

Initiation Coverage
December 26, 2017

Recommendation	Overweight
Current Price (SAR)	68.50
Target Price (SAR)	75.51
Upside/Downside (%)	10.2%

As of December 26, 2017
Key Data (Source: Bloomberg)

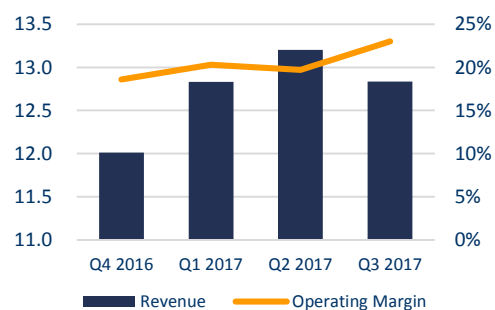
Market Cap (SAR bn)	137.6
52 Wk High (SAR)	78.9
52 Wk Low (SAR)	64.5
Total Outstanding Shares (in bn)	2.0
Free Float (%)	16.2%

STC vs. TASI (Rebased)


Price Performance (%)	Absolute	Relative
1m	-0.3	2.7
6m	10.6	5.8
12m	5.4	4.8

Major Shareholders (%)

Shareholder	%
Public Investment Fund	70.0%
General Org For Social Insurance	7.0%
General Retirement Org	6.8%

Quarterly Sales (SAR bn) and Operating Margin

Source: Bloomberg, Company Financials, FALCOM Research; Data as of December 26, 2017

Saudi Telecom Company's (STC) 3Q17 earnings beat consensus with net income rising to SAR 2.62bn (+10% QoQ, +12% vs. consensus and +18% YoY). Lower operating costs and higher gross margins more than offset a decline in revenue (-3% QoQ and -9% YoY), resulting in higher operating profit. STC's margins improved sequentially, reflecting the positive impact of its cost-control initiatives to improve profitability.

STC faces intensifying competition and saturation in mobile penetration level in KSA. However, its leadership position, strong customer base, operational efficiency, and robust dividend yield are key positives outweighing the constraints. Based on STC's dominant position in the Saudi market and its focus on improving its revenue mix leads to our overweight stance on the stock.

MTR cuts to affect top line

Saudi Arabia's Communications and Information Technology Commission (CITC) approved reducing local voice call rates on mobile networks (MTRs) by 45% to SAR 0.055 from SAR 0.100 and local voice fixed termination rates (landline charges) to SAR 0.021 from SAR 0.045. The revision will come into effect from December 23, 2017, and will attract smaller players in the market, thus intensifying competition. For market leaders (including STC), this move would pressurize ARPU and increase operating costs as they would be compelled to pass on these low rates to customers while maintaining their market share.

Operational efficiency program to boost margins

STC's 9M17 improvement in the bottom line was led by a drop in operating costs, despite a decline in revenue. The company has benefitted from its strategy to focus on expansion in high-growth GCC markets and improving efficiency by adopting an operational efficiency program launched in late 2015. STC significantly cut its cost of services, thereby strengthening its margins in 3Q17, and is expected to continue to reduce costs.

Well positioned to benefit from growth in enterprise and data segments

STC has the largest market share in the mobile segment and a near monopoly in the fixed-line network segment. The company is well positioned to gain from increasing data usage. Internet penetration in Saudi Arabia rose to 75% in 2016 from 55% in 2013. Although the contribution of data services (16.3% in 2016) to STC's revenue mix remains low, the company has been focusing on capitalizing on the changing consumer trend. In addition, STC is targeting enterprises more than consumers, to improve its average margin per user.

Strong balance sheet and high dividend yield to enhance shareholder value

STC has a healthy balance sheet, with cash of SAR 3.1bn as of 3Q17. The company's net debt-to-EBITDA ratio declined to 0.1x in 2016 from 0.4x in 2013, well within its targeted limits. Consequently, STC has a high credit rating with 'Stable' outlook. Moreover, the company's high dividend payout ratio and increasing investments are supported by strong cash flows.

Valuation: We valued STC using the DCF approach to arrive at a fair value of SAR 75.5 per share. We considered WACC at 11.4%, with a terminal growth rate of 2.0%.

	2016A	2017E	2018E	2019E
Revenue (SAR bn)	53.7	51.8	53.9	55.5
Operating profit (SAR bn)	10.0	11.2	12.3	13.6
EPS (SAR)	4.4	5.1	5.6	6.3
Operating margin (%)	18.5%	21.6%	22.8%	24.5%
RoE (%)	14.5%	16.2%	16.8%	17.6%
D/E (x)	0.1	0.1	0.1	0.0
P/E (x)	16.3	13.5	12.4	11.1
Price/BV (x)	2.4	2.2	2.1	2.0
EV/EBITDA (x)	8.1	7.2	6.6	6.0

Source: Company Financials, FALCOM Research

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Valuation Summary

Explanation of valuation methodology and assumptions

We valued STC using the DCF approach to arrive at a fair value of SAR 75.5 per share. We considered WACC at 11.4%, with a terminal growth rate of 2.0%.

In relative terms, the company is trading at a one-year forward EV/EBITDA of 6.6x, at a premium of 0.8% from its sector peers, but trading at a discount of 34.7% from the Tadawul All Share Index.

SAR Mn	FY 2016A	FY 2017E	FY 2018E	FY 2019E	FY 2020E	
EBIT	9,951	11,167	12,298	13,604	14,842	
Taxes	(751)	(707)	(773)	(862)	(951)	
Depreciation, amortization and impairment	8,078	8,099	8,187	7,795	7,521	
Changes in working capital	(3,502)	(2,282)	(180)	(63)	(531)	
Net capital expenditure	(10,502)	(7,979)	(6,309)	(6,386)	(6,579)	
Free cash flow to firm	3,274	8,298	13,222	14,087	14,302	
Discount factor		1.0	0.9	0.8	0.7	
PV of free cash flow to firm		8,311	11,851	11,355	10,330	
Net Present Value (A)					41,827	
PV Terminal Value (B)					112,090	
Assumed Terminal Growth Rate					2.0%	
Discount Rate					11.4%	
Enterprise Value (A+B)	153,917	WACC Assumptions				
Total cash	3,068	Risk-free rate				2.3%
Total debt	5,041	Market returns				11.8%
Minority interest	933	Beta				0.8x
Equity value in SAR mn	151,011	Cost of equity				11.6%
Number of shares in mn	2,000	Post tax cost of debt				6.0%
Target price in SAR per share	75.5	Weight of equity in capital structure				96.6%
CMP in SAR as on December 26, 2017	68.5	Weight of debt in capital structure				3.4%
Upside/(downside) to current market price	10.2%	WACC				11.4%

Source: Company Financials, FALCOM Research Estimates

Risks

Upside Risks:

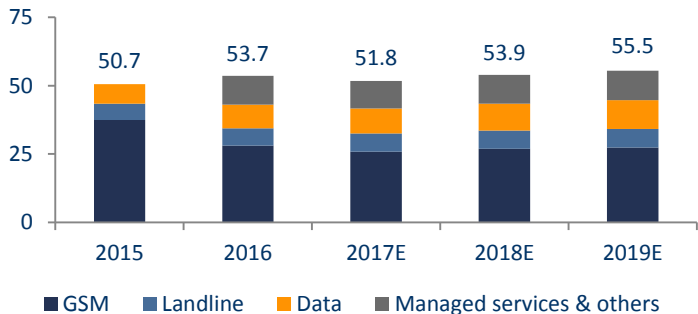
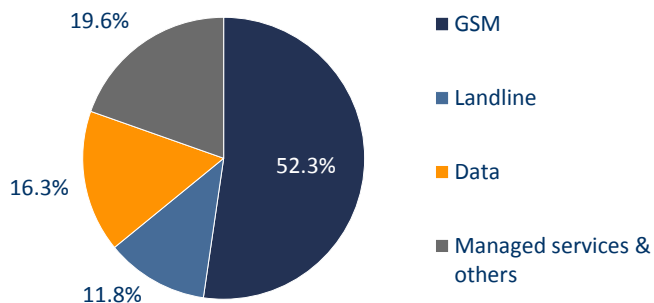
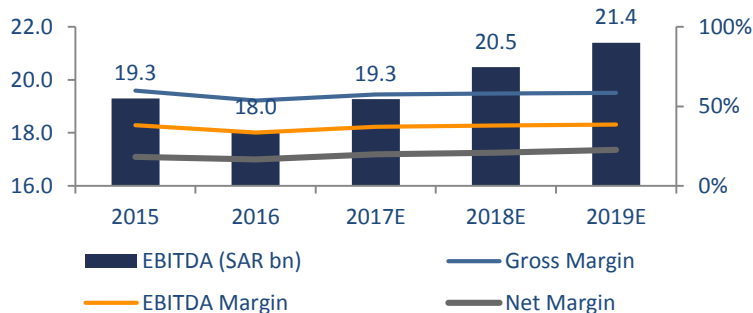
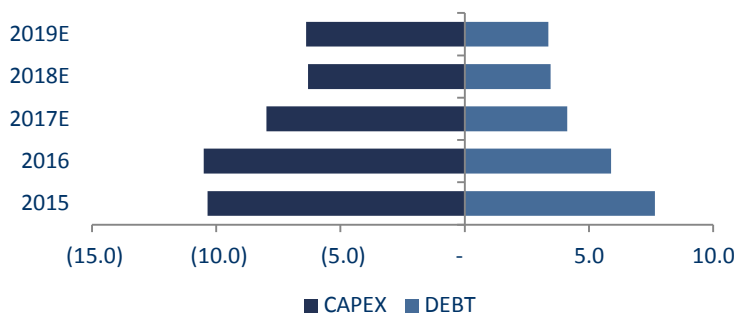
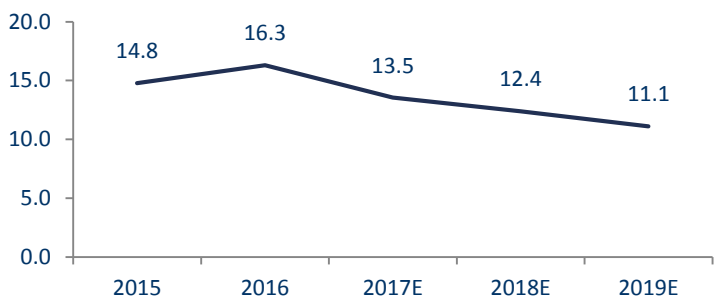
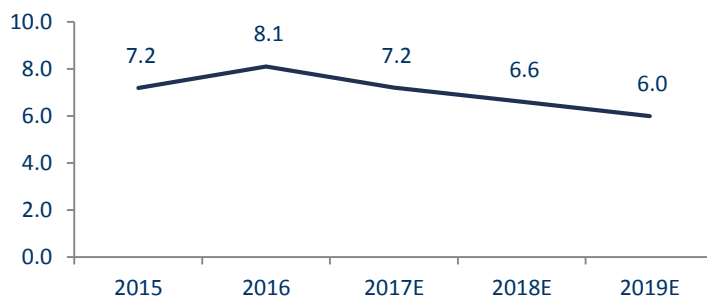
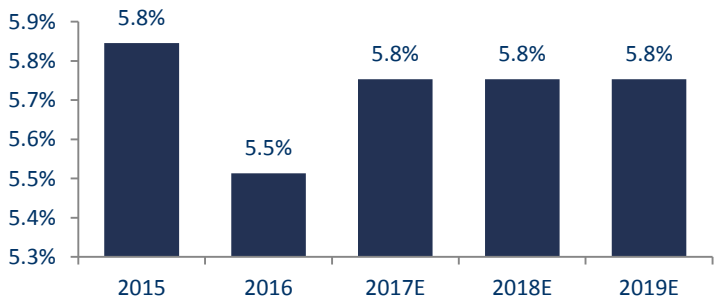
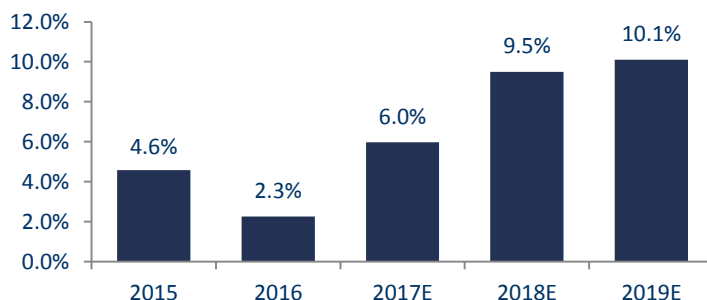
- Diversifying income and bundling of services will increase the value proposition for STC while also mitigating it from the impact of pro-consumer regulatory reforms.
- Growing investments in joint ventures and subsidiaries will result in increasing capacity and thus, reach.
- Possible tower-sharing deals which are underway are likely to provide operational savings, in a capital-intensive industry.

Downside Risks:

- Revisions in the MTR by reducing prices of voice and landline calls would result in a more competitive market. This would lead to additional price cuts, higher attrition, and margin compression.
- The mobile and landline segment has neared saturation. Implementation of stricter regulations such as finger print initiative and cancelling of inactive SIMs limited growth in mobile segment while cannibalization in the landline segment, reduced subscriptions in 2016.

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Key Charts
Revenue (SAR bn)

Revenue Split (2016)

EBITDA & Margins

CAPEX and Total Debt

PE

EV/EBITDA

Dividend Yield

Free Cash Flow Yield


Source: FALCOM Research Estimates

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Summary Financials

P&L (SAR mn)	2016	2017E	2018E	2019E
Sales	53,678	51,765	53,922	55,527
Gross Profit	28,838	29,714	31,259	32,438
EBITDA	18,029	19,267	20,484	21,398
EBIT	9,951	11,167	12,298	13,604
Earnings from Associates	116	347	348	364
Net Interest	344	357	351	475
Other	(534)	(650)	(731)	(752)
PBT	9,877	11,221	12,266	13,690
Zakat	(751)	(707)	(773)	(862)
Minorities	(228)	(244)	(267)	(298)
Net Income	8,898	10,269	11,226	12,529
EPS	4.4	5.1	5.6	6.3
DPS	4.0	4.0	4.0	4.0

BS (SAR mn)	2016	2017E	2018E	2019E
Cash	3,631	3,049	6,908	12,358
Current Assets	36,933	39,692	39,914	39,899
Fixed Assets	39,419	39,518	39,622	39,679
Intangibles assets and goodwill	7,840	7,621	5,639	4,173
Investments in associates and JVs	6,302	6,333	6,618	6,916
Total Assets	101,777	104,719	107,207	111,531
Current Liabilities	27,974	30,486	30,527	30,450
Short Term Debt	1,867	1,367	1,367	1,367
Long Term Debt	4,017	2,756	2,086	2,000
Shareholders Equities	61,278	63,552	66,669	71,157
Total Liabilities	101,777	104,719	107,208	111,532

CF (SAR mn)	2016	2017E	2018E	2019E
Operating Cash Flow	24,137	21,006	19,107	19,931
Working Capital Changes	(5,561)	(4,577)	(180)	(63)
Cash Flow from Operating Activities	18,576	16,430	18,926	19,868
Capex	(9,555)	(6,160)	(6,309)	(6,386)
Cash Flow from Investing Activities	(7,975)	(6,810)	(6,021)	(5,992)
Changes in Debt	(1,712)	(1,761)	(670)	(86)
Dividends	(8,031)	(8,000)	(8,000)	(8,000)
Cash Flow from Financing Activities	(11,511)	(10,202)	(9,046)	(8,426)

Growth	2016	2017E	2018E	2019E
Revenue	6.0%	-3.6%	4.2%	3.0%
EBITDA	-6.6%	6.9%	6.3%	4.5%
Operating profit	-16.1%	12.2%	10.1%	10.6%
PBT	-5.8%	13.6%	9.3%	11.6%
Net Income	-3.9%	15.4%	9.3%	11.6%

Ratios (%)	2016	2017E	2018E	2019E
Gross Margin	53.7%	57.4%	58.0%	58.4%
EBITDA Margin	33.6%	37.2%	38.0%	38.5%
EBIT Margin	18.5%	21.6%	22.8%	24.5%
Net Margin	16.6%	19.8%	20.8%	22.6%
ROE	14.5%	16.2%	16.8%	17.6%
ROCE	12.4%	14.1%	14.9%	15.7%
ROA	8.7%	9.8%	10.5%	11.2%
Debt/Equity	0.1	0.1	0.1	0.0
Net Debt/EBITDA	0.1	0.1	(0.2)	(0.4)
FCF Yield	2.3%	6.0%	9.5%	10.1%
Dividend Yield	5.5%	5.8%	5.8%	5.8%

Valuation	2016	2017E	2018E	2019E
PE	16.3	13.5	12.4	11.1
PB	2.4	2.2	2.1	2.0
EV/EBITDA	8.1	7.2	6.6	6.0
EV/EBIT	14.7	12.4	10.9	9.5
EV/Sales	2.7	2.7	2.5	2.3

Peer Valuations	12M Fwd PE	12m Fwd EV/EBITDA
Emirates Telecom Group	15.9	6.3
Ethiad Etisalat Co.	NA	5.7
Vodacom Group Ltd.	14.1	7.9
MTN Group Ltd.	19.3	6.5
Maroc Telecom	20.6	8.0
Safaricom Ltd.	18.7	8.9
Ooredoo Q.P.S.C	9.6	3.9
Saudi Telecom Co.	12.4	6.6
Sector Median	15.9	6.5
TASI	12.8	10.1

Source: Bloomberg, Company Financials, FALCOM Research

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FALCOM Rating Methodology

FALCOM Financial Services uses its own evaluation structure, and its recommendations are based on quantitative and qualitative data collected by the analysts. Moreover, the evaluation system places covered shares under one of the next recommendation areas based on the closing price of the market, the fair value that we set and the possibility of ascent/descent.

- Overweight:** The Target share price exceeds the current share price by $\geq 10\%$.
- Neutral:** The Target share price is either more or less than the current share price by 10%.
- Underweight:** The Target share price is less than the current share price by $\geq 10\%$.
- To be Revised:** No target price had been set for one or more of the following reasons: (1) waiting for more analysis, (2) waiting for detailed financials, (3) waiting for more data to be updated, (4) major change in company's performance, (5) change in market conditions or (6) any other reason from FALCOM Financial Services.

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