الجزيرة كابيتال
ALJAZIRA CAPITAL الجزيرة للأسواق المالية

KSA Telecom Sector Report

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Executive summary

The global telecom industry has changed significantly over the past few years with the development of new technologies and addition of new revenue streams. In the Kingdom of Saudi Arabia (KSA), the telecom market started expanding soon after liberalization in 2003. Since then, with the entry of foreign investment and government support, KSA has built an extremely competitive telecom market. The market is currently dominated by three players holding unified licenses: Saudi Telecom Company (STC), Etihad Etisalat Company (Mobily), and Mobile Telecommunication Company Saudi Arabia (Zain KSA). The market also hosts other Internet service providers (ISPs), mobile virtual network operators (MVNOs), and fixed-line service providers. The government has played a vital role in developing a transparent, competitive market that keeps up with advanced technologies and infrastructure.

- **Industry dynamics suggest great potential for revenue growth:** KSA is the most populous nation in the GCC region, with the majority of the population comprising young people. With the increasing use of technology, there is growing demand for information communication technology (ICT) services. We see telecom companies drawing a large share of their top line from high-value services, which should boost their ARPUs. Operators are also focused on expanding postpaid subscribers base and corporate clients, thus strengthening the case for ARPU accretion.
- **5G deployment crucial for the sector:** KSA had a head start with the launch of 5G in 2019 and is among the few quick adopters of the technology worldwide. With strong government backing, KSA should continue to lead the regional market in the near term. 5G provides great growth opportunity for telecom players to diversify services. Initial trends in some of the more advanced markets suggest growth in ARPU. However, to tap these opportunities, telecom companies need to invest large amounts in expanding 5G coverage and successfully transitioning their customer base to the technology.
- **Regulators in favor of increasing competition, advanced infrastructure:** The Communications and Information Technology Commission (CITC) and the Ministry of Communications and Information Technology (MCIT) have consistently supported competition in the sector and infrastructure development. This policy of the regulators clearly reflects in decisions such as the issuance of unified licenses, reduction in call termination charges, and settlement of royalty fees against investment in infrastructure from operators.
- **Lucrative future opportunities:** The KSA government is keen on developing a globally competitive economy under the Vision 2030. The government plans to construct future-ready smart cities possessing advanced infrastructure to cater to new communication technologies, thus providing attractive prospects for ICT service providers. Telecom companies are also venturing into related services, such as payment platforms (STC Pay), Internet protocol television (IPTV), content broadcasting, and OTT media.

Outlook

Long term, we have a positive outlook on KSA's telecom sector, which, we believe, has a lot to offer in future. A high proportion of tech-savvy young population is expected to drive data consumption growth. We also believe that digitization and an effective regulatory system, along with data growth are key drivers of investment in the sector. STC and Zain KSA have deployed 5G, and hence, are in better positions to take advantage of growth opportunities in the sector. STC is our top pick due to its dominant market position, sound financials, and continuous investment in 5G technology. We are also positive on Zain KSA; the proposed capital restructuring to improve balance sheet strength and reduce finance charges.

Table 1. Price target and recommendation

Company Name	Recommendation	PT (SAR/share)	Upside/ (Downside)
STC	**Overweight**	97.4	5.1%
Mobily	**Neutral**	22.1	-13.3%
Zain KSA	**Overweight**	15.4	42.6%

*prices as of 9th April 2020
Source: Bloomberg, AJC Research

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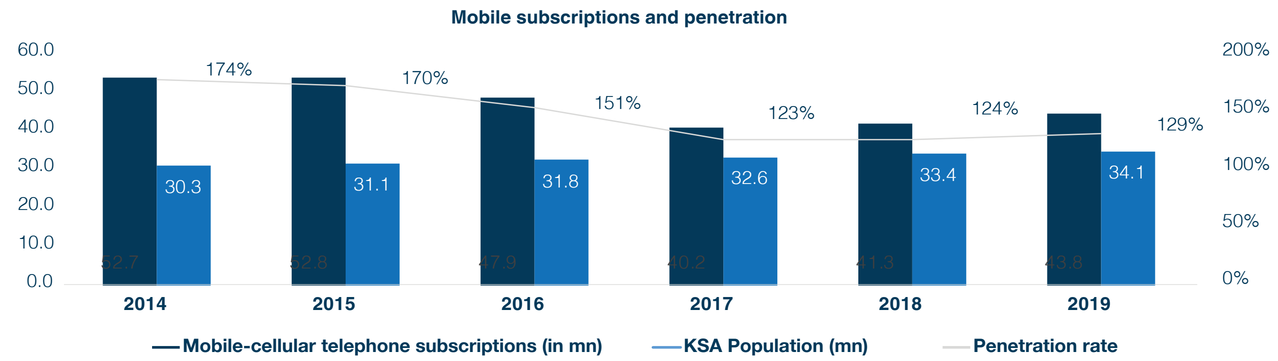
KSA telecom industry trends support ARPU accretion

KSA is currently the largest ICT market in the Middle East, with a mobile subscriber base of 43.8mn (+6% Y/Y) in 2019. Recent trends in the industry reveal an opportunity to expand ARPU in the long run for the three big telecom operators: STC, Mobily, and Zain KSA. Subscriptions continued to grow for the second consecutive year after declining for two years (2016-17) due to the implementation of the SIM authentication program. Penetration level also rose to 129% of the total population from 124% in 2018. Additionally, improved Internet accessibility, demographic advantage, and an increase in the demand for high-value services are likely to boost the top line of telecom operators.

Figure 1. Mobile subscriptions and penetration levels

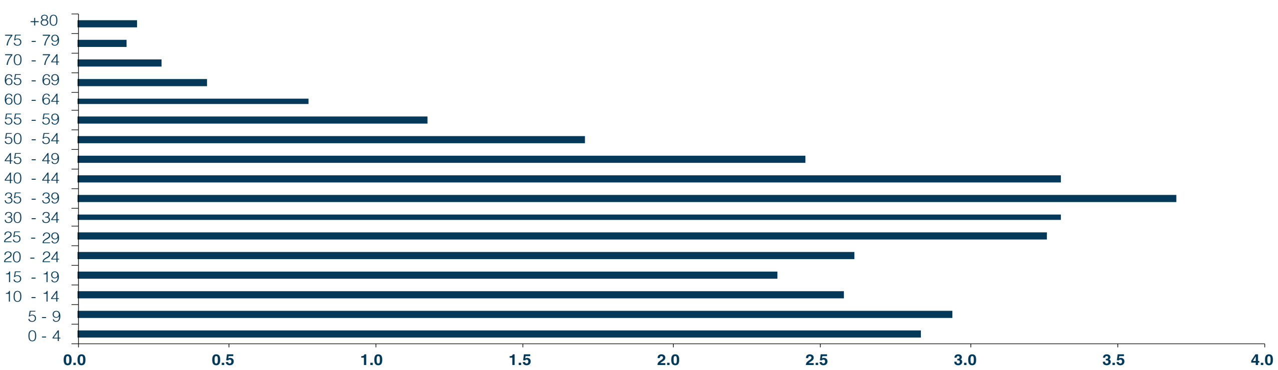


Source: International Telecommunication Union (ITU), IMF, Aljazira Capital Research

Data usage growth inevitable

As per the CITC, 93% of the population in KSA has access to the Internet versus the global average of 53%. Moreover, with a rising percentage of the population using smartphones, the improvement in service quality provided by operators, and technology and infrastructure upgrades, the number of Internet users is bound to further increase. Additionally, KSA's demographic structure – with ~69% of the population aged below 40 – suggests a future rise in the demand for ICT services. The recent stability in the number of expatriates (earlier affected by the announcement of expat fees) should also support this demand.

Figure 2. Age-group wise population



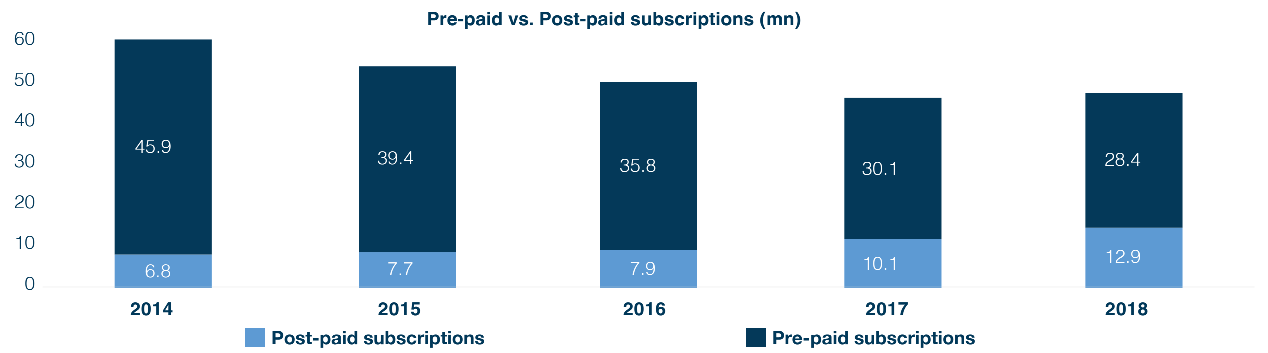
Source: GASTAT

Operators target high-value services and post-paid subscribers

In KSA, telecom operators are strategizing to make the most of the available opportunities. The three major telecom players are investing substantially to upgrade network infrastructure and technology to provide high-quality services. As part of the same strategy, these operators are focusing on the enterprise solutions segment, where the demand for ICT solutions is increasing due to the Saudi government's digitization drive. The government is attempting to diversify the economy, in line with the Saudi Vision 2030. We believe the higher contribution from the enterprise solutions business would benefit telecom companies in terms of better margins.

STC – as part of its initiative DARE (Digitalize STC, Accelerate core assist performance, Reinvent customer experience at world-class standards, and Expand aggressively scale and scope) – continues to focus on growing the enterprise solutions business. The company signed more than 25 agreements with several global IT firms, such as Cisco, Ericsson, Huawei, and Nokia, in October 2019. Recently, in January 2020, Mobily also joined with Ericsson to accelerate the deployment of digital services and expand the provision of IoT solutions. Zain KSA aims to launch a public cloud service in the country in association with Alibaba Group subsidiary Whale Cloud. We believe, STC and Zain KSA, with their launch of 5G services in 2019 and plans to expand 5G coverage in 2020, hold an advantage over Mobily.

Figure 3. Pre-paid versus post-paid subscriptions (mn)



Source: Fitch Solutions

Telecom companies are concentrating on expanding their post-paid subscriber base, which has traditionally been providing higher ARPUs. There has been consistent growth in the number of post-paid subscribers, which clocked a CAGR of 17.4% during 2014-18, reaching 12.9mn. Meanwhile, STC, Mobily and Zain KSA continue to provide pre-paid services, but the pre-paid subscribers' number decreased from 45.9mn in 2014 to 28.4mn in 2018.

If this trend continues, mobile operators would continue to draw a higher proportion of their revenues from post-paid customers, and thereby benefit from improved ARPUs and better margins.

5G technology: Good start, but a long way to go

In the Middle East and Africa (MEA) region, 5G subscriptions are expected to increase to 30mn by the end of 2024, according to the Ericsson Mobility Report (September 2019). Most of the growth in subscriber numbers in the Middle East is expected from countries like KSA, the UAE and Qatar, which are ahead of their peers in 5G deployments. KSA network operators STC and Zain KSA are among the first in the region to launch 5G services. STC, the pioneer of 5G in KSA, launched commercial services in June 2019; Zain KSA, which launched 5G in October 2019, expanded its network to 27 cities and 2,600 towers countrywide as of December 2019.

Strong government support

The Saudi government has been extremely supportive of 5G rollouts. Under the Saudi Vision 2030 development program, the kingdom aims to become a world leader in 5G as it aligns with the program's ultimate goal of building a diversified, globally competitive economy. Following are some key government decisions made over the past few years:

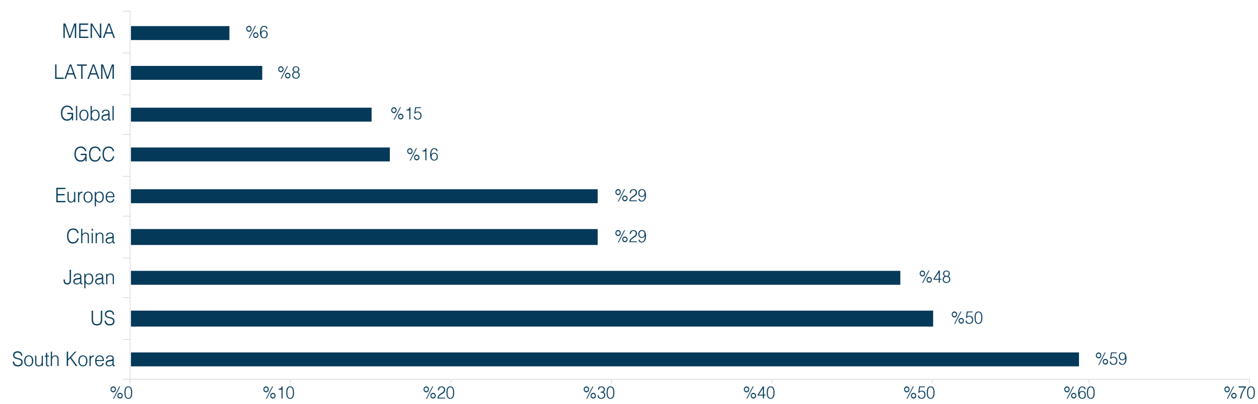
- Assigned 160MHz of additional spectrum in 700MHz, 800MHz and 1800MHz bands for 5G use in 2017-18
- Established National 5G Task Force
- Provided operators temporary licenses for 3.6GHz to 3.8GHz band to conduct 5G trials in May 2018
- Released additional 400MHz in 3.5GHz spectrum in February 2019

The GCC countries are among the early adopters of 5G technology globally. Total 11 operators in GCC countries (comprising KSA, Qatar, the UAE, Bahrain, Kuwait, and Oman) had commercially launched 5G services as of December 2019. However, we believe KSA stands out with its government's commitment to provide the required infrastructure and expend efforts towards network and technology upgrades.

Global scenario

Even though the GCC nations have progressed significantly in adopting 5G technology, they are trailing some of the more advanced countries. According to GSMA, South Korea is well positioned to lead the 5G adoption trend by 2025, with 5G connections forming 59% of total connections; it would be followed by the US (50%), Japan (48%) and China (29%). The adoption rate in GCC nations would, meanwhile, stand at 16%, with the MENA rate at 6%.

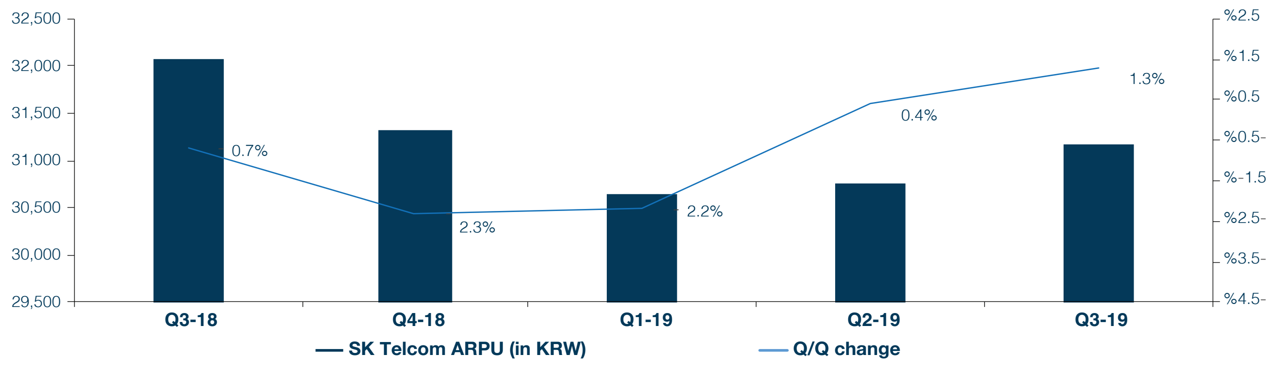
Figure 4. 5G connections as proportion of total by 2025



Source: GSMA

South Korean telecom operator SK Telecom, which claims to be the first operator globally to launch 5G services, had ~1.5mn 5G subscribers as of September 2019. The company's ARPU has also improved in the past two quarters owing to increase in 5G subscribers and growth in data usage.

Figure 5. ARPU improvement post 5G launch



Source: SK Telecom filings

Following are the challenges the Saudi telecom sector is likely to face in commercializing 5G services:

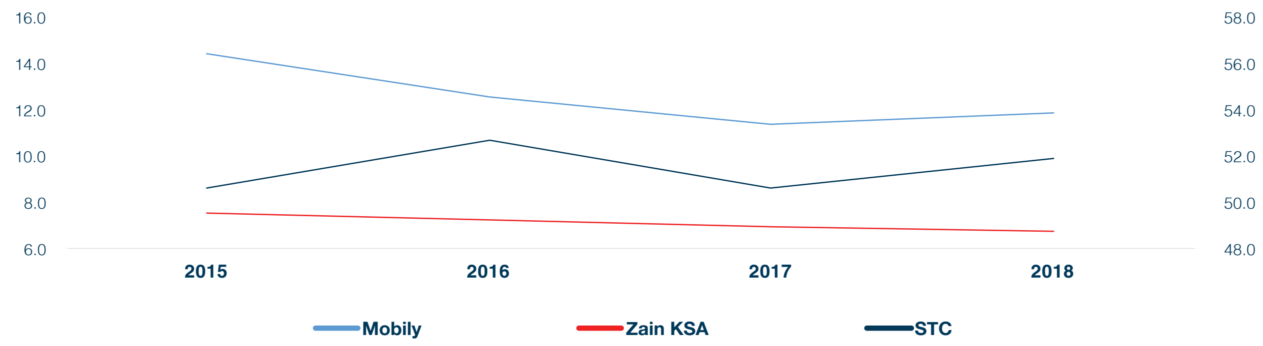
- Transitioning from 2G, 3G and 4G networks to 5G; bearing costs of maintaining these networks until the transition is completed
- Availability of affordable 5G devices
- Availability of advanced ICT skills
- Empowering 5G into vertical markets such as IoT, AI and V2X

Largely conducive regulatory environment benefits consumers

Biometric SIM registration adversely impacts telecom operators

KSA's Ministry of Interior started biometric registrations for SIM cards in January 2016 to restrict the use of fake, unregistered cards that might threaten national security. The registration drive had a negative impact on telecom operators' revenue due to a decrease in the number of mobile subscribers. The number reduced significantly during 2016-17 to 40.2mn from 52.8mn in 2015. Fixed broadband subscriptions, meanwhile, increased from 6.3mn to 6.7mn during the period, while fixed telephone connections also increased from 3.7mn to 4.7mn.

Figure 6. Impact of biometric registration on telecom operators' revenue



Source: Company filings

The adverse impact of biometric registration also reflected in revenues of all three operators in 2017. Mobily was impacted the most with a 9.7% decline in its top line, followed by Zain KSA (-5.2%) and STC (-3.8%). However, other factors also affected these companies' performance.

Universal licensing to infuse competitive dynamics

In October 2016, CITC announced an extension of licenses for telecom companies by 15 years and the issuance of unified licenses to four telecom service providers in the kingdom. For the extended period, telecom companies would have to pay 5% of their annual net profit as license fees. Mobily and Zain KSA were granted unified licenses in February 2017, which allowed them to offer a full range of telecommunications services, including mobile and fixed line, while STC already possessed a unified license; the CITC rejected Etihad Atheeb's (GO) application (matter is currently under investigation).

Mobily and Zain KSA both should benefit from unified licenses as well as the extension of licenses, whereas STC might lose its market share in the fixed-line segment because of increased competition. According to the companies' estimates, Zain KSA expects annual amortization charges to decrease by approximately SAR 433mn from the beginning of extended period; Mobily estimated a positive effect of SAR 260mn annually on finances. Meanwhile, STC does not expect any material impact on finances due to the extensions.

In an effort to stir competition and make more options available for users, KSA opened up the telecom market to MVNOs in 2013. Currently, there are two MVNOs operating in KSA – Virgin Mobile and Jawraa Lebara – with STC and Mobily as host mobile network operators (MNOs), respectively. Although the entry of MVNOs increased competition and pricing pressure, it also brought an opportunity for existing MNOs to generate extra revenue by leasing out their infrastructure facilities. In January 2020, CITC invited applications for issuing licenses to foreign MVNOs to increase foreign investment in the sector, indicating the regulator's intentions to maintain competitive pressure, considering consumer benefit.

Royalty issue settlement and impact

The long pending dispute about royalty fees was resolved in December 2018 as the three operators agreed with government authorities on changing rules of calculation of annual fees. According to the agreement, telecom service providers have to pay 10% of their annual net revenue from telecom services as royalty. Earlier, the operators paid 15% on mobile revenue, 10% on fixed-line revenue, and 8% on data revenue. Telecom companies also settled all differences related to royalties up to the end of 2017. In return, the three companies agreed to invest in upgrading network infrastructure up to 2021.

The financials of each player felt a different impact due to the settlements. For instance, Mobily is estimated to bear an extra annual cost of SAR 450–600mn for a few years, starting 2019, as it would be paying additional license royalties of 1% of its annual net revenue from telecom services. Meanwhile, Zain KSA benefitted with the reduction in fees by SAR 220mn for 2018, while the company anticipated a positive impact of about SAR 1.7bn over the next three years. STC expected a positive effect of the settlement on its results.

Reduction in termination charges and impact

CITC reduced call termination rates in October 2017, in which wholesale local voice call termination rates on mobile networks (MTR) were cut to SAR 0.055 from SAR 0.10, while wholesale local voice fixed termination rates were also reduced to SAR 0.021 from SAR 0.045.

STC and Mobily were impacted negatively by the decision as they have a higher number of connections that are net receivers of call termination charges. Zain KSA, with its smaller subscriber base, is a net payer of call termination charges and thus had to pay lower charges with the rate cut.

Government emphasis on improving telecom infrastructure and Internet connectivity

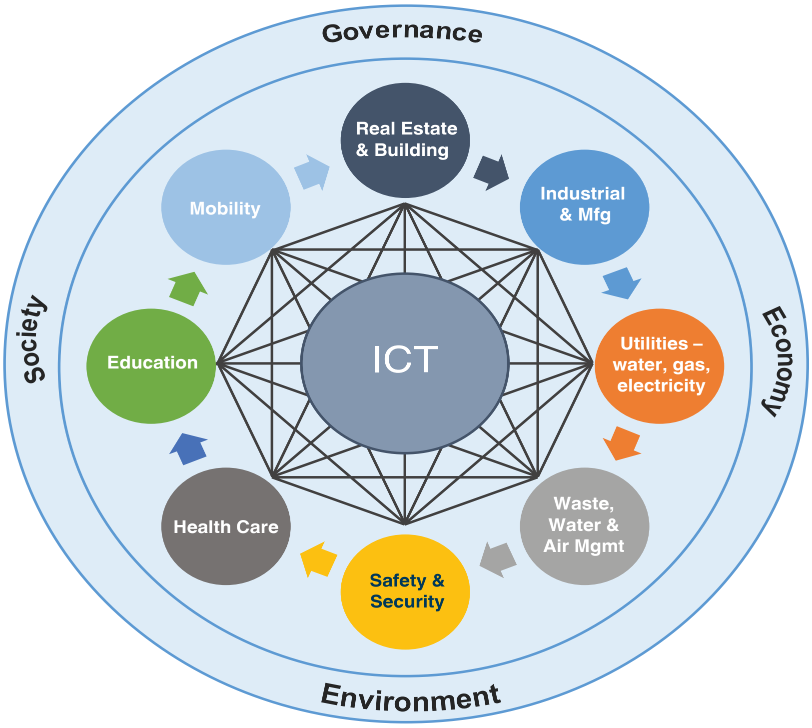
All the decisions by the Saudi MCIT, in collaboration with the regulator CITC, over the past few years were intended for the long-term development of the KSA's ICT sector. As a result of these decisions from the government and regulator, KSA has significantly progressed in improving its ICT establishment. The kingdom ranks second among all G20 countries in allocating the maximum number of frequency bands to telecommunication services. This has resulted in increased Internet speeds, which reached 51.8mbps as of November 2019. The United Nation's agency International Telecommunication Union (ITU) ranked KSA among the most mature countries in regulating the ICT sector and described the sector as one of the most developed worldwide.

KSA intends to enhance high-speed broadband Internet connectivity as part of its Vision 2030. The targets include exceeding 90% of housing coverage in densely populated cities and 66% in other urban areas. All these developments should benefit the telecom service provider in the long run and suggest a bright future for KSA's ICT segment.

Opportunities ahead

Investment in smart cities to boost demand for ICT

Saudi Arabia's Vision 2030 national development plan emphasizes on diversification and opening up of the economy, and development of non-oil sectors. To boost growth in non-oil sectors, KSA is investing significantly in constructing smart cities. The kingdom's Neom mega city project is estimated to cost USD 500bn. Neom and other smart city projects are expected to build integrated infrastructure required for advanced technologies. ICT is very crucial in the development of smart cities as it serves as a link between the different components of the infrastructure in these cities. Thus, telecom operators are likely to benefit from the upcoming cities as they can leverage their existing expertise in providing ICT services to fulfill the demand in smart cities.



Source: intechopen.com

Other opportunities

Telecom operators usually have a huge subscriber base, which they can leverage for cross-selling other related services such as payment platform (STC Pay), internet protocol television, content broadcasting, and OTT media services.

STC, Mobily and Zain KSA are preparing to cater to the increasing demand for ICT solutions by investing in the expansion or commercialization of 5G network. They are also collaborating with global technology firms such as Huawei, Nokia and Ericsson so as to access advanced technologies which would enable them to provide a full range of services across IoT verticals. Players that quickly adopt new technologies and implement them in growing their business are likely to outperform their peers in the future.

Zain KSA: Capital cut and rights issue

Zain KSA plans to reduce capital from SAR 5.8bn to SAR 4.2bn, representing a decrease of ~28%, to wipe out accumulated losses of SAR 1.6bn. Subsequently, the company would issue rights of SAR 4.5bn, increasing the capital from SAR 4.2bn to SAR 8.7bn.

According to our calculations, the process of capital reduction and subsequent issuance of rights should improve Zain KSA's leverage ratio from 4.1x to 1.9x, even if the additional capital is not used to repay debt.

Table 1

(in SAR mn)	Current (as of Dec 2019)	After capital reduction	Post rights issue
Share capital	5,837	4,229	8,729
Accumulated losses	-1,608	0	0
Equity	4,103	4,103	8,603
Debt	16,750	16,750	16,750
Cash	1,157	1,157	5,657
D/E	4.1	4.1	1.9

Source: Company filings, Aljazira Capital

In case of debt repayment from the new capital, we consider the following three scenarios:

Scenario 1: Debt repayment of SAR 1,500mn

Scenario 2: Debt repayment of SAR 3,000mn

Scenario 3: Debt repayment of SAR 4,500mn

Table 2

(in SAR mn)	Scenario 1 Debt repayment of SAR 1,500mn	Scenario 1 Debt repayment of SAR 1,500mn	Scenario 3 Debt repayment
Share capital	8,729	8,729	8,729
Accumulated losses	0	0	0
Equity	8,603	8,603	8,603
Debt	15,250	13,750	12,250
Cash	4,157	2,657	1,157
D/E	1.8	1.6	1.4
Finance cost	951	857	764
Interest rate	%6.2	6.2%	6.2%
Savings in finance cost	94	187	281

Source: Company filings, Aljazira Capital

Thus, the rights issue and debt reduction are expected to benefit Zain KSA's financials by improving the leverage ratio from 4.1x to 1.4–1.8x and reducing its annual finance costs by SAR 94–281mn.

Sector Outlook

Overall, our outlook for the KSA telecom sector is positive. We believe that the sector has made significant progress in the past few years toward developing a robust setup to take advantage of future opportunities. As per royalty fees settlement, operators are expected to invest significantly in network infrastructure development in the next two to three years. This large capital expenditure would likely impact cash flows of telecom companies but help them in the long run to expand their market reach and broaden their portfolio offering of non-traditional telecommunication services.

We see data usage and enterprise solutions to be key growth drivers for the industry, with 5G technology at the center stage. The voice segment is expected to remain subdued, while the FTTH segment would continue to advance at a moderate pace through expansions in the fiber optics network. With the launch of 5G services, data revenue is likely to accelerate in the market, which has a high proportion of tech-savvy young population. Simultaneously, the rising prominence of digitization and advanced technological requirements of the businesses offer great potential for ICT services in public as well as private enterprises.

The outbreak of Covid-19 in Q1-20 and the subsequent preventive measures taken by the government are likely to have a mixed impact on the sector. The suspension of Umrah pilgrimages and travel bans are expected to hit the sale of temporary SIMs, while the interest rate cut by SAMA (by 125bps in March 2020) to support the slowing economy would benefit Mobily and Zain KSA in terms of easing finance costs. Also, data demand is expected to be higher during the lockdown as most people are working from home and the Internet would be the most prominent medium of communication in these days. Meanwhile, with the significant reduction in oil prices and a slowdown in almost all businesses, spending on digitization might be subdued in FY20, which is anticipated to adversely impact on enterprise solution segment of telecom operators.

STC

Having launched the first 5G services commercially in KSA in June 2019, STC has a country-wide network of 2,300 5G towers. Thus, the operator is expected to get the first mover's advantage in attracting 5G subscribers. STC's strategy is highly focused on enterprise solution, IoT, and cloud services, and it is likely to benefit from the high potential demand in these areas. Furthermore, as the next two to three years are expected to be capex-heavy for mobile operators, STC is better placed vis-à-vis its competitors, given its strong financials and deep pocket. Also, STC is expanding its presence in the MENA region through the proposed acquisition of a controlling stake in Vodafone Egypt. Moreover, the company's presence in varied domains, such as digital payments (STC Pay: 500,000 subscribers), media, and entertainment, is also positive. We value STC on 100% weight for DCF and recommend "**Overweight**" with PT of **SAR 97.6/share.**

Mobily

Mobily witnessed robust growth in its revenue in recent quarters on account of growth in its subscriber base and data usage. The company's expansion into the FTTH segment adds to its revenue stream. In terms of 5G technology, Mobily lags behind its peers and needs to pick up pace to stay in competition. However, the acquisition of 100MHz in both, the 2.6GHz and 3.5GHz bands, should enable the company to improve its offerings. We believe that it would be challenging for Mobily to continue to invest large amounts in upgrading network infrastructure due to its already stressed balance sheet with high leverage. Financial cost is expected to continue to hurt the company's bottom line, despite efforts to rationalize operating cost. However, SAMA's recent interest rate reduction should help the company reduce its finance cost. We recommend the "**Neutral**" rating on Mobily with PT of **SAR 22.1/share.**

Zain KSA

Zain KSA launched 5G services commercially in October 2019. The company has the largest 5G coverage in the country with presence in 27 cities through nearly 2,600 towers. Zain KSA is expected to provide tough competition to STC in 5G services. Standing ahead of peers in the deployment of 5G network, Zain KSA might benefit in terms of market share gain. The company gained from royalty fee settlement through reduction in fees and reversal of provisions. Furthermore, the proposed capital reduction and rights issue should help Zain KSA improve its financial leverage and decreasing interest cost, thus enabling it to continue to stay ahead in the 5G race through capex. We believe that the cancellation of the tower sale to IHS, which could have been a game changer, proved to be a great setback for the company. We recommend the "**Overweight**" rating on Zain KSA with PT of **SAR 15.4/share.**

Top pick

We believe STC and Zain KSA are in better positions to grab future opportunities in the KSA telecom sector. STC, with its strong market position, sound financials, and continuous investment in 5G, should continue to lead the market, while we expect Zain KSA's capital restructuring would likely strengthen its financial position significantly and support the company's growth plan.

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1. Overweight: This rating implies that the stock is currently trading at a discount to its 12 months price target. Stocks rated "Overweight" will typically provide an upside potential of over 10% from the current price levels over next twelve months.
2. Underweight: This rating implies that the stock is currently trading at a premium to its 12 months price target. Stocks rated "Underweight" would typically decline by over 10% from the current price levels over next twelve months.
3. Neutral: The rating implies that the stock is trading in the proximate range of its 12 months price target. Stocks rated "Neutral" is expected to stagnate within +/- 10% range from the current price levels over next twelve months.
4. Suspension of rating or rating on hold (SR/RH): This basically implies suspension of a rating pending further analysis of a material change in the fundamentals of the company.

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