous two quarters. We forecast EBITDA margins to remain slightly lower at around 38% for 2020 because of expected increase in costs due to STC Pay and 5G related expenditure however there are likely to be no changes in termination rates and royalty fees. As for STC pay, the company is offering discounts and seeing increased expenditure to attract new clients.

We forecast **retirement expenses** at SAR450mn annually for 2020 and 2021. As per our understanding the average age of the employees in the company is still high and would need to reduce before we see this item reducing meaningfully.

Receivables from government continue to be increasing which is at SAR16.6bn now (from SAR12.3bn at the 2018 end) and after adjusting with accounts payables it is SAR14.7bn. Given the history of delays, we do not expect a quick resolution. For example, 9M sales to Govt. was SAR5bn but increase in receivables was SAR4.3bn. **Overall receivables have also been increasing**, possibly partly explained by higher enterprise revenues and migration to postpaid to a lesser extent.

The company paid SAR4 ordinary dividends + SAR2 special dividends last year. However the company is likely to increase capex from 13% of sales to 20% of sales in 2020, which equates to c.SAR2/share. Thus, we believe **dividends could be limited to SAR4/share** for 2019 and 2020 as well unless it resolves the huge receivables from Govt. Also, the company has already used cash raised from sukuk issuance (SAR5bn) and sale of investments (SAR7bn) for paying dividends in past and thus there is limited scope for any upside surprise in future dividend payments.

Moreover, the company has approved purchase of **additional 39% stake in Virgin Mobile Saudi Arabia** for SAR151mn. The legal and regulatory procedures concerning the transaction are expected to be completed during 2019. Upon completing the transaction, Saudi Telecom Group's share in Virgin Mobile Saudi Arabia shall increase to 49%.

Further, the associate line will be mainly driven by STC Asia (Maxis). However, given the complex number of associates, we forecast an immaterial contribution from associates annually overall.

On 26 March 2019, Uber Technologies signed an assets purchase agreement with Careem (associate accounted for using the equity method and the Group holds 8.83% stake) to acquire the net assets of Careem for about US$3.1bn subject to modifications. The total consideration for the agreement consists of the following: 1) About US$ 1.7bn of unsecured, interest-free convertible bonds. 2) About US$1.4bn in cash. The deal is expected to be completed and final impact recorded upon completion of the regulatory procedures. Accordingly, the Group's investment in Careem has been reclassified as assets held for sale as at 30 September 2019. Based on pro-rata stake, the company is expected to receive SAR565mn in convertible bonds and 450mn as cash. With book value at SAR267mn, there is **expected to be a gain of SAR750mn**. The transaction is in its final stages of getting clearance from competition boards and once resolved this could be an upside trigger for the stock.

Valuation: STC's strength lies in is its highly defensive high ARPU postpaid heavy Saudi subscriber base and deep pockets. While we revise our top line growth higher, we lower margins slightly. However, our main concern is that the receivables continue to increase. Our DCF model based on 2% terminal growth rate, 9.8% cost of equity gives us a fair value of SAR93.1/share and EV/EBITDA valuation method gives us SAR88.4/share, based on 7.5x multiple. We take an average of these to arrive at our target price of SAR91/share (prev. SAR97/share), which implies underweight rating.

Other **upside risks** to our valuation are, increase in data prices, more benign competition, lower than expected capex spends, payment from Government for receivables, meaningful contributions from other investments, cash from asset/land sales, higher efficiency driving up margins, further material traction in fintech boosting cash flows. **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.

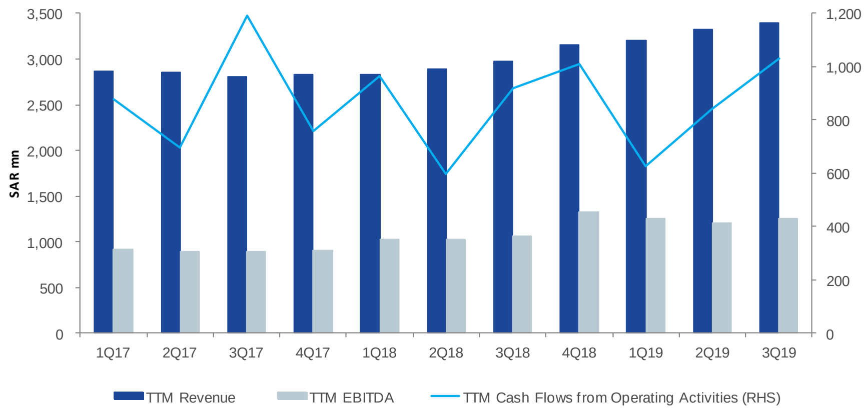
(SARmn)	2018	2019e	2020e	2021e
Revenue	11,865	13,407	14,212	14,638
Y-o-Y	4.5%	13.0%	6.0%	3.0%
Gross profit	6,582	7,850	8,243	8,490
Gross margin	55.5%	58.6%	58.0%	58.0%
EBITDA	4,437	5,004	5,180	5,296
EBITDA margin	37.4%	37.3%	36.4%	36.2%
Net profit	(123)	196	334	386
EPS (SAR)	-0.16	0.25	0.43	0.50
DPS (SAR)	0	0	0	0
EV/ EBITDA	7.6	6.8	6.5	6.4
P/E	-159.1	99.5	58.5	50.6

Mobily

Improved growth; Focus on debt repayment

The strong growth in consumer segment is a surprise relative to both STC's and Zain's mobile segment performance especially in Q3. The company reported healthy growth across all segments, which is positive. On the other hand, the operating cash flow on a last 12 months average basis has remained broadly flat which does not give us enough confidence about the quality of growth seen in 2019. We expect broadly industry inline growth to continue in 2020.

Figure 5 Operating cash flows have not seen as much improvement as revenues or EBITDA



Source: Company data, Al Rajhi Capital

Assuming SAR3.4bn cash flows from operations and capex at around SAR2bn, it would enable the company to lower debt to reasonable leverage levels (33% D/A) only by 3 years. Thus we do not expect dividends for another 3 years.

The company is investing in 5G but at a slower pace of adoption as compared to Zain/STC in terms of coverage, which may imply the need to have a higher capex in the future years. Thus we believe the company is focussed on repayment of debt to lower leverage ratios. Capex on spectrum acquisition is mostly done in our view.

The company recently renewed its financing contracts which may result in some higher one-off interest expenses in the immediate quarter but lower the recurring interest expenses.

The company has not just SAR12.4bn of debt but accounts payable and accrued expenses of SAR8bn. The accounts receivables are mostly related to fiber optic revenue in our view.

Our 1 year forward looking target price for the company is arrived using only EV/EBITDA is SAR24/share (and previously SAR22.5/share) based on 6x multiple, which is slightly higher than the last two years average multiple based on Bloomberg data. This is because the DCF is very susceptible to changes in WACC and leverage ratios. Based on our TP we have a Neutral rating. Upside risks to our valuation are increase in data prices, faster than expected top-line growth and lower capex spends. 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.

ZainKSA

Betting on 5G; Rights issue positive trigger

(SARmn)	2018	2019e	2020e	2021e
Revenue	7,531	8,208	8,619	8,877
Y-o-Y	3.1%	9.0%	5.0%	3.0%
Gross profit	5,425	6,033	6,335	6,525
Gross margin	72.0%	73.5%	73.5%	73.5%
EBITDA	3,009	3,833	3,951	4,084
EBITDA margin	40.0%	46.7%	45.8%	46.0%
Net profit	332	525	615	785
EPS (SAR)	0.57	0.90	1.05	1.31
DPS (SAR)	0	0	0	0
EV/EBITDA	8.3	6.5	6.3	6.1
P/E	20.6	13.0	11.1	8.9

We resume our coverage on ZainKSA after our Shariah board has re-categorized it as Shariah.

Zain is trying to get a lead on 5G by early deployment of 5G infrastructure. The company has the widest coverage of 5G in KSA. The success of this strategy would depend on global adoption of 5G devices and may prove to be a game changer if 5G devices and sentiments pick up, which could help the company gain market share. As per the company, 5G transition plan was a key strategic move and long planned, including obtaining the right frequencies of bandwidth for the investment. As a result of the early preparation the company believes the capex/sales is still not very high. Already, we note that Zain has been aggressive on 5G pricing to gain the lead in market share. The company would face competition from STC from 2020 in our view.

However, in terms of operating performance, excluding the approx. SAR115mn non-cash reversal of royalty provisions each quarter till 2022, the company has an annual run rate of only SAR65mn profits. Given that 5G requires heavy investments, it would be interesting to see how the company can keep investing while managing its debt ratios.

Topline growth was decent in the first half though the Hajj season revenues were lower than expected. We continue to see slightly lower EBITDA margins post increased promotional activity to gain subscribers and higher costs due to transition to 5G.

The upcoming right issue will have a positive impact on the balance sheet as it will reduce the debt levels and increase the equity which will lead to a better leverage ratio such as D/E ratio in future. With an improved balance sheet in terms of lower debt the interest expense will reduce in future and hence profitability will increase. From a standpoint of an individual shareholder, net worth today and after rights issue is unlikely to change materially.

Our 1 year forward looking target price for the company is arrived using only EV/EBITDA (and not DCF) SAR13/share, based on 6.3x multiple. This is because the DCF is very susceptible to changes in WACC. Based on our target price, we have a Neutral rating.

Upside risks to our valuation are faster adoption of 5G, successful rights issue with substantial cash infusion, increase in data prices, faster than expected top-line growth and lower capex spends, waiver from Zakat liabilities. Downside risks are impairment of receivables, higher than expected capex, further decline in prices, increase in SAIBOR.

Figure 6 Adjusted EV/EBITDA (GCC)

Company Name	2014	2015	2016	2017	2018	2019*
Saudi Telecom Company	6.4x	6.6x	7.4x	6.9x	8.4x	8.4x
Etihad Etisalat Company	16.0x	11.7x	8.1x	6.7x	5.2x	5.2x
Zain KSA	15.7x	9.2x	8.9x	5.6x	4.5x	4.5x
Emirates Telecom Group Co	5.8x	7.6x	8.6x	8.5x	7.7x	7.7x
Emirates Integrated Telecomm	4.2x	3.9x	4.8x	6.7x	5.8x	5.8x
Bahrain Telecom Co	4.3x	4.7x	4.3x	3.7x	4.1x	4.1x
Zain Bahrain Bscc	NA	NA	NA	NA	1.4x	1.4x
Ooredoo Qpsc	6.1x	4.4x	5.0x	4.4x	4.4x	4.4x
Vodafone Qatar	22.5x	26.3x	27.9x	14.4x	10.8x	10.8x
Mobile Telecommunications Co	5.3x	4.3x	5.1x	6.4x	6.6x	6.6x
National Mobile Telecommuni	4.0x	3.2x	3.5x	2.8x	2.5x	2.5x
Viva Kuwait Telecom Co	NA	NA	NA	5.4x	4.5x	4.5x
Oman Telecommunications Co	5.5x	4.6x	4.4x	15.6x	5.6x	5.6x
Ooredoo	4.5x	4.2x	3.6x	3.1x	2.9x	2.9x
Average	**8.4x**	**7.6x**	**7.6x**	**7.1x**	**5.7x**	**5.7x**
Median	**5.6x**	**4.7x**	**5.1x**	**6.5x**	**5.4x**	**5.4x**

Source: Bloomberg, Al Rajhi Capital

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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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