

Saudi Telecom Company

Growth in revenue weighed by investment in new domains impacted margins

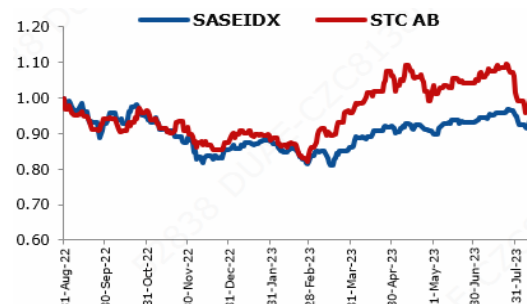
Current Price
SAR 40.75

Target Price
SAR 47.00

Upside/Downside (%)
+15.3%

Rating
BUY

- STC delivered a strong performance as it recorded the highest quarterly revenue of SAR 18.3 Bn in 2Q23.
- STC's mobile subscribers rose 8.6% YOY due to increased prepaid, postpaid and M2M subscribers. The fixed subscribers declined marginally 1.6% YOY in 2Q23.
- STC margin remained under pressure due to investment in new domains in line with the Company strategy.
- In July 2023, the Company's subsidiary Center3, successfully finished a 9.6MW expansion of its Khurais hyper scaler-grade data centre in Riyadh, which will support Center3's hosting capacity for customers and foster the advancement of the MENA region's digital sector.



2Q23 Net Profit lower than our estimate

STC Group ("STC, "the Company") recorded 6.0% YOY growth in net profit to SAR 3,008 Mn in 2Q23, lower than our estimate of SAR 3,463 Mn. The increase in profit is mainly attributable to growth in revenue supported by a growth in mobile subscribers, increase in finance income and profit from associates & JVs as compared to losses in 2Q22 partially offset by higher direct costs, G&A expense, D&A expense and finance cost.

P&L Highlights

STC's revenue grew 8.9% YOY to SAR 18.3 Bn in 2Q23 led by a growth across most of the segments except STC Banks. The increase in revenue is supported by a 8.2% YOY increase in mobile subscribers partially offset by a 1.6% YOY decline in fixed subscribers. As a result, revenue from Saudi Telecom Company rose 1.9% YOY and Channels revenue by 36.1% YOY in 2Q23. The Company revenue also benefitted from growth in subsidiaries topline growth as Solutions turnover rose 29.5% YOY in 2Q23. STC's direct cost grew significantly 20.1% YOY to SAR 9.2 Bn in 2Q23 higher than growth in topline. Hence, gross profit declined marginally 0.4% YOY to SAR 9,133 Mn in 2Q23 with a decline in gross profit margin from 54.5% in 2Q22 to 49.8% in 2Q23. Selling and overhead expenses grew 7.4% YOY to SAR 1,567 Mn in 2Q23, while, G&A expenses increased from SAR 1,537 Mn in 2Q22 to SAR 1,745 Mn in 2Q23 mainly due to ongoing investment in new domains aligned with the Group's strategy. Resultantly, EBITDA declined 6.2% YOY to SAR 5,821 Mn in 2Q23 with a 510 bps YOY decline in EBITDA margin to 31.8% in 2Q23. Depreciation and amortization expenses grew 2.2% YOY to SAR 2,540 Mn in 2Q23. Thus, operating profit declined 11.8% YOY to SAR 3,281 Mn in 2Q23 with a 420 bps YOY decline and 262 bps QOQ decline in operating profit margin to 17.9% in 2Q23. Other expenses declined significantly from SAR 464 Mn in 2Q22 to SAR 37 Mn in 2Q23 due to

Stock Information

Market Cap (SAR, mm)	203,750.00
Paid Up Capital (mm)	50,000.00
52 Week High	46.00
52 Week Low	33.95
3M Avg. daily value (SAR)	171,920,600

2Q23 Result Review (SAR, mm)

Total Assets	140,272
Total Liabilities	62,502
Total Equity	75,497
EBITDA	5,821
Net Profit	3,008

Financial Ratios

Dividend Yield (12m)	3.93
Dividend Pay-out (%)	115.03
Price-Earnings Ratio(x)	16.40
Price-to-Book Ratio (x)	2.69
Book Value (SAR)	15.15
Return-on Equity (%)	16.86

Stock Performance

5 Days	-1.93%
1 Months	-10.34%
3 Months	-7.91%
6 Months	16.43%
1 Year	-3.89%
Month to Date (MTD%)	-3.89%
Quarter to Date (QTD%)	-6.32%
Year to Date (YTD%)	11.34%

impairment expense recorded in relation to investment in BGSM in 2Q22 as compared to a nil impairment charge in 2Q23. Finance income increased from SAR 114 Mn in 2Q22 to SAR 382 Mn in 2Q23 due to higher benchmark rates. Finance charges also rose 42.6% YOY to SAR 248 Mn in 2Q23. Zakat expense increased from SAR 281 Mn in 2Q22 to SAR 331 Mn in 2Q23 due to growth in profitability. Profit attributable to non-controlling interest holders declined from SAR 77 Mn in 2Q22 to SAR 39 Mn in 2Q23 supporting profitability.

Balance Sheet Highlights

STC's gross debt declined from SAR 10.8 Bn in 1Q23 to SAR 10.7 Bn in 2Q23 with a debt-to-EBITDA ratio of 1.8x in 2Q23. Cash and cash equivalent rose from SAR 9.6 Bn in 1Q23 to SAR 10.4 Bn in 2Q23. STC cash flow from operation also rose from SAR 4,645 Mn in 1H22 to SAR 5,115 Mn in 1H23. The Company's free cash flow increased from SAR 1,097 Mn in 1H22 to SAR 1,691 Mn in 1H23.

Target Price and Rating

We maintain our BUY rating on Saudi Telecom Company with a revised target price of SAR 47.00. STC delivered a strong performance, recording the highest quarterly revenue of SAR 18.3 Bn in 2Q23 across all segments except STC Banks. The increase in performance was mainly driven by robust expansion in the Commercial, Carrier, and Wholesale units, as well as the Company's associated subsidiaries. The growth in the Carrier and Wholesale unit was underpinned by growth in its national revenue, while the upswing in the Commercial unit was fueled by the increase in the Mobility and Residential segment revenue. The Company also retained its top position as the leading digital enabler in the Middle East's telecommunications sector. STC's Mobile subscribers rose 8.6% YOY due to increased prepaid, postpaid and M2M subscribers. While the fixed subscribers declined marginally by 1.6% YOY in 2Q23. Recently the Company's subsidiary successfully expanded the capacity of its data centre in Riyadh by 9.6MW which aims to improve and increase the hosting capacity for customers and foster the advancement of the MENA region's digital sector. In addition, the Company's subsidiary Tawal signed an agreement to acquire United Group's telecommunications tower assets of SAR 5 Bn. The acquisition will likely boost Tawal's infrastructure growth plans and support STC's strategy to enter into international markets with growth potential. The company also maintains a strong balance sheet, adequate liquidity, low leverage, and stable credit rating further aiding in its internal as well as external expansion through internal accruals. Furthermore, as per the Company's dividend distribution policy for three years, which began from 4Q21, the company commits to pay a minimum dividend of SAR 0.4 per share every quarter. Thus, in line with its policy, the Company plans to pay a dividend of SAR 0.4 per share for the period 2Q23. Hence, based on our analysis, we maintain a BUY rating on the stock.

STC - Relative valuation

(at CMP)	2018	2019	2020	2021	2022	2023F
PE	18.9	19.1	18.5	18.0	16.7	15.8
PB	3.1	3.3	3.2	2.9	2.8	2.6
EV/EBITDA	9.6	9.6	8.8	8.7	7.6	7.9
Dividend yield	5.9%	3.9%	4.9%	3.9%	3.9%	3.9%

FABS Estimates & Co Data

STC – P&L

SAR mm	2Q22	1Q23	2Q23	2Q23F	Var.	YOY Ch	QOQ Ch	2022	2023F	Change
Sales	16,830	18,179	18,327	18,270	0.3%	8.9%	0.8%	67,432	72,921	8.1%
Cost of Sales	-7,656	-8,825	-9,194	-8,404	9.4%	20.1%	4.2%	-30,038	-35,002	16.5%
Gross profit	9,174	9,355	9,133	9,866	-7.4%	-0.4%	-2.4%	37,393	37,919	1.4%
S&D Expenses	-1,460	-1,298	-1,567	-1,462	7.2%	7.4%	20.8%	-6,110	-6,198	1.4%
G&A expenses	-1,510	-1,713	-1,745	-1,717	1.6%	15.6%	1.9%	-6,204	-7,073	14.0%
EBITDA	6,204	6,343	5,821	6,687	-13.0%	-6.2%	-8.2%	25,079	24,647	-1.7%
Dep & Amort	-2,485	-2,613	-2,540	-2,631	-3.5%	2.2%	-2.8%	-9,990	-10,525	5.4%
Operating profit	3,720	3,731	3,281	4,056	-19.1%	-11.8%	-12.1%	15,088	14,122	-6.4%
Other income/(Expenses)	-464	-340	-37	-229	-83.9%	-92.1%	-89.2%	-1,524	-505	-66.8%
Financial Income	114	360	382	219	74.2%	NM	6.2%	602	1,495	148.1%
Finance Charges	-174	-238	-248	-238	4.3%	42.6%	3.9%	-697	-957	37.3%
Profit before zakat	3,196	3,512	3,378	3,809	-11.3%	5.7%	-3.8%	13,470	14,155	5.1%
Zakat	-281	-377	-331	-305	8.6%	17.7%	-12.3%	-1,083	-1,154	6.5%
Profit before NCI	2,915	3,135	3,047	3,504	-13.0%	4.6%	-2.8%	12,387	13,002	5.0%
Non-controlling interests	77	26	39	41	-6.0%	NM	48.2%	216	165	-23.7%
Net Profit	2,837	3,109	3,008	3,463	-13.1%	6.0%	-3.2%	12,171	12,837	5.5%

FABS estimate & Co Data

STC – Margins

	2Q22	1Q23	2Q23	YOY Ch	QOQ Ch	2022	2023F	Change
Gross Profit	54.5%	51.5%	49.8%	-467	-162	55.5%	52.0%	-345
EBITDA	36.9%	34.9%	31.8%	-510	-313	37.2%	33.8%	-339
Operating Profit	22.1%	20.5%	17.9%	-420	-262	22.4%	19.4%	-301
Net Profit	16.9%	17.1%	16.4%	-44	-68	18.0%	17.6%	-45

FABS estimate & Co Data

Valuation:

We use Discounted Free Cash flow (DCF) and Relative Valuation (RV) to value Saudi Telecom Company. We have assigned 70% weight to DCF and 30% to RV.

Valuation Method	Target	Weight	Weighted Value
DCF Method	49.94	70.0%	34.96
Relative Valuation (RV)	40.15	30.0%	12.05
Weighted Average Valuation (SAR)			47.00
Current market price (SAR)			40.75
Upside/Downside (%)			+15.6%

1) DCF Method:

STC is valued using free cash flow to firm. We have discounted the cash flow using the weighted average cost of capital of 8.1%. It is arrived after using cost of equity of 8.1% and after-tax cost of debt of 7.1% with debt-to-equity ratio of 4.9%. Cost of equity is calculated by using 10-year government bond yield of 4.7%, beta of 0.95 and equity risk premium of 3.6%. Government bond yield is calculated after adding KSA 10-year CDS spread over 10-year US risk free rate. Cost of debt of 7.3% is calculated after adjusting a tax rate of 2.5%. Also, assumed a terminal growth rate of 2.0%.

Sum of PV (SAR, Mn)	53,032
Terminal value (SAR, Mn)	190,456
FV to Common shareholders (SAR, Mn)	249,680
No. of share (Mn)	5,000
Current Market Price (SAR)	40.75
Fair Value per share (SAR)	49.94

DCF Method

(All Figures in SAR Mn)	FY 2023E	FY 2024E	FY 2025E	FY 2026E	FY 2027E
NOPAT	13,670	15,499	16,219	16,861	17,099
Depreciation and Amortization	10,525	10,819	11,373	11,796	12,291
(-) CAPEX	-13,094	-13,621	-13,987	-13,849	-13,649
(-) Change in Net Working Capital	-552	59	-3,842	575	326
Free Cash Flow to Equity (FCFF)	10,550	12,756	9,762	15,383	16,067
Discounting Factor	0.97	0.90	0.83	0.77	0.71
Discounted FCFF	10,252	11,460	8,107	11,809	11,403

Source: FAB Securities

2) Relative Valuation:

We have used local as well as international peers to value STC and it is valued using the EV/EBITDA multiple. It is valued at EV/EBITDA multiple of 7.7x in line with peers.

Company	Market (USD Mn)	EV/EBITDA (x)		P/E (x)	
		2023F	2024F	2023F	2024F
Etihad Etisalat Company (Mobily)	9,694	7.0x	6.4x	20.3x	18.0x
Emirates Telecommunications Group Company	53,045	8.3x	7.9x	19.7x	19.2x
Mobile Telecommunications Co Saudi Arabia	3,227	6.2x	5.7x	11.2x	16.5x
Telstra Group Ltd	33,199	7.8x	8.4x	51.1x	36.4x
Bharti Airtel	63,173	7.0x	6.4x	20.3x	18.0x
Average		7.4x	7.2x	25.6x	22.6x
Median		7.7x	7.4x	20.3x	19.2x
Max		7.8x	7.9x	25.9x	22.9x
Min		7.0x	6.4x	19.7x	18.0x

Source: FAB Securities

Research Rating Methodology:

Rating	Upside/Downside potential
BUY	Higher than +15%
ACCUMULATE	Between +10% to +15%
HOLD	Lower than +10% to -5%
REDUCE	Between -5% to -15%
SELL	Lower than -15%

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