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INITIATING COVERAGE

The Gate to The Future

We initiate coverage on Arabian Internet and Communication Services Company (Solutions by STC or Solutions) with a Neutral rating and a PT of SAR193.4. Solutions is the leading IT service provider and a key enabler of the on-going digital transformation of the Saudi economy. The company's leadership is built on one-stop offerings, local presence and its unique partnership with STC. We expect the company to deliver a 2020-2025f net income CAGR of 10.6% driven by strong growth in Managed and Digital services. The stock is trading at 2022f PE and EV/EBITDA of 27.6x and 19.0x vs peer group average of 25.9X and 15.5x, respectively.

- Digitalisation is at the heart of Vision 2030**

Technology is an essential enabler to achieve Vision 2030 goals. The digitalisation trend has accelerated over the last few years with various government entities investing heavily in IT infrastructure to improve citizens' services and to enhance efficiency. Moreover, digitalisation is the corner stone of new smart cities and mega projects. According to the IDC, the Saudi B2B ICT market is expected to increase from SAR33.8bn in 2018 to SAR53.1bn in 2025f, a growth of 57.1%. We believe Solutions is well positioned to benefit from the Saudi digital transformation as one of the leading players and trusted partners in the digital space.

- A leading player in a fragmented market**

Although the Saudi ICT industry is highly fragmented, Solutions has a leading market share of 13%, more than 2x the second largest system integrator. The company is also among the top three players in five out of seven key segments. We believe that Solutions' market leadership is built on its unique partnership with STC and being the largest local one-stop shop provider. Moreover, Solutions local presence is a key factor in maintaining its market leadership position.

- Earnings to grow by 66% over the next five years**

In 2020-2025, we expect Solutions to deliver revenue CAGR of 9.1%, with System Integration (SI) being the enabler while Managed and Digital segments being the key growth drivers. Although high margin Core ICT segment contribution will decline, we expect the impact on the overall margins to be limited given the margin expansion of the other two segments. Solutions net income is expected to record a 2020-2025f CAGR of 10.6% to SAR1.16bn by 2025f.

- Initiate coverage with Neutral rating and PT of SAR193.4**

We initiate coverage on Solutions by STC with a Neutral rating and a PT of SAR193.4. The stock is currently trading at 2022f PE and EV/EBITDA of 27.6x and 19.0x vs peer group average of 25.9X and 15.5x, respectively. We believe the premium is justified due to 1) strong digital transformation of the Saudi economy 2) local presence and 3) unique partnership with STC.

Summary Financials

SAR mn	2020	2021f	2022f	2023f	2024f	2025f
Revenues	6,891	7,704	8,525	9,305	10,016	10,669
Gross Income	1,422	1,663	1,798	1,947	2,088	2,224
Gross margin (%)	20.6%	21.6%	21.1%	20.9%	20.8%	20.8%
Operating Income	757	879	956	1,054	1,159	1,259
Operating margin (%)	11.0%	11.4%	11.2%	11.3%	11.6%	11.8%
Net Income	702	819	881	972	1,069	1,162
Net margin (%)	10.2%	10.6%	10.3%	10.5%	10.7%	10.9%

Source: The company, SNB Capital Research

NEUTRAL

Price target (SAR)	193.4
Current price (SAR)	202.6
Upside/Downside (%)	(4.6)

VALUATION MULTIPLES

	20	21f	22f
P/E (x)	34.6	29.7	27.6
P/B (x)	12.6	11.3	8.4
EV/EBITDA (x)	27.1	21.5	19.0
Div Yield (%)	0.0	1.6	0.6

Source: SNB Capital Research estimates

MAJOR SHERHOLDERS

Investor	% Ownership
STC	79.0%
Foreign Ownership	3.42%

Source: Saudi Exchange, SNB Capital. As of 02 Nov 2021

STOCK DETAILS

M52-week range H/L (SAR)	235/166
Market cap (\$mn)	6,483
Shares outstanding (mn)	120
Listed on exchanges	Saudi Exchange

Price perform (%)	since IPO
Absolute	33.1
Rel. to market	29.1

Avg daily turnover (mn)	SAR	US\$
1m	255	68.1

Reuters code	7202.SE
Bloomberg code	SOLUTION.AB
	www.solutions.com.sa

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Investment Thesis

Digitalisation is at the heart of Vision 2030

Vision 2030 is the key driver of the Saudi economy with technology earmarked as an essential enabler to achieve its goals. The government is at the forefront of digital transformation with an aim to be amongst the top 5 nations in the E-Government Index by 2030. The digitalisation trend has accelerated over the last few years with various government entities investing heavily in IT infrastructure to improve citizens' services and to enhance efficiency and reliability. Moreover, digitalisation is the corner stone of new smart cities and mega projects. Regulatory framework is evolving to accommodate the digitalisation move. According to the IDC, the Saudi B2B ICT market is expected to increase from SAR33.8bn in 2018 to SAR53.1bn in 2025f, a growth of 57.1%. We believe that Solutions is well positioned to benefit from Saudi digital transformation as one of the leading players and trusted partners in the digital space.

New growth opportunities across sectors

Digital transformation is opening new growth avenues for Saudi ICT players. Traditionally, public and financial services are the largest spenders, which accounted for 25% and 15% of the market in 2018, respectively. As digitalisation trends are accelerating, we expect higher spending on technology by Manufacturing, Transportation, Healthcare and Retail sectors. To meet specific requirements of these verticals, the fastest growing ICT channels is expected to be Cloud (2018-2025 CAGR of 20.7%) and IoT services (CAGR 16.4%). However, System Integration (SI) will remain the largest segment, accounting for 30% of the sector in 2025f (vs 49% in 2018).

Solutions by STC – A leading player in a fragmented market

The Saudi ICT industry is highly fragmented with several local, international and telecom companies actively operating in the country. Nevertheless, Solutions has a leading market share of 13%, more than 2x the second largest system integrator. The company is also among the top three players in five out of seven key segments. We believe that Solutions' market leadership is built on its unique partnership with STC and being the largest local one-stop shop provider. The well-balanced ecosystem of established and innovative players (+150 partners), add value and diversity to the company's offerings.

Relationship with STC – A major value proposition

We believe one of the major competitive advantages of Solutions is its unique, mutually beneficial and reinforcing relationship with STC (the leading telecom player in Saudi). STC is not only an anchor client for Solutions (representing 35% of its sales in 2020), but it also provides access to a wide range of customers and projects through its +1,000 account managers. Moreover, Solutions benefit from sharing brand equity, best practices with STC and is leading the digital transformation of the group. This unique value proposition creates a high barrier for new entrants.

Saudi presence – The partner of choice

Solutions local presence, with on-shore calibres who understand culture and market dynamics while being close to clients, is a key factor in maintaining its market leadership position. Through its 1,494 highly skilled employees with a Saudisation rate of 58% at the end of 2020, the company is the partner of choice especially in critical projects for the government and large corporates.

Solutions' revenue to grow by 55% over the next five years

Over the past three years (2018-2020), Solutions reported strong organic growth from all reporting segments. It reported a revenue of SAR6.9bn in 2020, growing from SAR4.0bn in 2018 (CAGR of 30.6%). Core ICT (includes SI) had the highest contribution of 54%, followed by Managed Services (c24%) and Digital Services (c22%). The company has reported a backlog works of SAR6.3bn in 2020, growing from SAR4.4bn in 2018 with a CAGR of 19.7%. Over the next five years (2020-25f), we expect the company to deliver revenue CAGR of 9.1%, with SI being the enabler while Managed and Digital segments being the key growth drivers.

Scalability to improve margins and profitability

Solutions gross margins declined from 23.9% in 2018 to 16.1% in 2019, before recovering to 20.6% in 2020. Going forward, we expect gross margins to expand marginally to 20.8% by 2025f, albeit with a lower share of high margin Core ICT segment. We expect the impact on the overall margins to be limited given the margin expansion of the other two segments driven by scalability factor. We expect opex-to-sales ratio to remain stable and EBITDA margins to expand from 12.5% in 2020 to 14.3% in 2025f. Overall, Solutions net income is expected to show a 2020-2025f CAGR of 10.6% to reach SAR1.16bn by 2025f.

Higher profitability to lead to robust FCFF

Solutions business nature requires limited capex and inventory. Therefore, working capital is determined by account receivables and payables. We project the company's cash cycle to improve from 58 days in 2020 to 40 days in 2025f, driven by an improvement in receivable days. We note that c74% of receivables are from related parties in 2020, which we believe is due to the nature of the business model. We expect higher profitability to lead to robust FCFF and to reflect a CAGR of 11.3% during 2020 and 2025f.

Promising growth opportunities

We believe the growing FCFF, conservative dividends pay-out ratio of 15%-20% and high cash levels will translate into considerable room for organic and inorganic expansions. We believe the company might potentially acquire entities with unique business lines or expand into other regional markets, particularly where STC operates. Moreover, the untapped SME segment provides a major growth opportunity for Solutions.

NOVEMBER 2021

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