الرياض المالية
Riyad Capital

March 19, 2023

ARABIAN INTERNET AND COMMUNICATIONS SERVICES CO. (SOLUTIONS)

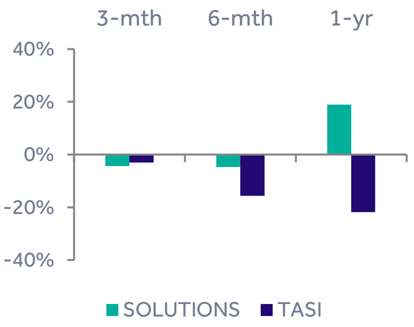
Company Update

Rating	Buy
12- Month Target Price	SAR 284

Price as on Mar-16, 2023	SAR 238.2
Upside to Target Price	19.2%
Expected Dividend Yield	2.2%
Expected Total Return	21.4%

Market Data

52 Week H/L	SAR 293.0/190.2
Market Capitalization	SAR 28,584 mln
Shares Outstanding	120 mln
Free Float	20%
12-Month ADTV	203,885
Bloomberg Code	SOLUTION AB



Scaling Through M&A Strategy

Valuation at SAR 34.0 bln (SAR 284/share)

We have valued SOLUTIONS on the basis of Discounted Cash Flows (DCF) and relative valuations. Integrating the two valuation methods, assigning a weight of 70% for DCF and 30% for relative multiples valuation, we arrive at a fair value of SAR 34.0 bln. Thus, we raise our target price from SAR 235.00 to SAR 284.00 and upgrade our recommendation to Buy. We expect the company to expand its service portfolio and its geographic reach through its M&A strategy, although we are concerned about margins in the short to medium-term.

Strong M&A interest in a highly fragmented market

The sector is well-known for its fragmentation. SOLUTIONS is the market leader with a 19.8% market share, which provides ample possibility for consolidation in favor of the leader. The Company recently announced two acquisitions as part of its M&A strategy, as it completed its acquisition of Giza Company in 4Q2022 at a value of SAR 466 mln. Second, it signed a sale and purchase agreement (SPA) to buy 100% of the Contact Center Company (CCC) for SAR 450 mln in 1Q2023.

Revenue to grow at +13.3% CAGR between 2022-2027

Top-line growth of +22% Y/Y in 2022 is almost twice the guidance of between +11% and +14% Y/Y and the 13% KSA ICT growth. For 2023, the management's guidance is for a growth in revenues between 11% and 13% in-line with the sector growth of +12%, we expect the Company to achieve revenue growth above the company guidance in 2023. Going forward, we expect a CAGR of +13.3% in the revenue mainly supported by the growth in the private clients.

Acquisitions may put margins under pressure

The fragmented nature of the IT sector makes it ideal for M&A activity. SOLUTIONS leads this sector and as part of the sector's maturation, we expect the sector to begin to consolidate. We expect expansion through acquisitions to put pressure on margins in the coming years. Thus, we expect gross margins to decline from 22.8% in 2022 to 21.6% in 2023, before beginning to gradually rebound to 22.5% in 2027.

Solid cash generation ability to support M&A's

A combination of the strong improvement in EBITDA along with low Capex intensity led to SOLUTIONS ending the year with cash and equivalents of SAR 3.2 bln. In the short-term, we expect working capital requirement to increase but continued growth in EBITDA and lower capex will mitigate the increase in working capital. In the medium-term, free cash flows will improve further as working capital requirement declines. This will help the Company in executing its M&A strategy.

Table 1: Key Financial Figures and Ratios (2022-2027)

	2022	2023E	2024E	2025E	2026E	2027E
Income Statement (SAR mln)						
Revenues	8,805	10,446	12,096	13,655	15,128	16,419
Gross Profit	2,011	2,256	2,638	3,010	3,370	3,694
EBIT	1,160	1,253	1,500	1,726	1,953	2,166
Net Income	1,053	1,234	1,461	1,615	1,801	1,999
Key Ratios (%)						
Gross Margin	22.8%	21.6%	21.8%	22.0%	22.3%	22.5%
EBIT Margin	13.2%	12.0%	12.4%	12.6%	12.9%	13.2%
Net Margin	12.0%	11.8%	12.1%	11.8%	11.9%	12.2%

Source: Riyad Capital

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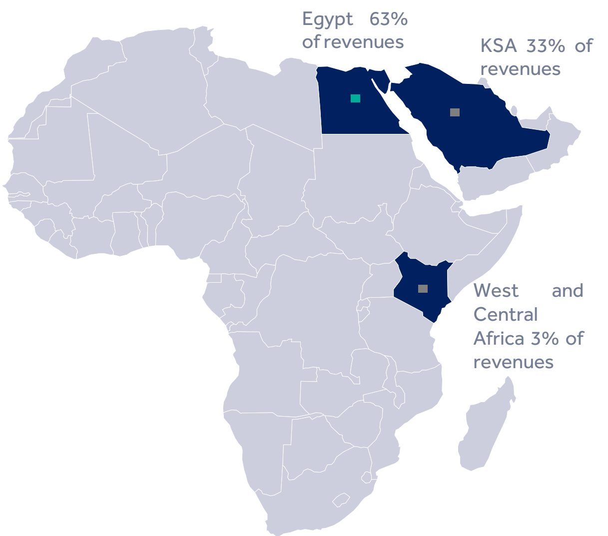
Strong M&A interest in a highly fragmented market

The sector is well-known for its fragmentation, with small and specialized firms accounting for 52% of the market. SOLUTIONS is the market leader with a 19.8% market share, which provides ample possibility for consolidation in favor of the leader. The Company recently announced two acquisitions as part of its M&A strategy. It completed its acquisition of Giza Company in 4Q2022 for a value of SAR 466 mln. Second, it signed a sale and purchase agreement (SPA) to buy 100% of the Contact Center Company (CCC) for SAR 450 mln in 1Q2023.

Backed by its solid cash position and operating in a highly fragmented market, SOLUTIONS intends to broaden its services portfolio through further M&A activity. The company aims to grow its services portfolio and gain market share, especially within Business Process Outsourcing (BPO), application services and digital services.

Giza acquisition: We believe that this acquisition will broaden SOLUTIONS' portfolio and reinforce its one-stop shop proposition by giving the company access to the application integration market. Furthermore, SOLUTIONS will have access to new markets through this transaction as Giza has a strong presence in Egypt, accounting for approximately 7% of the Egyptian market. It is worth mentioning that as per the management, Giza contributed around SAR 400 mln to top-line in 2022.

Exhibit 1: Giza's Services Portfolio & Geographical Presence



System & Application Integration

Digital solutions

Application Development & Management

Data Center & Cloud Services

Source: SOLUTIONS, Riyad Capital

Contact Center Company (CCC): CCC was founded in 2011 as a JV between STC Group and the US-based global company Startek. CCC mainly provides Customer Care BPO, staffing (MPO) for mostly large clients in KSA, as well as nascent shared services, consulting and other specialized services. CCC now is the biggest customer experience management provider in the Kingdom, managing over 35 mln interactions. Through this acquisition, SOLUTIONS aspires to accelerate its penetration into the BPO domain and complete its coverage of the ICT customer journey by enabling end-to-end offerings from design to operations. As per management, this acquisition is expected to be completed in 2Q2023.

Exhibit 2: CCC Services Portfolio

Customer Lifecycle Management
- Customer care
- Telesales
- Social media management
- Retention & loyalty management

Digital Platforms
- Business intelligence
- Speech analytics
- Big data
- Cyber security
- Work from home
- Omni channel

HR Services
- Staff augmentation
- Recruitment
- Training
- On-boarding
- Payroll processing

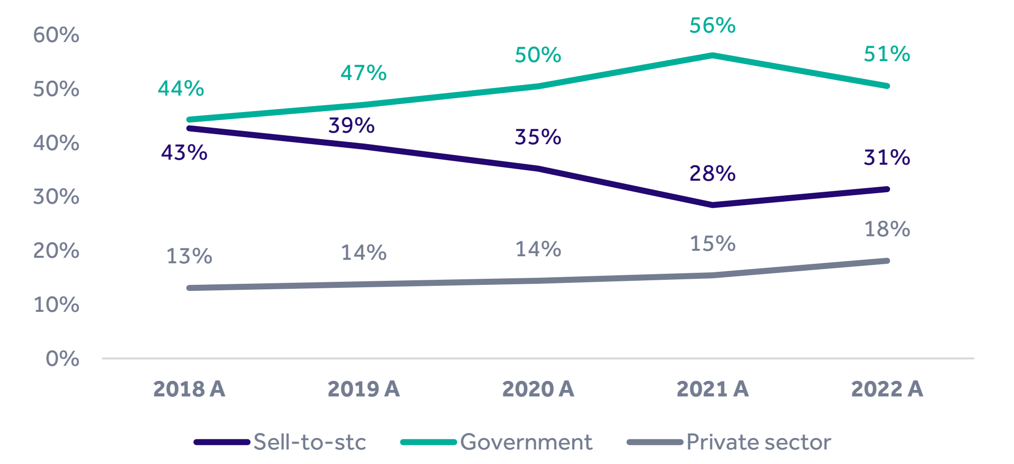
Shared Services
- Finance
- Accounting
- Business process engineering

Source: SOLUTIONS, Riyad Capital

Increase in private sector foothold

SOLUTIONS seeks to lessen its reliance on STC by expanding the private sector's contribution to the revenue mix. SOLUTIONS currently generates 18% of its revenues from the private segment (excluding STC) as of 2022. Although the amount of the contribution seems limited, this percentage has been steadily increasing over the past few years, making it the fastest growing segment. Despite large projects with STC in recent years, it grew by +44% Y/Y. We would note that the increase in the proportion of the revenue from STC in 2022 compared with 2021 came mainly from a single project with STC related to data centers in which the Company recorded the majority of the revenues in 1Q2022. We view SOLUTIONS' strategy to expand into the private sector as a key driver for future growth. We believe further acquisitions will spur client growth in the private sector.

Exhibit 3: Revenue by Customer Type



Source: SOLUTIONS, Riyad Capital

Deferred revenues to support top-line growth

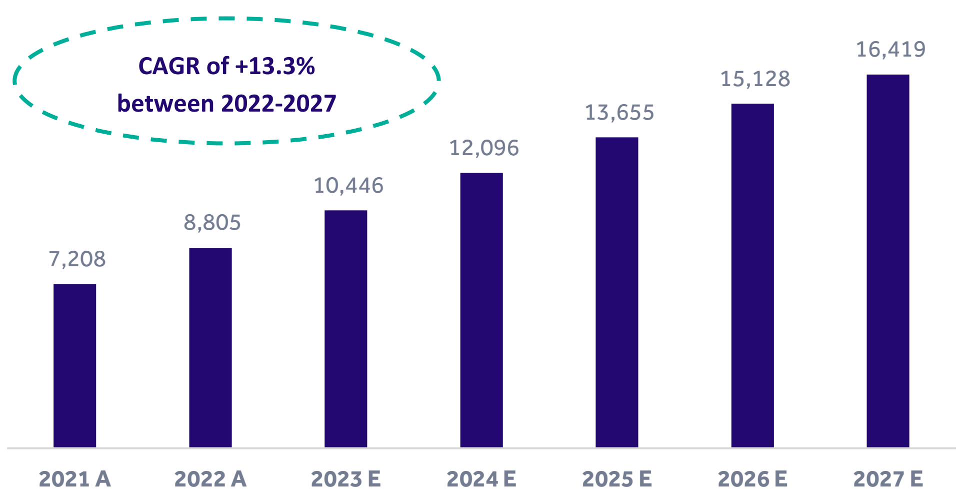
Owing to the contractual nature of the business, SOLUTIONS' deferred revenue is a strong predictor of the performance of the top line. For the year 2022, deferred revenues grew faster than the growth in revenues (44% vs. 22%, respectively) reaching SAR 3.3 bln. We can see from this that topline has strong growth potential in the coming years once these revenues are recognized.

Revenue to grow at +13.3% CAGR between 2022-2027

SOLUTIONS delivered a +22% Y/Y growth in revenues to SAR 8.8 bln in 2022. During 2022, further clarifications in IFRS 15 principal versus agent guidelines for reselling software licenses were provided. Therefore, the Company reclassified several contracts that had previously been classified as principals. Consequently, rather than recording the gross amount, the Company now recognizes the net commission income from such a contract. This resulted in reclassification in revenues and COGS but leaves gross and net profit unchanged. Based on our calculations, the impact for 2021 was around SAR 607 mln and for 9M2022, it was approximately SAR 533 mln.

- SOLUTIONS' largest segment, Core ICT, grew by +30% Y/Y in 2022. Due to the high maturity in networks integration market, minimal differentiation and a competitive landscape that limits price increases, this segment has a rather restrained growth potential. Despite all this, we expect this segment to grow by +13.4% CAGR between 2022 and 2027 as the Company (through Giza) tapped into application integration, which has a greater potential for growth. There is incremental growth that the government's mega-projects could bring it and the company's ability to grow its market share by taking advantage of its comprehensive portfolio of services.
- IT managed segment grew by +19% Y/Y in 2022. We look at this segment with optimism, as we expect it to be the fastest growing segment with a CAGR of +15.2% between 2022 and 2027. Our expectation is based on the continuous transition of companies and government entities from Capex to Opex-based models. In addition, we believe that with the completion of the CCC acquisition, SOLUTIONS will be a leader in the BPO market. This in turn will strengthen the Company's position within the segment and expand its market reach especially for the private clients.
- Digital services grew by +7.4% Y/Y in 2022. We anticipate this segment to deliver lower growth than others with a CAGR of +10.0% between 2022 and 2027 mainly due to the cybersecurity business line, which has a lower growth profile. We view this segment as complementary to the company's portfolio in order to strengthen its position as a one-stop-shop as it is much less profitable than other segments. We believe further acquisitions could support the growth of this segment but the fierce competition, particularly from smaller players, will be a challenge for the Company to expand in this market.

Exhibit 4: Revenue to grow by +13.3% CAGR between 2022 and 2027

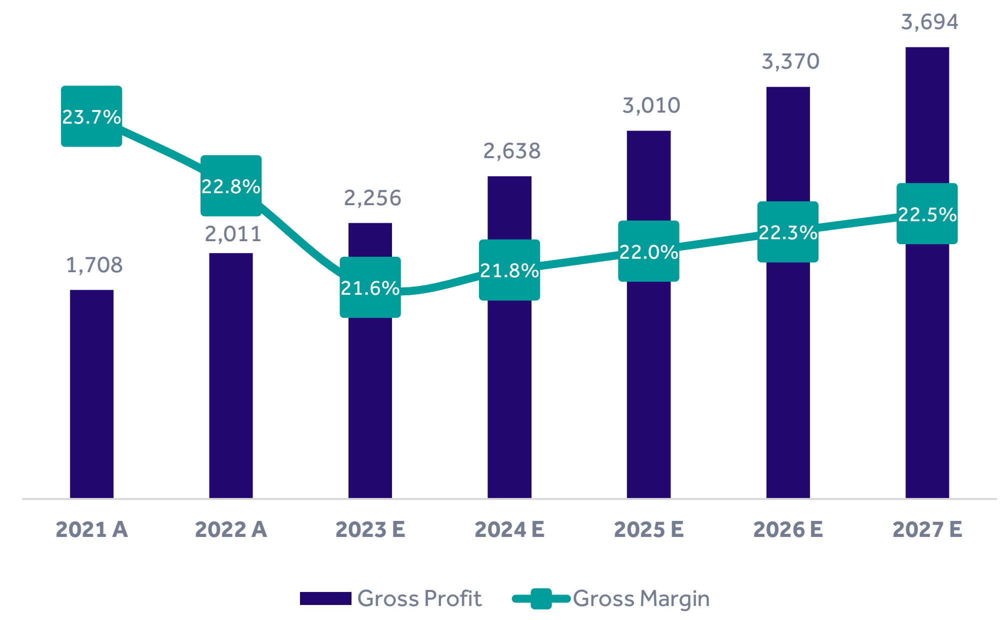


Source: SOLUTIONS, Riyad Capital

Acquisitions may put margins under pressure

The fragmented nature of the IT sector makes it ideal for M&A activity. SOLUTIONS leads this sector and as part of the sector's maturation, we expect consolidation. Indeed, SOLUTIONS finalized one acquisition during 2022 (Giza) and it is expected to finalize the acquisition of the second (CCC) in 2Q2023. Giza operates on much lower margins than that of SOLUTIONS (EBITDA margin of 7.4% in 2021). Therefore, we expect that with expansion through acquisitions, there could be pressure on margins in the coming years. Thus, we expect the gross margin to decline from 22.8% in 2022 to 21.6% in 2023 before beginning to gradually rebound to 22.5% in 2027.

Exhibit 5: Gross Profit (SAR mln) and Gross Margins (%)

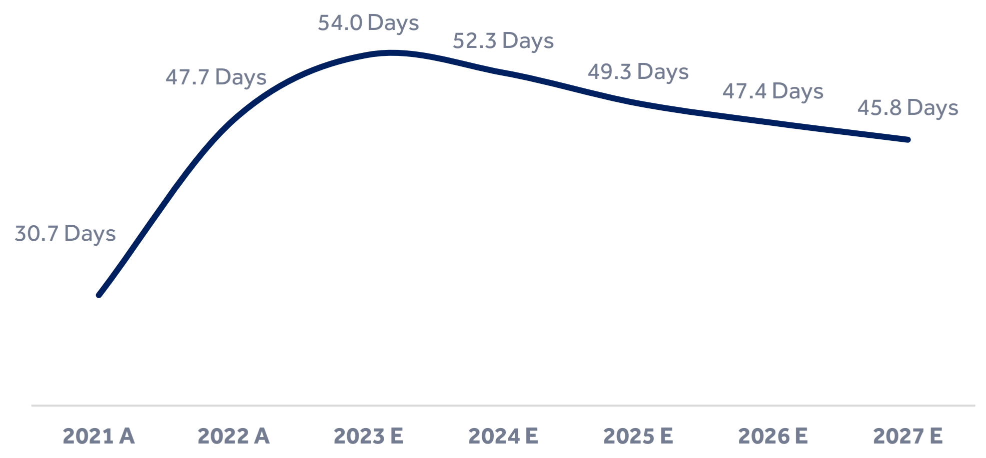


Source: SOLUTIONS, Riyad Capital

Higher AR days in the short-term

The proportion of total receivables attributable to STC declined from 76% in 2021 to 58% in 2022. This decline was due to an increase in receivables from government entities and private companies. Over the medium term, we expect that SOLUTIONS will be more susceptible to collection risk as a result of the rising private sector revenue contribution in the revenue. Over the short-term, we expect an increase in receivable days receivables to 157 days in 2023 due to the increase in receivables from STC as a result of the large contracts signed with the company during the past year. Account payable days declined to 121 days from 130 days in 2021, we expect this decline to continue to stand in the range of 105-120 days going forward. This would result in a short-term rise in the cash conversion cycle, followed by a medium-term decrease.

Exhibit 6: SOLUTIONS' Cash Cycle (days)

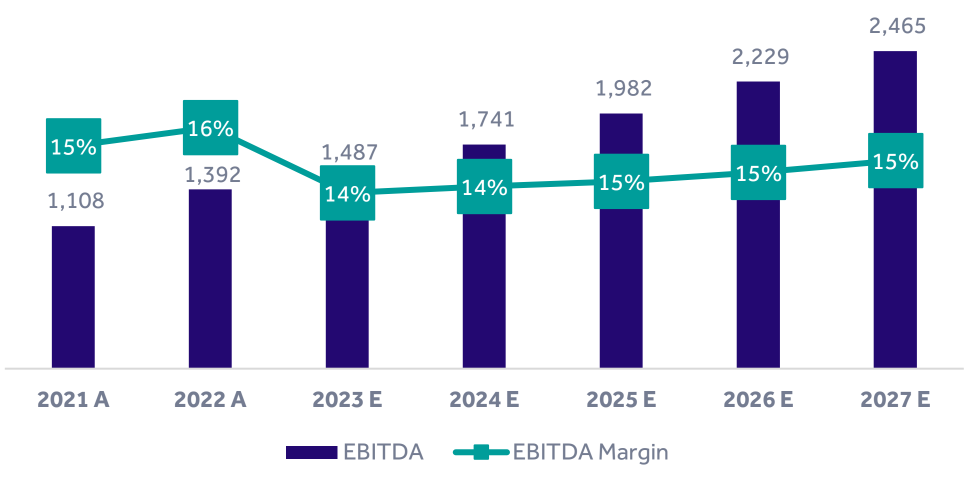


Source: SOLUTIONS, Riyad Capital

Solid cash generation ability to support M&A's

A combination of the strong improvement in EBITDA (+26% Y/Y in 2022), along with low Capex intensity (1.5% in 2022) have offset Giza acquisition expenses as well as the unfavorable increase in working capital. This translated into a free cash flow generated of SAR 1.6 bln in 2022 and led to SOLUTIONS ending the year with cash and eqv. of SAR 3.2 bln. Going forward, although we expect that in the short-term working capital requirements will increase, continued growth in EBITDA and lower capex will mitigate the increase in working capital requirements. In the medium-term, free cash flows will improve further as working capital starts to improve. Furthermore, given its healthy FCF generation and limited Capex needs, SOLUTIONS has been running a debt-free balance sheet. In 3Q2022, the company raised a SAR 500 mln facility (total of SAR 1 bln out of which SAR 500 mln was used) as the company pushes through on its M&A plan. In summary, the low debt in the balance sheet coupled with a healthy outlook for FCF indicates that there are no current obstacles that prevent SOLUTIONS from executing its M&A strategy.

Exhibit 7: EBITDA (SAR mln) and EBITDA Margin (%)



Source: SOLUTIONS, Riyad Capital

Top-line to exceed the management's guidance again

SOLUTIONS' top-line grew by+22% Y/Y in 2022, almost twice the guidance of between +11% and +14% Y/Y and the 13% KSA ICT growth. 15.8% EBITDA margin also exceeded the guidance of between 13.0% to 15.0% while Capex intensity came in-line with the guidance at 1.5%. For 2023, the management's guidance is for a growth in revenues by 11% to 13% in-line with the sector growth of +12%, which is less than the previous year's guidance. It is worth noting that, according to the management, the consolidation of Giza revenues was included in its guidance for this year, but the revenues from CCC were not considered (the acquisition is expected to be completed in 2Q2023). As for the EBITDA margin and Capex, the management's guidance is unchanged from last year. We expect SOLUTIONS to achieve revenue growth above the company guidance, supported by the revenue from Giza and the recently signed contracts with STC. However, we expect the EBITDA margin to be at 14.2% (158 basis points lower than last year) on the back of declining margins from core ICT segment and due to the inclusion of the profits of Giza (which has relatively low margins with SOLUTIONS), in addition to the increase in expenses related to completion of acquisitions.

Table 2: SOLUTIONS' Guidance for 2023

	2022 Guidance	2022 Actual
Revenue	+11% to +14% Y/Y growth	Revenue grew by +22% Y/Y
Profitability	EBITDA margin to stand between 13.0% and 15.0%	EBITDA margin came at 15.8%
Capex Intensity	1.5% to 2.0% of revenue	Capex intensity was 1.5%

	2023 Guidance	2023 RC assumptions
Revenue	+11% to +13% Y/Y growth	Revenue to grow by +19% Y/Y
EBITDA Margin	EBITDA margin to stand between 13.0% and 15.0%	EBITDA margin to reach 14.2%
Capex Intensity	1.5% to 2.0% of revenue	Capex intensity ratio to stand at 1.8%

Source: SOLUTIONS, Riyad Capital

Valuations

We increased our target price for the stock from SAR 235.0 to SAR 284.0. Hence, we upgrade our recommendation to Buy. Based on our valuation, we arrive at a valuation at SAR 34.0 bln or SAR 284.00 per share as summarized below.

Valuation Summary

Valuation Method	Fair price	Weight	Weighted Average
DCF	283.2	70%	198.2
P/E	271.4	15%	40.7
EV/Revenues	300.2	15%	45.0
Fair price (SAR)			**284.0**

Key Risks to our valuation

- Increase in account receivable at an accelerated rate
- Slowdown in project flow
- Inability to realize synergies from new acquisitions
- Competitive pressures on margins

Discounted Cash Flows (DCF) valuation at SAR 34.0 bln (SAR 283.2/share)

Using our DCF valuation approach, we arrive at an equity value for the company of SAR 34.0 bln or SAR 283.2 per share. WACC of 8.7% was driven by a risk-free rate of 4.35%, an equity risk premium of 5.3% and Beta of 0.96 Our calculation calls for an equity and debt weight of 82.2% and 17.8% respectively while our cost of debt assumption is at 5.5% for SOLUTIONS. We arrive at an equity value of SAR 34.0 bln or SAR 283.2 per share.

Table 3: Discounted Cash Flow Valuation

SAR '000	2023 E	2024 E	2025 E	2026 E	2027 E
EBIT	1,252,871	1,500,078	1,726,240	1,952,506	2,165,551
Plus: D&A	234,130	240,850	255,620	276,066	299,808
Minus: Increase in NWC	(57,936)	25,513	110,589	65,011	56,594
Plus: non-cash items	125,381	124,138	144,093	144,102	142,267
Minus: Capex	(265,483)	(287,151)	(322,244)	(355,374)	(384,422)
Cash Flow to the Firm	**1,372,412**	**1,688,504**	**1,868,721**	**2,073,895**	**2,253,513**
Terminal Value					37,074,365
Total FCFF	**1,372,412**	**1,688,504**	**1,868,721**	**2,073,895**	**39,327,878**
Discounting Factor	0.92	0.85	0.78	0.72	0.66
Discounted Cash Flows	**1,262,217**	**1,428,238**	**1,453,759**	**1,483,830**	**25,878,985**

Long-term growth rate	2.5%
Enterprise value	31,507,029
Net Debt	2,504,768
NCI	(28,890)
Equity Value	33,982,907
Number of shares	120,000
Fair Value per Share (SAR)	283.2

Source: Riyad Capital

P/E multiple valuation at SAR 32.6 bln (SAR 271.4/share)

We have used the average P/E multiple of ten relatively comparable companies that we have identified. We arrive at an equity value of SAR 32.6 bln or SAR 271.4 per share.

Table 4: P/E multiple valuation at SAR 271.4 per share

P/E Valuation			
MAXIMUS INC	21.9x	SOLUTIONS 2023E EPS	12.17
ACCENTURE PLC-CL A	23.1x		
TATA CONSULTANCY SVCS LTD	29.2x	SOLUTIONS Equity value	32,564,042
WIPRO LTD	21.0x	No of shares	120,000
SAP SE	20.4x	Fair Price (SAR)	271.4
INFOSYS LTD	25.4x		
CHINASOFT LTD	12.8x		
INTL BUSINESS MACHINES	13.7x		
PERFECT PRESENTATION	23.0x		
ELM CO	32.4x		
Comparable and Target P/E (x)	*22.3x*		

Source: Bloomberg, Riyad Capital

EV/Revenues valuation at SAR 36.0 bln (SAR 300.2 /share)

Using the same comparable companies, we have used the average EV/Revenues multiples. We arrive at an equity value of SAR 36.0 bln or SAR 300.2 per share.

Table 5: EV/Revenues multiple valuation at SAR 300.2 per share

EV/Revenues Valuation			
MAXIMUS INC	1.3x	2023E Revenues	12,095,592
ACCENTURE PLC-CL A	2.4x		
TATA CONSULTANCY SVCS LTD	4.1x	EV	33,546,533
WIPRO LTD	2.0x	Net Debt	2,504,768
SAP SE	4.0x	NCI	(28,890)
INFOSYS LTD	3.2x	Equity Value	36,022,411
CHINASOFT LTD	0.5x	No of shares	120,000
INTL BUSINESS MACHINES	2.5x	Fair Price (SAR)	300.2
PERFECT PRESENTATION	2.5x		
ELM CO	5.3x		
Comparable and Target EV/Rev (x)	*2.8x*		

Source: Bloomberg, Riyad Capital

Financial Statements

The following are the summarized Income statement, Balance Sheet and Cash Flow statement for SOLUTIONS:

Table 6: Summarized Financials for SOLUTIONS (2021-2027)

	2021	2022	2023E	2024E	2025E	2026E	2027E
Income Statement (SAR mln)							
Sales	7,208	8,805	10,446	12,096	13,655	15,128	16,419
Gross profit	1,708	2,011	2,256	2,638	3,010	3,370	3,694
Operating profit	899	1,160	1,253	1,500	1,726	1,953	2,166
Net Income	833	1,053	1,234	1,461	1,615	1,801	1,999
Balance Sheet (SAR mln)							
Current Assets	6,446	9,383	10,528	12,275	14,027	15,890	17,324
Non-Current Assets	726	899	930	977	1,043	1,123	1,207
Current Liabilities	4,634	6,656	7,165	8,172	9,151	10,069	10,867
Non-Current Liabilities	268	803	837	861	886	910	432
Total Liabilities	4,902	7,459	8,001	9,034	10,037	10,979	11,299
Total Equity	2,271	2,823	3,458	4,218	5,033	6,034	7,232
Total Liabilities and Equity	7,173	10,282	11,459	13,252	15,070	17,013	18,531
Cash Flow (SAR mln)							
CFO	1,395	2,091	1,620	1,936	2,080	2,280	2,475
CFI	(171)	(3,191)	5	628	193	(340)	(369)
CFF	(610)	57	(814)	(716)	(814)	(815)	(1,315)
Growth							
Sales	5%	22%	19%	16%	13%	11%	9%
Gross Profit	20%	18%	12%	17%	14%	12%	10%
Net Income	19%	27%	17%	18%	11%	12%	11%
Margins							
Gross Margin	24%	23%	22%	22%	22%	22%	23%
EBITDA Margin	15%	16%	14%	14%	15%	15%	15%
Net Margin	12%	12%	12%	12%	12%	12%	12%
Key Ratio's							
Current Ratio	1.4	1.4	1.5	1.5	1.5	1.6	1.6
Quick Ratio	1.3	1.4	1.4	1.5	1.5	1.5	1.6
ROA	12%	12%	11%	12%	11%	11%	11%
ROE	40%	42%	40%	38%	35%	33%	30%
Operating Ratios (days)							
Inventory Outstanding	12.8	16.0	12.5	12.5	12.5	12.5	12.5
Sales Outstanding	147.5	152.7	157.2	147.5	144.4	142.5	140.8
Payable Outstanding	129.6	121.0	115.7	107.8	107.6	107.6	107.6
Cash Cycle	30.7	47.7	54.0	52.3	49.3	47.4	45.8
Operating Cycle	134.6	136.6	144.7	135.1	131.9	130.0	128.3
Per Share (SAR)							
EPS	6.94	8.78	10.29	12.17	13.46	15.01	16.65
BVPS	18.92	23.28	28.57	34.91	41.70	50.04	60.03

Source: Company financials, Riyad Capital

Stock Rating

Buy	Neutral	Sell	Not Rated
Expected Total Return Greater than +15%	Expected Total Return between -15% and +15%	Expected Total Return less than -15%	Under Review/ Restricted

* The expected percentage returns are indicative, stock recommendations also incorporate relevant qualitative factors

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