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Al Rajhi Capital

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Key themes

Q1 performance of the telecom sector was mixed. Though the macro enviroment remains challenging, companies were able to report stable revenues and EBITDA margins. Top line trend for the past few quarters likely suggests that the worst may be over for the sector. Companies were able to raise price in January, and we could see the impact in Q2 results, though declining expat population will restrict any improvement in the topline (mainly for the smaller players)

What do we think?

Stock	Rating	Price Target
STC (STC AB)	Neutral	SAR78.5
Mobily (EEC AB)	Neutral	SAR16.5
Zain (ZAINKSA AB)	Neutral	SAR7.3

Saudi Arabian Telecom Sector: Q1 2018 results review

In Q1 2018, the telecom companies delivered mixed results. While STC came in-line with our expectations, Mobily performed slightly better than our expectation and Zain KSA slightly underperformed. While the results were nothing extraordinary, they highlighted that the sector may have found a bottom in terms of revenue. Adjusting for the MTR cut and VAT impact, both the smaller players may have seen a slight increase in sequential revenues. Further, EBITDA margins were largely stable for all players (excluding one-offs). Notably, Zain and Mobily saw an increase in amortization expenses from the new spectrum which was partly offset by cut in interconnection costs. Apart from operational improvement, Mobily benefitted from reduction in provisions, which had been declining in the past. Overall we have revised Mobily's estimates higher, and raised its target price to SAR16.5/sh (prev. SAR14.9/sh) with a Neutral rating (based on equal mix of DCF and EV/EBITDA, for all the three companies). STC is trading at a premium to both its historical past and global peers which we think may not sustain. We maintain our target price of SAR78.5/sh for STC and reiterate our Neutral rating. We make no change for Zain KSA as well (TP: SAR7.3/sh, Neutral rating).

Q1 results review – nothing extraordinary: The telecom industry continues to be impacted by a saturated market, falling expat population, intense competition and regulatory changes. Though the telecom players raised prices from January 2018, we did not see its impact this quarter due to a) pre-purchasing ahead of VAT implementation, b) carry forward of promotional offers seen in Q4, c) lower international calls (due to VoIP). Zain lost some revenue market share in Q1 2018, which could be because some offers allowed carry forward of some promotions in Q4 2017 into Q1 2018. Given that Zain has higher contribution of revenue from data segment, relatively there are higher chances for its customers to use VoIP for international calling, than its peers. The cut in interconnection rates, which was applicable from the last week of December 2017, also marginally impacted revenues. However, at this level of termination rates, interconnection rates will cease to matter for the telecom players any more.

Expectation for the next quarter: The second quarter results may benefit from the hike in prices, implemented by all players from January 2018. However, falling expat population remains a concern and may continue to hit the subscriber base (as dependent levy increases every July), and thus limit topline growth. On a y-o-y basis, telecom players would be especially hurt by VoIP during the festive season which falls in Q2. Though there is limited scope for any further major cost efficiency measures, profit margins drivers depend mainly on rising share of data services in total revenue, as well as the increase in prices. Data usage may also get additional boost this quarter due to the festive Ramadan period, and the Football World Cup, which starts in mid-June. Overall, at the moment, we believe Q2 could be better than Q1, including for Mobily, which outperformed this quarter.

Saudi Telecom Company (STC AB Equity)

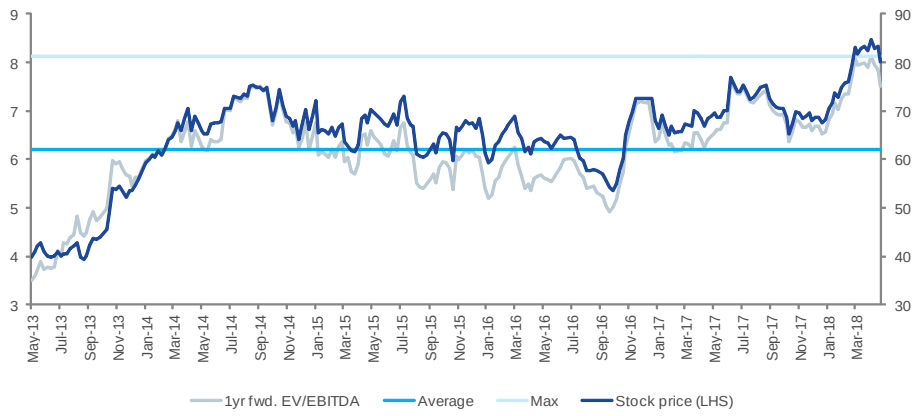
Despite the cut in MTR, STC reported a strong top line with revenues rising ~4% q-o-q, on account of lower inter segmental sales. On a y-o-y basis, revenues were down 1.1%, which could be attributable to a lower subscriber base, decline in international calls as the regulator approved VoIP calls, and the cut in MTR. The company was able to maintain a healthy gross profit margin, which is likely to have been supported by rising proportion of data revenues (y-o-y) basis.

Despite a 9% q-o-q decline in operating profit, net profit was flat sequentially due to a SAR150mn fall in early retirement program cost.

STC maintained its quarterly dividend pay-out of SAR1 per share for Q1 2018. The stock has gained over the last six months, resulting in rising valuations (~7.5x 2018E EV/EBITDA). We have valued STC on an average of DCF and EV/EBITDA (7x 2018E, in-line with global peers). We maintain our TP of SAR78.5 on the stock with a Neutral rating. The company is investing its huge cash reserve into new technologies and services, which will allow it to grow its service offering and thus revenue base. STC also has an ambitious digital content and media strategy all of it could be the reason for the premium – however we believe the base is too large for the company to achievable meaningful growth.

Risks: Upside risks to our estimates are from higher than expected revenues from its newer investments, tower sale/sharing, lower than expected cost of early retirement, hike in quarterly dividends and improvement in valuation of subsidiaries. Downside risks are from unfavourable regulatory changes, aggressive competition leading to lower than expected ARPUs and acquisitions at expensive valuations.

Figure 1 STC 1-yr forward EV/EBITDA trend



Source: Bloomberg, Al Rajhi Capital

Figure 2 STC Q1 results

(SAR mn)	Q1 2017	Q4 2017	Q1 2018	Y-o-Y	Q-o-Q	ARC est	Comments
Revenue	**12,524**	**11,916**	**12,386**	**-1.1%**	**3.9%**	**12,632**	**Revenue grew sequentially despite the cut in MTR**
Gross profit	6,924	7,393	6,997	1.1%	-5.4%	7,453	Cost of services surged unexpectedly on a sequential basis, resulting in lower GP
Gross margin	55.3%	62.0%	56.5%			59.0%	
Operating profit	2,615	2,899	2,632	0.7%	-9.2%	2,738	Decline in GP led to lower OP, but the decline was restricted by lower general and administrative exp. and D&A charge on a sequential basis
Operating margin	20.9%	24.3%	21.2%			21.7%	
Net profit	**2,535**	**2,586**	**2,588**	**2.1%**	**0.1%**	**2,531**	**Lower expenses related to early retirement program resulted in a substantial improvement in the bottom line compared to the operating profit**
Net margin	20.2%	21.7%	20.9%			20.0%	

Source: Company data, Al Rajhi Capital

Figure 3 Relative valuation

Name	Market Cap ($ mn)	Annual EBITDA (y-o-y growth)	EBITDA Margin (%)	OPM (%)	EV/EBITDA 1-yr forward	EV/EBITDA 2-yr forward
Saudi Telecom Company	42,878	7.0	38.0	21.8	7.5	7.4
Oman Telecommunications	1,558	26.3	38.7	18.5	4.6	4.3
Ooredoo	6,012	4.2	40.5	14.8	3.7	3.5
Telecom Egypt	1,523	17.1	22.2	11.4	6.4	6.3
Bahrain Telecom Co.	1,059	-7.8	32.9	15.4	NA	NA
Telkom SA SOC LTD	2,263	23.5	26.5	12.7	3.2	3.1
Maroc Telecom	14,556	1.3	49.3	29.5	8.9	8.7
Emirates Integrated Telecomm	5,974	-3.1	40.0	28.3	3.4	3.4
Zain Kuwait	5,436	-19.0	40.3	22.3	5.7	5.4

Source: Company data, Al Rajhi Capital

Figure 4 Income statement

Income statement (SARmn)	12/16A	12/17A	12/18E	12/19E
Revenue	53,678	51,362	51,485	52,000
Cost of services	-24,991	-21,807	-22,138	-22,360
Gross profit	28,688	29,555	29,346	29,640
SG&A	-10,659	-10,244	-9,937	-10,036
EBITDA	18,029	19,311	19,410	19,604
D&A	-8,078	-8,207	-7,659	-8,338
Operating profit	9,951	11,104	11,750	11,266
Finance cost	-379	-354	-256	-233
Other expenses (net)	305	382	648	1,395
Profit before tax	9,877	11,132	12,142	12,428
Tax	-751	-721	-777	-795
Minority interest	-226	-237	-225	-239
Net profit	8,900	10,174	11,140	11,394

Source: Company data, Al Rajhi Capital

Figure 5 Per share data

	12/16A	12/17A	12/18E	12/19E
Adjusted shares o/s (mn)	2,000	2,000	2,000	2,000
EPS	4.45	5.09	5.57	5.70
DPS	4.00	4.00	4.25	4.50
CFO per share	9.19	8.48	9.74	9.92

Source: Company data, Al Rajhi Capital

Mobily

Mobily continued to show its resilience in top-line. The company reported flat revenues on a sequential basis in Q1. Adjusting for the cut in MTR, revenues would have been higher by ~2% q-o-q, which suggests that top line may have found a floor. While the top line was in line with our forecast, the company's EBITDA was ~SAR100mn higher than expected, which resulted in the company posting a less than expected net loss of SAR93mn (our estimate: -SAR176mn, consensus: -SAR180mn) .

Majority of the ~SAR130 q-o-q increase in EBITDA was attributable to cost efficiency measures taken by the company, while the rest was due to write back of certain provisions. Mobily includes provisions on accounts receivables above operating profit line item. This quarter around SAR7mn was provisioned, as compared to around SAR60mn quarterly average in the last year. We also note that this has been after the increase in retrospective provisioning, an adjustment post IFRS9 application. Thus, while we expect provisions to decline, we do not expect any meaningful operational improvement in Q1 to continue. Hence though EBITDA margin is likely to improve from the ~32% average witnessed over the last four quarters, they are unlikely to sustain above the 36% level seen in this quarter. On the downside, increase in SAIBOR rates could offset the return to profitability. It is important to note that accounts payables increased by around SAR500mn in this quarter to SAR5.4bn as it has in the last 4 quarters which is a key concern for us as this is not sustainable. The net working capital stands at negative SAR4.5bn and debt stays at SAR14.3bn.

Given the stabilization of revenues and improvement in operational efficiencies, we have revised our estimates on Mobily. Based on the revised estimated and our equal weighted DCF and EV/EBITDA (7x 2018E) valuation methodology, we raise our target price on the company to SAR16.5. The stock has already run up more than 15% over the last couple of months. Thus we maintain our Neutral rating on Mobily.

Risks: Key upside risks to our estimates would be no meaningful reduction in overall market size, a value accretive tower sale and higher than expected shift to post-paid subscribers which could improve ARPU. Faster than expected reduction in debt levels could also lead to improvement in profitability. Key downside risks are related to further erosion in market share, higher capex needs, lower than expected cost savings.

Figure 6 Mobily Q1 results

(SARmn)	Q1 2017	Q4 2017	Q1 2018	y-o-y	q-o-q	Our est.	Comments
Revenue	**2,865**	**2,827**	**2,833**	**-1.1%**	**0.2%**	**2,859**	Impact of increase in prices was offset by VoiP and decrease of the interconnection rates
Gross Profit	1,665	1,560	1,663	-0.1%	6.6%	1,641	
Gross margin (%)	58.1%	55.2%	58.7%			57.4%	
EBITDA	**932**	**911**	**1,036**	**11.2%**	**13.7%**	**935**	Implementation of IFRS 9 and 15, writeback of some provisions and cost saving measures boosted EBITDA above our estimates
EBITDA margin (%)	32.5%	32.2%	36.6%			32.7%	
Interest exp	(194)	(163)	(188)	-3.1%	15.6%	(167)	Interest expense rose on rising SAIBOR and reclassification of certain interest charges related to CAPEX projects.
Net profit	**(163)**	**(182)**	**(93)**	**-42.9%**	**-48.8%**	**(176)**	Higher than expected EBITDA led to better net profit
Capex	(354)	(658)	(814)	129.9%	23.7%	(429)	Excluding the impact of capitalization of spectrum stood at SAR 505mn

Source: Company data, Al Rajhi Capital

Figure 7 Income statement

Income statement (SARmn)	12/16A	12/17A	12/18E	12/19E
Revenue	12,569	11,351	11,385	11,499
Cost of services	-5,144	-4,821	-4,759	-4,772
Gross profit	7,425	6,530	6,626	6,727
SG&A	-3,416	-2,918	-2,846	-2,875
EBITDA	4,009	3,612	3,780	3,852
D&A	-3,775	-3,626	-3,772	-3,505
Operating profit	235	-14	8	347
Finance cost	-556	-678	-677	-640
Other expenses (net)	75	45	59	57
Profit before tax	-246	-648	-611	-236
Tax	43	-61	-25	-25
Minority interest	-	-	-	-
Net profit	-203	-709	-635	-260

Source: Company data, Al Rajhi Capital

Figure 8 Per share data

	12/16A	12/17A	12/18E	12/19E
Adjusted shares o/s (mn)	770	770	770	770
EPS	-0.26	-0.92	-0.84	-0.35
DPS	0.00	0.00	0.00	0.00
CFO per share	5.09	4.67	3.10	3.18

Source: Company data, Al Rajhi Capital

Zain KSA

Zain may have lost some revenue market share this quarter, which we believe was due to some carry forward of promotional offers from Q4 2017. Also Zain's data contribution to topline is higher compared to its peers and hence with VoIP calling, it faces higher probability of a decline in international calling revenues. Zain's revenue slipped 1.7% q-o-q to SAR1,686mn in Q1 2018. However, adjusting for the cut in MTR, revenues were mostly flat sequentially. Zain was also able to marginally increase its subscriber base for the first time in five quarters, adding a net ~130,000 subscribers in Q1 2018.

Zain was also able to maintain its EBITDA margins at the healthy 34% level. However, operating profit margin declined on higher D&A charges (related to network expansion and spectrum). Adjusting for a one-off VAT related expense of SAR7mn, bottom line stood at a loss of SAR 70mn (Q4 2017: loss SAR45mn). We maintain our target price of SAR7.3 on Zain with a Neutral rating, based on our weighted average of DCF and EV/EBITDA valuation.

Going ahead, the macro environment remains weak for the company with expats continuing to leave the Kingdom, to which Zain is particularly susceptible given that its subscriber base is majorly expats. However, the company plans to partially offset this by increasing the higher ARPU post-paid and B2B businesses revenues.

However, increase in spectrum costs and SAIBOR rates could put pressure on the bottom line. The company acquired 10MHz of 1800MHz in late 2017, which was made available from January 2018, for a total cost of SAR844mn. Assuming an amortization of 10 years (the period of payment), it would amount to a quarterly impact of SAR21mn, in addition to any usage charges. Further, Zain acquired 2x10MHz of 800MHz spectrum, for a period of 15 years for a total license fee of SAR84mn, and an annual usage charge of SAR54mn. This spectrum will be available from H2 2018, and is thus likely to start impacting financials from Q3 2018, which is likely to raise costs by another ~SAR15mn on a quarterly basis.

Restructuring: Zain has applied to the CMA for the approval of its restructuring plan under which it will write off SAR2.2bn of accumulated losses against its share capital, reducing the latter by 38% to SAR 3.6bn, and subsequently plans to raise SAR 6bn through a rights issue. CMA may take 1-2 months to take a decision on the same, post which the company will need to get an approval from the shareholders.

Risks: Key upside risks to our estimates would be no meaningful reduction in overall market size, a value accretive tower sale and higher than expected shift to post-paid subscribers which could improve ARPU. Faster than expected reduction in debt levels could also lead to improvement in profitability. Key downside risks are related to further erosion in market share, higher capex needs, lower than expected cost savings.

Figure 9 Zain Q1 results

(SAR mn)	Q1 2017	Q4 2017	Q1 2018	Y-o-Y	Q-o-Q	ARC est	Comments
Revenue	**1,919**	**1,716**	**1,686**	**-12.1%**	**-1.7%**	**1,759**	**Topline declined as subscribers pre bought plans ahead of VAT implementation, increasing VoIP calls, leading to lower international voice call revenues, and MTR cut**
Gross profit	1,291	1,133	1,157	-10.4%	2.2%	1,187	Gross profit margin improved as proportion of data revenues increased, and the cut in MTR rates
Gross margin	67.3%	66.0%	68.6%			67.5%	
Operating profit	273	167	143	-47.6%	-14.2%	189	Operating profit fell sequentially on higher D&A expenses and one-off cost saving in previous quarter
Operating margin	14.2%	9.7%	8.5%			10.7%	
Net profit	**45**	**(45)**	**(77)**	**NM**	**NM**	**(33)**	**Lower operating profit resulted in a higher net loss for the quarter**
Net margin	2.4%	-2.6%	-4.6%			-1.9%	

Source: Company data, Al Rajhi Capital

Figure 10 Income statement

Income statement (SARmn)	12/16A	12/17A	12/18E	12/19E
Revenue	6,927	7,306	7,197	7,269
Cost of services	-2,526	-2,393	-2,339	-2,326
Gross profit	4,401	4,913	4,858	4,943
SG&A	-2,605	-2,396	-2,368	-2,392
EBITDA	1,795	2,517	2,490	2,552
D&A	-1,850	-1,614	-1,734	-1,655
Operating profit	-54	903	756	896
Finance cost	-953	-910	-907	-867
Other expenses (net)	28	18	17	11
Profit before tax	-980	12	-134	41
Tax	0	0	0	-1
Minority interest	0	0	0	0
Net profit	-980	12	-134	40

Source: Company data, Al Rajhi Capital

Figure 11 Per share data

	12/16A	12/17A	12/18E	12/19E
Adjusted shares o/s (mn)	584	584	584	584
EPS	-1.68	0.02	-0.23	0.07
DPS	-	-	-	-
CFO per share	2.11	4.05	2.65	2.96

Source: Company data, 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.

"Target price": We estimate target value per share for every stock we cover. This is normally based on widely accepted methods appropriate to the stock or sector under consideration, e.g. DCF (discounted cash flow) or SoTP (sum of the parts) analysis.

Please note that the achievement of any price target may be impeded by general market and economic trends and other external factors, or if a company's profits or operating performance exceed or fall short of our expectations.

Contact us

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