Saudi Telecom
Telecom –Industrial
STC AB: Saudi Arabia
10 May 2010

US$21.33bn	16.4%	US$13.00mn
Market cap	Free float	Avg. daily volume

Target price	44.20	10.5% over current
Consensus price	55.60	39.0% over current
Current price	40.00	as at 9/5/2010

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Underweight | **Neutral** | Overweight

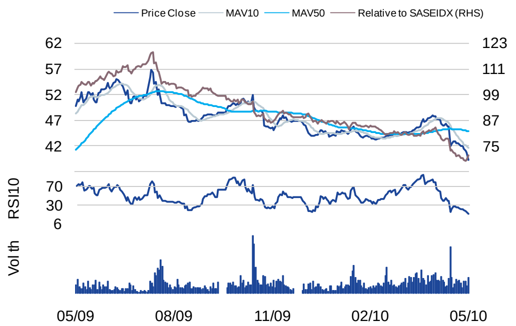
Key themes

We expect mobile to outperform fixed-line telecoms in Saudi Arabia over the next few years. Growth in 3.5G mobile data threatens the DSL market dominated by STC. We regard STC's overseas expansion as confused and think that Mobily in particular has taken advantage of STC's distraction to strengthen its position in the domestic market

Implications

With questions about its strategy and dull near-term earnings prospects, STC lacks catalysts for share price performance. However, STC is the least expensive of the three Saudi telecoms operators and its 7.5% yield offers support. We rate STC Neutral.

Performance

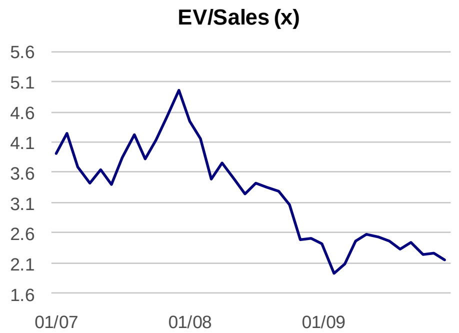


Earnings

Period End (SAR)	12/09A	12/10E	12/11E	12/12E
Revenue (SARmn)	50,780	53,212	56,290	59,578
Revenue Growth	7.0%	4.8%	5.8%	5.8%
EBITDA (SARmn)	20,612	19,916	22,049	24,129
EBITDA Growth	-5.2%	-3.4%	10.7%	9.4%
EPS	5.43	4.58	5.39	5.43
EPS Growth	-1.6%	-15.6%	17.6%	0.6%

Source: Company data, Al Rajhi Capital

Valuation



Source: Company data, Al Rajhi Capital

STC
Positives and negatives balanced

We remain concerned about certain aspects of STC's strategy, while STC's complexity makes forecasting profits very difficult. We thus lack confidence that a negative surprise similar to the very weak Q1 results will not recur. On the other hand, STC is financially stable with a 7.5% dividend yield. Moreover, we expect prospects in Saudi Arabia to improve gradually and cost pressures overseas to abate from now. We have lowered our 2010 net profit forecast by 23%, but our target price by only 5%, to SAR44.20. We retain a Neutral rating.

Strategic questions remain: Regarding the Saudi market, a recent visit to STC increased our confidence that its investment in next-generation fixed-line network technology (NGN) will both create new growth opportunities and permit substantial cost savings. However, we are more cautious about STC's apparent interest in fibre-to-the-home (FTTH), which involves heavy investment and in our view is unlikely to yield high returns outside the business sector. As explained in our detail in our major report *Saudi Telecoms Sector: we prefer jam today* (25 January), we are concerned about aspects of STC's expansion abroad. We note that STC lacks control of its most valuable operations (Turkey and Malaysia) and that it ranks no.3 or lower in all its other foreign markets.

Dire Q1 results, but operating prospects should improve: STC's recently announced Q1 2010 results featured a 38% year-on-year drop in operating profit and what we believe was the lowest EBITDA margin since at least Q4 2006. We find it hard to explain fully why the results were so poor. Looking ahead, however, prospects are brighter. In the Saudi mobile market, we judge that STC has maintained its ARPU premium over its rivals, and that it is starting to catch up with Mobily in mobile broadband. We see major new revenue opportunities for STC from the government sector (e.g. the new economic city projects) and large corporate clients. Abroad, we expect investment and start-up losses to fall gradually in STC's newer markets. That said, the timing of improvement in the overseas operations is hard to predict, and subject to exchange rate fluctuations.

Financially stable and dividend looks safe: Our preferred measure of gearing for telecoms operators is net debt/EBITDA. At the end of Q1 2010, STC's net debt/EBITDA ratio was 1.3x. While above our forecast, this is a very healthy level. STC announces dividends each quarter, and for the past several quarters has paid a total dividend of SAR1.5bn; it maintained this level for Q1 2010. Since net profit was SAR1.77bn in Q1, the dividend was covered 1.2x. We expect STC's quarterly results to improve from now on and expect the full-year dividend to be unchanged at SAR6.0bn or SAR3.0 per share. On this basis STC yields 7.5%.

Valuation and conclusion: Reflecting the 8% fall in its share price on the day after the announcement of the Q1 results (20th April), as of the close on 8th May STC had fallen by 12% and underperformed the TASI by 15% since we launched coverage on 25th January. After the Q1 results and a review of our assumptions, we have cut our net profit forecast for 2010 by 23%, and for 2011 by 15%. However, these cuts have a more limited impact on our long-run valuation, and so we have lowered our target price by only 5%, to SAR44.20. We think most potential bad news is now reflected in STC's share price. STC trades on a modest PE of 8.7x and its 2010 yield of 7.5% is one of the highest levels in the TASI. As the leading stock in a traditionally defensive sector, it may also outperform if recent market weakness continues. We retain our Neutral rating.

Corporate summary

STC is the largest telecoms operator in the GCC region, with a market value of US$22bn. STC completely dominates the Saudi fixed-line telecoms market and retains the highest share of the mobile market by revenues. STC is committed to expansion by investment abroad and acquisition, and has made major investments in Turkey, Malaysia, South Africa and elsewhere. These investments account for around one-quarter of its value.

Share information

Market cap (SAR/US$)	80.00bn / 21.33bn
52-week range	39.40 - 56.75
Daily avg volume (US$)	13.00mn
Shares outstanding	2,000mn
Free float (est)	16.4%

Performance:	1M	3M	12M
Absolute	-15.4%	-7.8%	-19.7%
Relative to index	-13.9%	-15.4%	-30.6%

Major Shareholder:	
Public Investment Fund	70%
Gen. Organisation for Social Insce.	7%

Source: Bloomberg, Al Rajhi Capital

Valuation

Period End	12/09A	12/10E	12/11E	12/12E
Revenue (SARmn)	50,780	53,212	56,290	59,578
EBITDA (SARmn)	20,612	19,916	22,049	24,129
Net Profit (SARmn)	10,176	9,167	10,782	10,851
EPS (SAR)	5.43	4.58	5.39	5.43
DPS (SAR)	3.00	3.00	3.09	3.15
EPS Growth	-1.6%	-15.6%	17.6%	0.6%
EV/EBITDA (x)	4.9	5.0	4.5	4.1
P/E (x)	7.4	8.7	7.4	7.4
P/B (x)	1.9	1.8	1.6	1.5
Dividend Yield	7.5%	7.5%	7.7%	7.9%

Source: Company data, Al Rajhi Capital

Strategic questions remain

The discussion below concerns specific aspects of STC's strategy. We do not claim to present here a full analysis of STC's FORWARD strategy for domestic and international markets.

Domestic fixed-line market

STC plans to invest in "next-generation network" (NGN) between 2009 and 2012

We discussed STC's plans for investment in "next-generation network" (NGN) infrastructure in the Saudi fixed-line market in our comprehensive report *Saudi Telecoms Sector: we prefer jam today* (25 January; see page 12). In common with many other incumbent telecoms operators, STC believes that investment in NGN will strengthen its position in the fixed-line telecoms market, which has been under pressure for many years. STC's plan involves phased replacement of existing fixed-line infrastructure over a four year period between 2009 and 2012. On completion, the NGN should permit substantial operating cost savings as the new network equipment will require less expenditure on repairs. It should also facilitate both the delivery of faster broadband speeds – potentially up to 100 gigabytes per second – and the introduction of new services such as IP-TV.

We support STC's NGN plans, but are more cautious about its investment in "fibre-to-the-home" (FTTH)

While we support STC's plans for NGN *per se*, we are more concerned about what we see as its rising interest in FTTH ("fibre-to-the-home") investment. While the terms NGN and FTTH are often loosely used synonymously, in fact they mean something different. NGN refers in particular to the architecture of a telecoms network and entails investment in the network backbone: routers, switches, transmission systems, etc. By contrast, FTTH refers to the most modern medium of fixed-line communication: fibre-optic cables, which have far higher capacity to carry data than traditional copper wires. FTTH entails investment at the periphery of the network, i.e. in the "last mile" leading to homes and offices.

On a recent visit to STC, the topic of FTTH arose several times in our discussion. We understood that STC already has the ability to offer FTTH in Riyadh and Jeddah, and that it plans to invest in FTTH in most major Saudi cities. Investment in FTTH for large public sector and business customers makes sense: in combination with the NGN, FTTH should allow STC to offer high-speed, high-capacity communication services far superior to those offered by its rivals. However, to us the discussion appeared to suggest that STC is also contemplating investment in FTTH on a substantial scale for residential customers.

We think FTTH requires various conditions for success…

In our view, this is unlikely to be a good idea. Full FTTH requires heavy investment in laying lines to end-users. The author of this report has argued in previous research on the global telecoms sector that full FTTH is only likely to yield high returns in markets where five conditions apply:

- The country is relatively small, or highly urbanised
- The country is relatively wealthy
- There are high levels of network-based competition, notably from alternative telecoms operators or digital cable TV operators
- There is a proven revenue opportunity from high-capacity telecoms applications, eg, broadband internet access, pay-TV, video-on-demand or interactive gaming
- The regulator is prepared to allow the incumbent to make an adequate return on its next-generation investment, eg, by not actively promoting open network access

…which may not hold true in Saudi Arabia

Markets where FTTH is starting to yield, or may yield, good returns include small Asian city states like Hong Kong or Singapore, where the majority of the population lives in tall apartment blocks. This contrasts with Saudi Arabia, which is large and sparsely populated and where many people live in individual houses. Other markets where operators have made substantial investment in FTTH include Japan and the north-eastern US. In the latter in particular, one of the key incentives for the operator Verizon to adopt full FTTH was the competitive threat from cable TV networks offering internet access and voice telephony service as well as television. Such a threat does not exist on the same scale in Saudi Arabia, where alternative operators are small and there is no cable TV sector. There is clearly huge demand for broadband internet access in the kingdom, partly because entertainment opportunities are so limited; there is also huge demand for largely unregulated satellite TV service. STC's CEO recently announced (see, for example, the report on Bloomberg of 21st April, citing the CEO's interview with Al Arabiya Television) that the company planned to launch television service over broadband lines in Q2. However, we suspect initial steps will be small in scale; it may also turn out that the authorities only permit STC, as a regulated telecoms operator, to offer TV service under tight controls. Finally, point 5. above regarding network access is an open question. The Saudi telecoms regulator requires the incumbent operator, i.e STC, to offer access to its network to rival fixed-line operators. However, at present this does not really affect STC because the rivals are small and few in number.

We stress that STC's plans for FTTH do not appear to be finalised, and we look forward to further indications from the company about the direction that it plans to take. While we would need to carry out further analysis, a modest strategy of focusing on public sector, corporate and very high-end customers for FTTH might make sense after all.

Overseas operations

We remain concerned about STC's overseas expansion, and regard only its operations in Turkey and Malaysia as strong

We refer investors to page 17 of *Saudi Telecoms Sector: we prefer jam today* for detailed discussion of STC's overseas expansion. Here let it suffice to say that we remain concerned about several aspects of STC's expansion. Historical examples of expansion in the global telecoms sector suggest that it is always better to aim for control than for minority stakes in overseas operators, but we note that STC lacks control of its most valuable operations in Turkey and Malaysia. Likewise, the historical examples suggest that telecoms groups expanding overseas should avoid investment in minor operators; however, we note that STC ranks no.3 or lower in all its foreign markets other than Turkey and Malaysia. In our opinion, STC did not pay sufficient attention to the historical examples; and this helps explain why its overseas investments are proving a near-term drag on its results. That said, we regard some of STC's investments as good ones which will yield good returns over time.

Figure 1. STC: overseas investments

Associate of STC	Ownership	Major subsidiary	Countries where present	Segment of telecoms mkt	Mkt. posn.	ARC assessment of market position
Binariang	25.0%	Maxis	Malaysia	Mobile	1	Strong
		Maxis (Aircel)	India	Mobile	5	Medium
		Maxis (Axis)	Indonesia	Mobile	4	Very weak
Oger Telecom	35.0%	Turk Telekom	Turkey	Fixed line	1	Strong
		Avea*	Turkey	Mobile	2	Medium
		Cell C	South Africa	Mobile	3	Weak
Kuwaiti Telecom Company	26.0%	n/a	Kuwait	Mobile	3	Weak
Bahrain third mobile licence	100.0%	n/a	Bahrain	Mobile	3	Medium

** Mobile subsidiary of Turk Telekom*

Source: STC, Al Rajhi Capital

Source: Company data, Al Rajhi Capital

Hard to explain why Q1 results were so weak

Profit and loss account

We believe STC's Q1 2010 results were the weakest since at least Q4 2006

STC's Q1 2010 results featured year-on-year declines in operating profit of 38% and in net profit of 29%. We calculate the EBITDA margin at 35.6%, which based on the quarterly historic figures that we have collected was the lowest level since at least Q4 2006 (we have historic figures back to Q1 2007). We believe that operating profit of SAR2,353mn and net profit of SAR1,772mn were likewise the lowest figures since at least Q4 2006, although we pay less attention to net profit because foreign exchange gains and losses and exceptional items have made it very volatile.

Figure 2. STC: quarterly results since Q1 2007

(SAR mn)	Q107	Q207	Q307	Q407	Q108	Q208	Q308	Q408	Q109	Q209	Q309	Q409	Q110
Revenues	7,938	7,909	8,584	10,027	9,575	12,030	13,538	12,326	12,143	12,674	12,934	13,029	12,520
EBITDA	3,843	4,187	4,452	4,234	4,904	5,791	6,481	4,566	5,611	5,136	5,092	4,773	4,460
EBITDA mar. (%)	48.4%	52.9%	51.9%	42.2%	51.2%	48.1%	47.9%	37.0%	46.2%	40.5%	39.4%	36.6%	35.6%
Oper. profit	2,920	3,227	3,482	2,989	3,569	4,345	4,604	2,818	3,836	3,228	3,112	2,637	2,353
Net profit	2,719	3,103	3,140	3,060	3,029	3,840	3,012	1,156	2,488	2,990	2,403	2,983	1,772

Note:
1. We have not fully adjusted Q1 2009 numbers in our model for certain restatements by STC in Q1 2010.
2. In certain cases we have calculated Q4 figures by subtracting figures for the first nine months from those in the annual report. These figures may differ slightly from the Q4 results published by STC in its original Q4 results releases.
Source: Company data, calculations by Al Rajhi Capital

STC's results fell well below both consensus forecasts and our own, which with hindsight were clearly too optimistic. Reflecting the negative surprise, STC's share price fell by 8% on 20 April, the day after the results announcement in the evening. Below we present key details of the figures, together with our comments.

Figure 3. STC: Q1 2010 results

(SAR mn)	Q1'09 actual	Q4'09 actual	Q1'10 actual	% chg y-y	Q1'10 ARC est	Comment
Subscriptions (000s)	19,550	21,000	22,000	12.5%	21,979	Published irregularly by STC, but these figures should be approximately correct
Subscriptions market share (%)	51.9%	46.4%	46.5%	-5.4pp	46.4%	As above
Broadband subscriptions (000s)	n/a	600	1,000	n/a	1,000	ARC estimates
Service revenues	12,143	13,029	12,520	3.1%	12,952	Solid performance, but not as strong as the 5.5% performance seen in Q4
Gross profit	7,913	n/a	7,160	-9.5%	n/a	As significant decline driven by pressure on international call prices and rising aggregate access charges
Gross margin	65.2%	n/a	57.2%	-8.0pp	n/a	SG&A costs rose 27% year-on-year, partly reflecting an 88% increase in bad debt expenses
EBITDA	5,611	4,773	4,460	-20.5%	5,634	A disappointing outcome, albeit in comparison to a strong Q1 2010
EBITDA margin (%)	46.2%	36.6%	35.6%	-10.6pp	43.5%	We believe the 35.6% EBITDA margin in Q1 2010 was the weakest figure since at least Q4 2006
Depn. & amortisation	-1,775	-2,136	-2,107	18.7%	-1,861	Depreciation charges rose substantially due partly to continuing investment in overseas operations
Operating profit	3,837	2,637	2,353	-38.7%	3,773	A very weak figure: well below both our estimate and consensus
Financing cost	-364	-352	-427	17.3%	-313	Hard to explain why interest costs rose significantly quarter-on-quarter
Foreign exchange gains/losses	-695	94	109	-115.7%	0	A big turnaround from a large forex loss in Q1 2009
Other	-113	251	110	-197.3%	93	Very volatile
Net income before tax	2,665	2,630	2,145	-19.5%	3,553	A weak figure: well below both our estimate and consensus
Tax and zakat	-220	-262	-244	n/m	-222	In line with our estimate
Minority interest	44	-72	-129	-393.2%	-142	In line with our estimate
Exceptional items	0	687	0	n/m		No major exceptional items in Q1 2010
Net profit	2,488	2,983	1,772	-28.8%	3,189	The second lowest net profit since Q1 2007
Capex	-5,581	-2,673	-1,556	-72.1%	-2,802	Well below our forecast, although quarterly capex is very volatile for telecoms operators
Capex/sales (%)	46.0%	20.5%	12.4%	-33.6pp	21.6%	As above
Net debt	21,764	23,580	22,572	3.7%	20,895	Net debt exceeded our forecast because profits and cash flow were weaker than we had expected
Net debt/annualised EBITDA (x)	1.0	1.2	1.3	n/m	0.9	This is a very healthy gearing level

Note. We have calculated Q4 figures by subtracting figures for the first nine months from those in the annual report. These figures differ slightly from the Q4 results published by STC in its original results release for 2009.

Source: Company data, Al Rajhi Capital

It has taken us some time to analyse STC's figures more closely. However, we can now comment in slightly greater detail on what went wrong in Q1. STC gives four principal explanations for the weakness of the results; we comment on these issues below.

Pressure on international call prices

While we underestimated price pressure in international calls in Q1, the pressure should ease from Q2 onwards

Pressure on international call prices appears to have intensified in Q1 in both the mobile and fixed-line markets. Mobily did much to instigate this pressure, launching an aggressive promotion featuring international mobile calls at a rate of 1 halala (SAR0.01) per second. According to STC, it did not respond with direct price cuts, but it did launch limited promotions in both mobile and fixed-line service over the quarter. Considering that international fixed-line prices have fallen so far in recent years in most markets that international fixed calls no longer constitute a major element of revenues for most telecoms operators, we had not expected price pressure in this area to be a major negative factor in Q1; however, it appears that we had underestimated the importance of international mobile calls. STC's CEO has recently stated (see again the report on Bloomberg of 21st April, citing the CEO's interview with Al Arabiya Television) that he expects pressure on international calls to abate from Q2 onwards. This view seems reasonable, given our understanding that Mobily has now called off its big promotion.

Rising access charges

We remain surprised by the scale of the increase in access charges in Q1

In telecoms, access charges or interconnection rates are the fees that operators pay to deliver calls to the networks of other operators. STC has pointed for some time to rising international access charges as a cause of upward pressure on costs; in Q1, access charges rose in aggregate by 46% year-on-year, from SAR1,303mn to SAR1,904mn, compared to the 3% increase in revenues. (We calculate that access charges fell by 13% compared to Q4 2009, but telecoms traffic volumes are seasonally high in Q4.) We have been confused by the upward trend in access charges, since we see very little evidence that international access charges are rising on a per-call or per-unit basis. STC has confirmed to us that access charges have not been rising on a per-unit basis. According to the company, however, there was an increase in aggregate international call volumes due to the promotions in the Saudi market; there was also an increase in international traffic volumes from India, Indonesia and affiliates in other foreign markets. We can understand why that this factor pushed up aggregate access charge payments, although the scale of the increase continues to surprise us.

Continuing investment overseas

Continuing investment abroad is the mot understandable reason for pressure on results

STC continues to invest heavily overseas. The present focus of capital expenditure is the newly established, wholly owned ventures in Kuwait and Bahrain. As investment in these companies increases, so depreciation costs rise. At the same time, STC continues to experience heavy start-up costs in operations such as Aircell in India and Cell C in South Africa. This is the most easily understandable reason for continuing pressure on STC's results.

Decline in ownership of Maxis Malaysia

We had mistakenly assumed that the IPO of Maxis Malaysia would not reduce Binariang's contribution to STC

One of the reasons for the complexity of STC's financial statements is its use of proportionate accounting. STC owns 35% of Oger Telecom, the owner of Turk Telecom and Cell C, and 25% of Binariang, the owner of Maxis Malaysia. Under more common consolidated accounting, it would probably treat both Oger and Binariang as equity associates, and simply include 35% and 25% of their net profit respectively in its profit & loss account. However, under proportionate accounting STC includes in its own accounts 35% and 25% respectively of all lines of Oger's and Binariang's income statements (together with the same proportions of all lines of their balance sheets and cash flow statements). Binariang's subsidiary Maxis Malaysia was listed by IPO in Q4 2009, and its ownership consequently fell from 100% to 70%. Because Binariang remains the majority owner of Maxis Malaysia, we had wrongly assumed that the latter's IPO would not significantly affect STC's results. In fact, under proportionate accounting the reduction in Binariang's ownership does appear to have had a material adverse impact on profits.

Besides the reasons cited by STC, we can think of two possible further reasons for weakness in STC's results:

Possible adverse foreign exchange effects

We cannot assess accurately the positive or negative impact of hedging on STC's results

With 27-28% of revenues now coming from overseas operations by our estimate, STC is vulnerable to fluctuations in foreign exchange rates. This has been reflected in the inclusion of very large foreign exchange gains and losses in financial income in the profit & loss account: the largest in recent quarters was the loss of SAR695mn in Q1 2009. In our opinion, we have not received sufficient guidance from STC about its hedging policies to comment accurately on the impact of hedging on its results. STC has argued to us that its subsidiaries and affiliates have strict hedging policies which are now closely aligned with group policy, and that this closer alignment has reduced the impact of exchange rates on its results. This argument seems reasonable, considering that STC reported foreign exchange gains of SAR90-110m as part of financial income in both Q4 and Q1. However, we cannot judge to what extent, if any, these gains offset a negative impact from exchange rate movements o revenues and operating profit.

Figure 4. STC: foreign exchange gains and losses

(SAR mn)	Q108	Q208	Q308	Q408	Q109	Q209	Q309	Q409	Q110
EBITDA	4,904	5,791	6,481	4,566	5,611	5,136	5,092	4,773	4,460
Oper. profit	3,569	4,345	4,604	2,818	3,836	3,228	3,112	2,637	2,353
Forex gains or losses	-18	583	-418	-1,563	-695	1,026	216	94	109
Net profit	3,029	3,840	3,012	1,156	2,488	2,990	2,403	2,983	1,772

Source: Company data, Al Rajhi Capital

Possible weakness in mobile

Besides proportionate accounting, in our view the second major factor which makes interpreting and forecasting results for STC very difficult is very limited disclosure of revenues and profits in the overseas operations. STC does not publish a geographical breakdown of results; it simply publishes a segment presentation which aggregates results in Saudi Arabia and the overseas markets. There are four segments: GSM (mobile), PSTN (fixed-line voice), data (leased data transmission circuits, DSL and internet) and unallocated activities.

Net profit in the GSM segment fell by 56% y-o-y in Q1 2010

The segment presentation in Note 11 of STC's Q1 results shows that net profit in the GSM segment declined by 56% year-on-year, from SAR2,725mn in Q1 2009 to SAR1,190mn in Q1 2010. The magnitude of this decline is again hard to understand. One of the explanations is, of course, rising investment and start-up losses in STC's foreign mobile operations. However, on seeing this result we wondered whether it was an indication of increasing competitive pressure in the domestic mobile operations. STC has told us that a "one-time adjustment" affected the results of the mobile segment in Q1, but has not yet elaborated on this. This explanation seems plausible, given that the strangely sharp decline in profitability in the GSM segment was matched by an equally strange recovery in the PSTN segment, whose net result recovered from a net loss of SAR78mn to a net profit of SAR243mn.However, in the absence of further clarification we cannot rule out the possibility that the poor headline result of the GSM segment does partially reflect increasing pressure in the domestic mobile business.

Balance sheet and dividends

STC's overall financial position is stronger than its weak headline results would suggest

We have spent some time discussing the weakness of STC's results in Q1 – or, more specifically, the weakness of items in the profit & loss account. We should make clear that STC's balance sheet still looks very solid. Our preferred measure of gearing for telecoms operators is net debt/EBITDA. At the end of Q1, STC's net debt/EBITDA ratio was 1.3x. While above our forecast, this is a very healthy level and actually well below our recommended optimum gearing level for a telecoms operator in a developed market (a net debt/EBITDA ratio of around 2.0x). Regarding dividends, STC announces dividends each quarter, and for the past several quarters has paid a total dividend of SAR1.5bn; it intends to maintain this level for Q1 2010. Since net profit was SAR1.77bn in Q1, the dividend was covered 1.2x. We expect STC's quarterly results to improve gradually from now on and expect the full-year dividend to be unchanged at SAR6.0bn or SAR.3.0 per share. On this basis STC yields 7.4%.

Operating prospects should gradually improve

Our forecasts for STC carry a higher margin of error than for the other Saudi operators

In our view, the wide geographical spread of STC's operations, the lack of any geographical breakdown of results and STC's and STC's use of proportionate accounting all complicate analysis of the company The same factors naturally complicate forecasting of results; we believe that our estimates for STC carry a significantly higher margin of error than our estimates for the other Saudi operators. All that said, we expect STC's earnings to pick up gradually from Q2 2010 onwards. There are various reasons for this apart from the probable easing of price pressures in international calls that we mentioned earlier.

Saudi mobile market

We think STC has maintained its ARPU premium, and expect its mobile market share to stabilise from now on

Accurate figures for the Saudi mobile market are difficult to obtain: we are sceptical even about the data provided by the telecoms regulator, the Communications and Information Technology Commission (CITC), which we find hard to reconcile with indications from the operators. In the Saudi mobile market, we judge that STC has so far been able to maintain its ARPU premium over its rivals, with ARPU of around SAR100 compared to SAR60-65 for Mobily and Zain KSA by our estimates. With the market shifting increasingly to mobile broadband, it may be that our concern about the impact on STC of what we see as probable loss of prepaid voice subscriptions to cheaper rivals is overdone. We also believe that STC is starting to catch up with Mobily in mobile broadband: we estimate that it had 0.85mn broadband mobile subscriptions at the end of Q1, compared to Mobily on around 1.2mn. We estimate that STC's share of the domestic mobile market by subscriptions fell from 53% to 46% over 2009, although by revenues its market share remains much higher, falling from 66% to 61% last year by our estimate. With slightly more positive signs emerging, we believe that its mobile market share can stabilise from now on.

Domestic fixed-line market

We see significant new revenue opportunities in fixed-line data for STC, although there are threats too

We see significant new revenue opportunities for STC in the domestic fixed-line data market – and maybe even in the fixed-line voice market – from the government segment and large corporate clients. In the near term, we expect these to come from large new contracts relating, for example, to the government's new economic city projects. In the medium to long term, we think investment in NGN and FTTH will drive business in these market segments. However, one risk for STC is that further decline in the residential fixed-line voice market will offset much of this growth. DSL, which has been a very strong business for STC over the past couple of years, may also start to mature and even decline; we believe that DSL is threatened by mobile broadband. In this context, it is interesting to note that net income in STC's data segment dropped by 20% year-on-year in Q1, from SAR416mn to SAR335mn. We do not have an explanation for this.

Overseas operations

Earnings prospects overseas should gradually improve

We expect investment and start-up losses to decline gradually in STC's overseas markets. The operation in Malaysia in particular is mature, highly profitable and cash-generative, although prospects in Turkey are perhaps less certain. Regarding the other markets, we expect investment activity to peak shortly in Kuwait and Bahrain (which are small markets) and perhaps India. We are pessimistic about prospects in Indonesia in particular, where STC has invested in the no.4 player in a low-price market dominated by three reasonably strong large players. We should stress that the timing of improvement in the overseas operations is hard to predict, and is subject to fluctuations to exchange rates.

Valuation and conclusion

We have cut our estimate of net profit for 2010 by 23%, and for 2011 by 13%. We now expect earnings to fall this year

Reflecting the 8% fall in its share price on the day after the announcement of the Q1 results (20th April), as of the close of business on 8th May STC had fallen by 12% and underperformed the TASI by 15% since we launched coverage on 25th January. Following the Q1 results and a full review of our assumptions, we have cut our forecast of net profit for 2010 by 23%, from SAR11,977mn to SAR9,167mn. We now expect net profit to fall by 16% in 2010 (or by 10% excluding last year's capital gain of SAR687mn on the IPO of Maxis Malaysia), whereas previously we had assumed it would rise by 10% (18% excluding the capital gain). We have cut our estimate of net profit for 2011 by 15%, from SAR12,755mn to SAR10,782mn. Our 2011 forecast implies growth of 18% over 2010.

On an SoTP basis we estimate fair value at SAR43.8; on a long-run DEP basis we estimate fair value at SAR44.6

We continue to value STC in two ways. Firstly, we use a comparative sum-of-the-parts (SoTP) valuation which uses aggregate EV/EBITDA multiples for peer companies to estimate fair values for STC's constituent parts (although we include the listed Turk Telekom and Maxis Malaysia in our valuation at actual market enterprise values). After recently rolling forward our STC model so that our comparisons are now based on 2010 rather than 2009 figures, we have increased our estimate of fair value per share on a comparative basis from SAR 42.7 to SAR43.8. Secondly, we use a long-run discounted economic profit (DEP) model with a sliding WACC weighted by the estimated contribution that STC's domestic and foreign operations make to sales each year. While we have sharply cut our near-term profit forecasts for STC, these cuts have a more limited impact on our long-run valuation. In addition, the long-run valuation has been boosted by revisions to our WACC assumptions, which have led us to lower our estimate of STC's group WACC for 2010 from 10.1% to 9.3%. We have reduced our estimate of fair value per share on a long-run DEP basis by 11%, from SAR50.0 to SAR44.6.

Our new target price for STC is SAR44.2, a reduction of 5% from our previous estimate

Our target price for STC remains a simple average of our estimates of fair value under the two methods, i.e. SAR44.2. This represents a 5% reduction from our previous target price of SAR46.4. We should note that our target is towards the low end of a wide range of estimates, but not at the bottom: the seven most recent published target prices on Bloomberg range between SAR37.00 and SAR67.70. We consider that most potential bad news is now reflected in STC's share price. STC now trades on a modest PE of 8.7x and its prospective dividend yield of 7.5% is one of the highest levels in the TASI. As the leading stock in a traditionally defensive sector, it may also start outperforming if recent market weakness continues. We retain our Neutral rating.

We expect organic sales growth of 5-6% over the next few years, driven by the overseas operations

We expect the dividend to be maintained at SAR3.0 in 2010

We now expect net profit to decline in 2010

We expect the EBITDA margin to drop by 3.3 percentage points this year

However, ROIC remains well above cost of capital; STC is generating economic profits

Income Statement (SARmn)	12/08A	12/09A	12/10E	12/11E	12/12E
Revenue	**47,469**	**50,780**	**53,212**	**56,290**	**59,578**
Access Charges	(6,131)	(7,494)	(8,419)	(8,478)	(8,937)
Employee Costs	(6,164)	(6,772)	(7,022)	(7,318)	(7,745)
Government Charges	(5,542)	(5,664)	(5,904)	(6,192)	(6,554)
S.G. & A. Costs	(5,762)	(7,614)	(8,525)	(8,731)	(9,235)
Repairs & Maintenance Costs	(2,128)	(2,623)	(3,425)	(3,522)	(2,979)
Operating EBIT	**15,335**	**12,814**	**11,597**	**13,485**	**13,317**
Cash Operating Costs	(25,727)	(30,168)	(33,295)	(34,242)	(35,449)
EBITDA	**21,743**	**20,612**	**19,916**	**22,049**	**24,129**
Depreciation and Amortisation	(6,408)	(7,799)	(8,319)	(8,564)	(10,812)
Operating Profit	**15,335**	**12,814**	**11,597**	**13,485**	**13,317**
Net financing income/(costs)	(809)	(1,023)	(1,033)	(845)	(662)
Forex and Related Gains	(1,415)	642	109	-	-
Provisions	(675)	(811)	-	-	-
Other Income	(394)	(178)	61	-	-
Other Expenses					
Minority Interests	(172)	(290)	(473)	(632)	(759)
Net Profit Before Taxes	**11,870**	**11,153**	**10,261**	**12,008**	**11,896**
Taxes	(832)	(977)	(1,094)	(1,227)	(1,045)
Net Profit	**11,038**	**10,176**	**9,167**	**10,782**	**10,851**
Dividends	-	(6,000)	(6,000)	(6,180)	(6,304)
Transfer to Capital Reserve	-	-	-	-	-

	12/08A	12/09A	12/10E	12/11E	12/12E
Adjusted Shares Out (mn)	2,000	2,000	2,000	2,000	2,000
CFPS (SAR)	8.72	8.99	8.74	9.67	10.83
EPS (SAR)	5.52	5.43	4.58	5.39	5.43
DPS (SAR)	0.000	3.000	3.000	3.090	3.152

Growth	12/08A	12/09A	12/10E	12/11E	12/12E
Revenue Growth	37.8%	7.0%	4.8%	5.8%	5.8%
EBITDA Growth	30.1%	-5.2%	-3.4%	10.7%	9.4%
Operating Profit Growth	21.5%	-16.4%	-9.5%	16.3%	-1.2%
Net Profit Growth	-8.2%	-1.6%	-15.6%	17.6%	0.6%
EPS Growth	-8.2%	-1.6%	-15.6%	17.6%	0.6%

Margins	12/08A	12/09A	12/10E	12/11E	12/12E
EBITDA margin	45.8%	40.6%	37.4%	39.2%	40.5%
Operating Margin	32.3%	25.2%	21.8%	24.0%	22.4%
Pretax profit margin	25.0%	22.0%	19.3%	21.3%	20.0%
Net profit margin	23.3%	21.4%	17.2%	19.2%	18.2%

Other Ratios	12/08A	12/09A	12/10E	12/11E	12/12E
ROCE	20.7%	16.6%	14.0%	15.3%	14.3%
ROIC	28.8%	15.7%	12.6%	14.3%	13.5%
ROE	30.0%	27.3%	21.0%	22.6%	20.7%
Effective Tax Rate	7.0%	8.8%	10.7%	10.2%	8.8%
Capex/Sales	34.3%	30.8%	23.1%	25.0%	24.4%
Dividend Payout Ratio	0.0%	55.2%	65.5%	57.3%	58.1%

Valuation Measures	12/08A	12/09A	12/10E	12/11E	12/12E
P/E (x)	7.2	7.4	8.7	7.4	7.4
P/CF (x)	4.6	4.5	4.6	4.1	3.7
P/B (x)	2.1	1.9	1.8	1.6	1.5
EV/Sales (x)	2.1	2.0	1.9	1.8	1.7
EV/EBITDA (x)	4.7	4.9	5.0	4.5	4.1
EV/EBIT (x)	6.6	7.9	8.7	7.4	7.5
EV/IC (x)	1.4	1.2	1.2	1.1	1.1
Dividend Yield	0.0%	7.5%	7.5%	7.7%	7.9%

Source: Company data, Al Rajhi Capital

STC's balance sheet is expanding as a result of investment overseas

Balance Sheet (SARmn)	12/08A	12/09A	12/10E	12/11E	12/12E
Cash and Cash Equivalents	8,061	7,710	6,793	7,638	7,146
Current Receivables	8,120	11,461	12,169	12,766	13,107
Inventories	778	710	830	870	894
Other current assets	1,987	2,782	4,241	4,241	4,241
Total Current Assets	**18,946**	**22,663**	**24,033**	**25,517**	**25,389**
Fixed Assets	44,382	52,737	57,721	64,299	69,095
Investments	2,452	2,533	2,580	2,580	2,580
Goodwill	-	-	-	-	-
Other Intangible Assets	31,695	29,222	28,730	27,682	26,635
Total Other Assets	**2,287**	**2,433**	**2,426**	**2,426**	**2,426**
Total Non-current Assets	**80,816**	**86,924**	**91,456**	**96,988**	**100,736**
Total Assets	**99,762**	**109,587**	**115,490**	**122,504**	**126,125**
Short Term Debt	3,905	8,579	5,889	5,889	5,889
Trade Payables	18,994	20,762	25,559	27,281	25,563
Dividends Payable	-	-	(1,500)	(1,500)	(1,500)
Other Current Liabilities	-	(0)	-	-	-
Total Current Liabilities	**22,899**	**29,341**	**29,949**	**31,670**	**29,953**
Long-Term Debt	28,081	22,711	23,939	23,939	23,939
Other LT Payables	3,482	3,859	4,044	4,044	4,044
Provisions	2,738	2,844	2,917	2,917	2,917
Total Non-current Liabilities	**34,301**	**29,414**	**30,900**	**30,900**	**30,900**
Minority interests	4,924	8,798	9,242	9,874	10,633
Paid-up share capital	20,000	20,000	20,000	20,000	20,000
Total Reserves	17,638	22,035	25,399	30,060	34,639
Total Shareholders' Equity	**37,638**	**42,035**	**45,399**	**50,060**	**54,639**
Total Equity	**42,562**	**50,833**	**54,641**	**59,935**	**65,272**
Total Liabilities & Shareholders' Equity	**99,762**	**109,587**	**115,490**	**122,504**	**126,125**

STC's financial ratios are mostly very healthy

Ratios	12/08A	12/09A	12/10E	12/11E	12/12E
Net Debt (SARmn)	23,925	23,580	23,035	22,190	22,682
Net Debt/EBITDA (x)	1.10	1.14	1.16	1.01	0.94
Net Debt to Equity	56.2%	46.4%	42.2%	37.0%	34.8%
EBITDA Interest Cover (x)	26.9	20.1	19.3	26.1	36.4
BVPS (SAR)	18.82	21.02	22.70	25.03	27.32

Capex exceeded 30% of sales in both 2008 and 2009, although we expect it to moderate from now on

Cashflow Statement (SARmn)	12/08A	12/09A	12/10E	12/11E	12/12E
Net Income before Tax & Minority Interest	12,042	11,443	10,734	12,641	12,655
Depreciation & Amortisation	6,408	7,799	8,319	8,564	10,812
Decrease in Working Capital	1,610	(3,671)	851	1,083	(2,081)
Other Operating Cashflow	1,089	385	(768)	(1,227)	(1,045)
Cashflow from Operations	**21,149**	**15,956**	**19,136**	**21,060**	**20,341**
Capital Expenditure	(16,278)	(15,637)	(12,284)	(14,095)	(14,561)
New Investments	-	-	(365)	-	-
Others	(19,190)	2,094	-	-	-
Cashflow from investing activities	**(35,468)**	**(13,542)**	**(12,649)**	**(14,095)**	**(14,561)**
Net Operating Cashflow	**(14,319)**	**2,413**	**6,487**	**6,965**	**5,781**
Dividends paid to ordinary shareholders	(8,552)	(5,943)	(6,043)	(6,120)	(6,273)
Proceeds from issue of shares	-	-	-	-	-
Increase in Loans	18,406	(696)	(1,462)	-	-
Effects of Exchange Rates on Cash	-	-	-	-	-
Other Financing Cashflow	4,908	3,874	100	-	-
Cashflow from financing activities	**14,763**	**(2,764)**	**(7,404)**	**(6,120)**	**(6,273)**
Total cash generated	443	(351)	(917)	845	(492)
Cash at beginning of period	7,618	8,061	7,710	6,793	7,638
Implied cash at end of year	**8,061**	**7,710**	**6,793**	**7,638**	**7,146**

Ratios	12/08A	12/09A	12/10E	12/11E	12/12E
Capex/Sales	34.3%	30.8%	23.1%	25.0%	24.4%

Source: Company data, Al Rajhi Capital

Disclaimer and additional disclosures for Equity Research

Disclaimer

Additional disclosures

1. Explanation of Al Rajhi Capital's rating system

Al Rajhi Capital uses a three-tier rating system based on absolute upside or downside potential for all stocks under its coverage except financial stocks and those few other companies not compliant with Islamic Shariah law:

"Overweight": Our target price is more than 15% above the current share price, and we expect the share price to reach the target on a 6-9 month time horizon.

"Neutral": We expect the share price to settle at a level between 5% below the current share price and 15% above the current share price on a 6-9 month time horizon.

"Underweight": Our target price is more than 5% below the current share price, and we expect the share price to reach the target on a 6-9 month time horizon.

2. Definitions

"Time horizon": Our analysts make recommendations on a 6-9 month time horizon. In other words, they expect a given stock to reach their target price within that time.

"Fair value": We estimate fair 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.

"Target price": This may be identical to estimated fair value per share, but is not necessarily the same. There may be very good reasons why a share price is unlikely to reach fair value within our time horizon. In such a case we set a target price which differs from estimated fair value per share, and explain our reasons for doing so.

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.

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