Riyad Capital

May 01, 2023

Saudi Telecom Co.

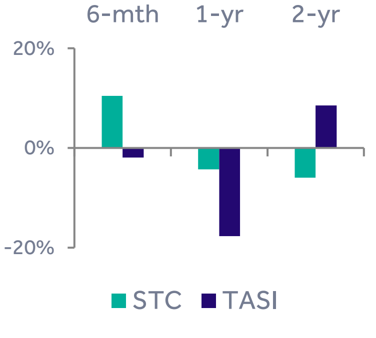
Company Update

Rating	Neutral
12- Month Target Price	SAR 48.00

Price as on April-30, 2023	SAR 44.40
Upside to Target Price	8.1%
Expected Dividend Yield	4.5%
Expected Total Return	12.6%

Market Data

52 Week H/L	SAR 48.3/34.0
Market Capitalization	SAR 222 bln
Shares Outstanding	5,000 mln
Free Float	36%
12-Month ADTV	5,013,061
Bloomberg Code	STC AB



Positioned to Capitalize on Opportunities

Trim Target Price, reduce to Neutral

Our SAR 241.5 bln (SAR 48.3 per share) valuation is based on Discounted Cash Flows (DCF). We raise our forecast for revenue growth in addition to lowering our forecast for capex. However, higher operating expenses in addition to our concern about slower collection of receivables compared to our previous assumption led to an increase in our net working capital estimate, which reduced our target price slightly from SAR 50.00 per share to SAR48.00 per share. As the stock price has rallied by +26% in the last two months, we downgrade to Neutral.

Enterprise Unit momentum to persist

Over the last three years, STC outpaced its peers as the top-line grew by a CAGR of +7.4% compared to +5.2% for Mobily and +2.7% for Zain KSA. We raise our outlook for revenues as we believe the momentum in the enterprise unit would continue due to the rapid expansion of the digital infrastructure in the Kingdom resulting in +3.7% CAGR in total revenues for the period between 2022 and 2027 to reach SAR 81.0 bln in 2027.

Subsidiaries margin expansion

The gross margin for the company improved to 55.5% in 2022 from 53.6% in 2021. STC recently started disclosing revenues and gross profit of its subsidiaries. As expected, there was a strong improvement in most of the subsidiaries gross margin, especially the new ones. However, we notice a decline in margins in older regional subsidiaries such as STC Kuwait and Bahrain.

Capex Intensity to increase between 14%-15%

If the Tawal deal is completed, this would shift the Capex related to the passive wireless infrastructure away from STC, offering greater efficiency in allocation of capital to invest in new domains and dive deep into data center infrastructure. Although the Capex related to Tawal will stop if the deal goes thru, we do expect to see an increase in Center3's and submarine cable project Capex, which will offset the decline in Tawal's Capex.

Abundant cash for acquisitions and investment in new tech domains

STC recorded a strong CFO amounting to SAR 26 bln, mainly supported by strong EBITDA, in addition to collecting some of its receivables related to the government. These solid cash flows led to cash and equivalents of SAR 25.8 bln at year-end. Abundant cash with STC is likely to increase further during the coming period. The key challenge for the company is to deploy this liquidity and generate a return that is satisfactory to investors.

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

	2022	2023E	2024E	2025E	2026E	2027E
Income Statement (SAR mln)						
Revenues	67,432	70,691	73,444	75,986	78,451	80,995
Gross Profit	37,393	38,520	40,376	41,902	43,330	44,806
EBIT	15,088	15,033	16,075	17,157	18,013	18,913
Net Income	12,171	12,763	13,920	14,743	15,329	16,097
Key Ratios (%)						
Gross Margin	55%	54%	55%	55%	55%	55%
EBIT Margin	22%	21%	22%	23%	23%	23%
Net Margin	18%	18%	19%	19%	20%	20%

Source: Riyad Capital

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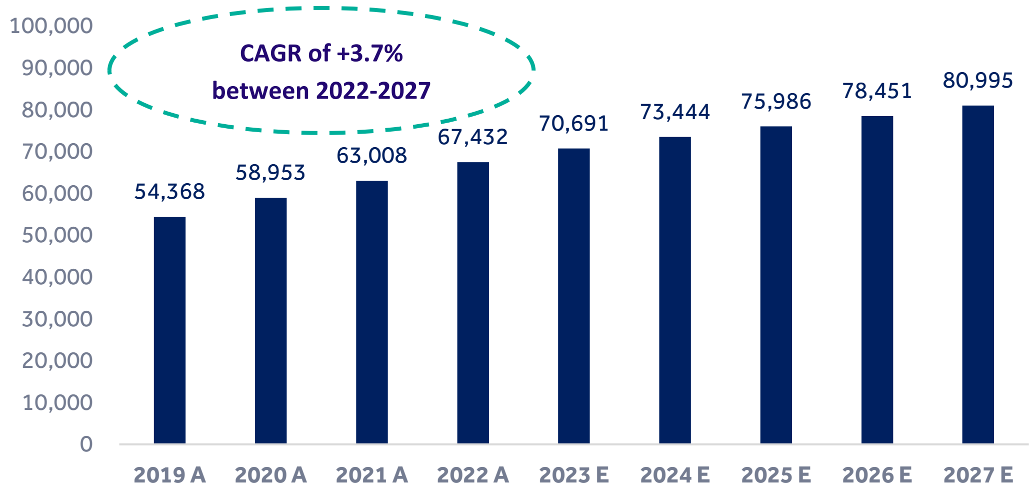
Enterprise Unit momentum to persist

The sector revenue grew at a CAGR of +6.5% between 2019 and 2022, driven by public and private sector demand for B2B communication and digital services. Due to its wide range of offering through its subsidiaries, STC's revenue 3-Y CAGR of + 7.4% outpaced that of both Mobily (+5.2%) and Zain KSA (+2.7%), despite being at a far larger scale than its competitors.

We anticipate the momentum in the enterprise unit to continue due to the rapid expansion of the digital infrastructure in the Kingdom as we are more optimistic about its growth in the medium term than we are about the consumer segment. However, we expect the consumer segment growth to pick up steam as well in the not-too-distant future due to a rise in the number of tourists and pilgrims; the key challenge facing this segment is sustaining a high level of average revenue per user (ARPU).

Exhibit 1: Revenue to Grow at a CAGR of +3.7% between 2022 and 2027



Source: Company Financials, Riyad Capital

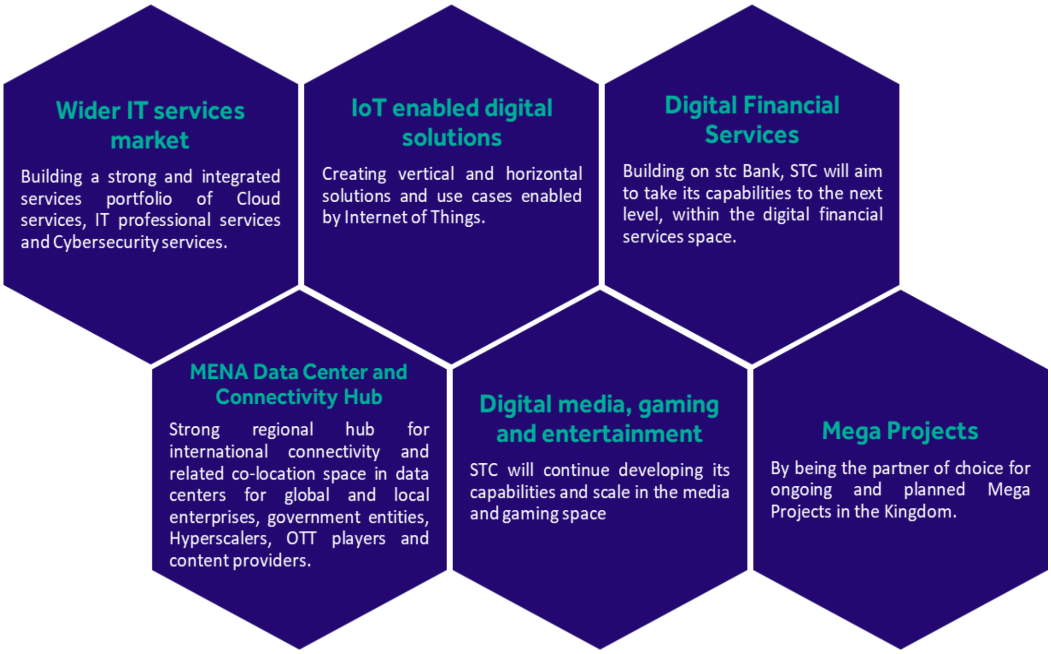
Going forward, we have raised our estimates for the revenue due to higher revenue growth from the enterprise unit segment along with higher growth in the subsidiaries. Thus, we forecast a growth of +3.7% CAGR in the total revenue for the period between 2022 and 2027, reaching SAR 81.0 bln in 2027. It is worth noting that if the Tawal deal transaction is completed, this may result in lower revenues as it is expected that the income from Tawal will be recognized under other income as STC will not be the majority owner of the company.

STC to expand its offering and geographical reach

STC is still in growth mode as the Company was able to achieve strong expansion during the last year. Furthermore, under "Saudi Vision Cable", STC lunched in 2022 the Digital Centers for Data and Telecommunications Company "center3", a regional digital connectivity hub, which owns digital infrastructure assets, including data centers and submarine cables, capitalizing on the Kingdom and the region's strategic location at the heart of the three continents. This supports STC in increasing connectivity in European, Asian and African markets.

Under DARE 2.0 strategy, STC strives to diversify its portfolio of assets and services into new prospects while also deepening its footprint in existing businesses.

Exhibit 2: STC Growth Areas



Source: The Company, Riyad Capital

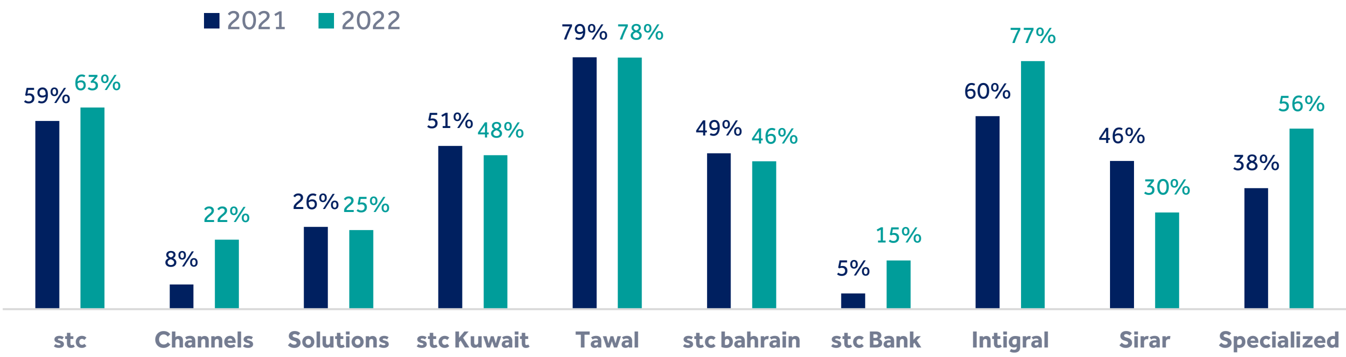
The company has regional ambitions to support the goals of STC strategy. In addition to these specific growth areas, STC will also be active for the geographical expansion in the telecom sector.

Subsidiaries margins expansion

The gross margin for the company improved considerably to 55.5% in 2022 from 53.6% in 2021. However, this was mainly due to a reversal of contingent liability provision amounting to SAR 1,079 mln in 3Q2022. Without this reversal, the gross margin would have been 53.9%, which is still considered a decent improvement due to the Company's size and its diversified revenue stream.

STC started disclosing the revenues and gross profit of its subsidiaries. As expected, there was strong improvement in most of the subsidiaries gross margin, especially the new ones; STC Bank, Integral and Specialized which witnessed significant margin improvement. However, we noticed a decline in margins in older regional subsidiaries such as STC Kuwait and Bahrain.

Exhibit 3: Gross Margin by Subsidiary

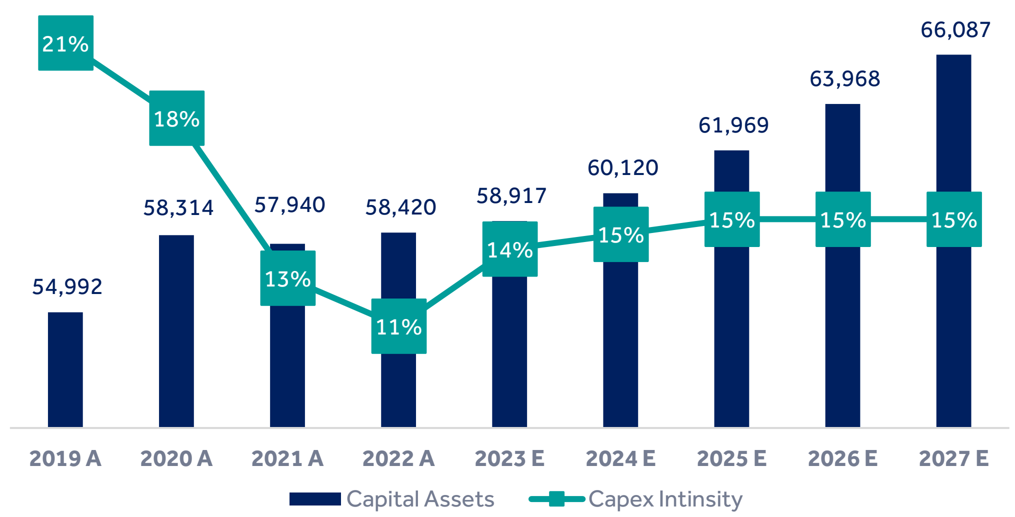


Source: Company Financials, Riyad Capital

Capex Intensity to increase between 14%-15%

In 4Q2022, STC announced that it had received a non-binding offer from the Public Investment Fund (PIF) to acquire 51% of the shares of Tawal (STC's TowerCo subsidiary), while retaining 49% of the shares. Tawal was valued at SAR 21.94 bln. If completed, this would shift the Capex related to the passive wireless infrastructure away from STC, offering a greater efficiency in allocation of capital to invest in new domains and dive deep into data centers infrastructure. Although the Capex related to TAWAL will no longer be there if the deal goes through, on the other hand, it is expected to see an increase in Center3's and submarine cable project Capex that will partially offset the decline in TAWAL's Capex. We expect Capex intensity to come in-line with the management guidance of 14% to 15% in the next three years.

Exhibit 4: Capex (SAR mln) and Capex Intensity (%)



Source: Company Financials, Riyad Capital

Abundant cash for acquisitions and investment in new tech domains

STC was able to achieve strong cash flow during the year 2022 as it recorded cash flows from operational activities (CFO) amounting to SAR 26 bln, mainly supported by strong EBITDA, in addition to the company's collection some of its receivables related to the government. Receivables from the government decreased from SAR 22 bln to SAR 19 bln at the end of 2022. STC ended the year with SAR 25.8 bln as cash & equivalents. This high level of cash with STC is likely to increase further during the coming period as there are several factors that could provide the Company with an additional cash:

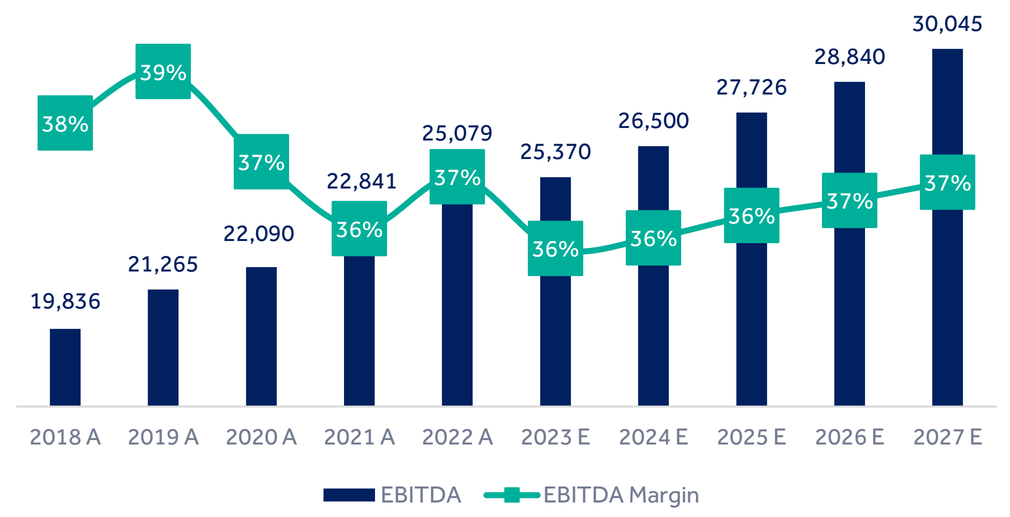
- Non-binding offer from PIF to acquire 51% of Tawal. The proceeds will be around SAR 11.17 bln cash inflow (in the event that the acquisition is completed).
- Selling a vacant land owned by the Company located in Khobar city for a total value of SAR 1.38 bln. It is expected that the IS will be positively impacted by SAR 1.30 bln once all related procedures are completed.
- Although the company received government payments in the recent past of around SAR 2 bln, the account receivables to the government currently amount to SAR 19 bln. There were two big government payments in 2018 and 2020 of about SAR 10 bln each. Once the AR related to the government is collected, this will further strengthen the Company's financial position.

The current cash & equivalent position in addition to SAR 12.55 bln (from the sale of Tawal and the land in Khobar), will result in a total of SAR 41.5 bln, 3.4x times STC's 2022 net income. We are concerned about whether STC can deploy all this liquidity in its BS. We believe deploying this liquidity in new tech-focused domains or utilizing it through acquisition overseas and achieving additional returns for shareholders will be challenging for STC.

Future investments amid margin concern

STC recorded a strong improvement in EBITDA in 2022, increasing by +10% Y/Y to SAR 25.1 bln. This was mainly due to the increase in the top-line as well as the higher gross margin resulting from the reversal of SAR 1.0 bln in provisions. While we believe in STC's ability to achieve synergy and integration, we feel that if STC utilizes the liquidity in investments in new tech-focused domains or acquisitions, we caution that these activities may have a negative impact on margins in the short-term although they would be good for growth. STC management has attributed the EBITDA margin decline in 4Q2022 to the company's establishment of three new start-ups, in addition to the expansion of its subsidiaries. We expect the EBITDA margin to decline in 2023 to 36% due to more contribution of the newer subsidiaries to revenues. However, we expect EBITDA margin to start improving gradually going forward.

Exhibit 5: EBITDA (SAR mln) and EBITDA Margin (%)



Source: Company Financials, Riyad Capital

Strong financial position paves the way for premium dividends

The payout ratio for STC currently stands at 66% (70% for the year 2021). As expected, the company did not distribute premium dividends for 2022 and this supported the company's cash position even more. The total dividends cost the Company SAR 8.0 bln for the year 2022, compared to its cash position of SAR 27 bln, meaning that the company has the ability to distribute premium dividends without any significant impact on its liquidity. Therefore, we maintain our previous estimates regarding dividends. We expect the company to distribute a premium dividend for 2023 to reach SAR 2.00 per share and then to rise to SAR 2.40 per share until 2027, mainly with the support of its strong and solid financial position.

Valuation

Our target price has been revised slightly downward due to updated assumptions in our financial model. We now project a slower decrease in the Account Receivables days leading to higher net working capital compared to our previous assumptions. Additionally, we anticipate higher operating expenses. These factors are partially offset by lower Capex intensity forecast compared to our previous forecast and higher revenue growth. Consequently, the overall impact on the free cash flow is modest resulting in only slight adjustment to our target price from SAR 50.00 to SAR 48.00 per share.

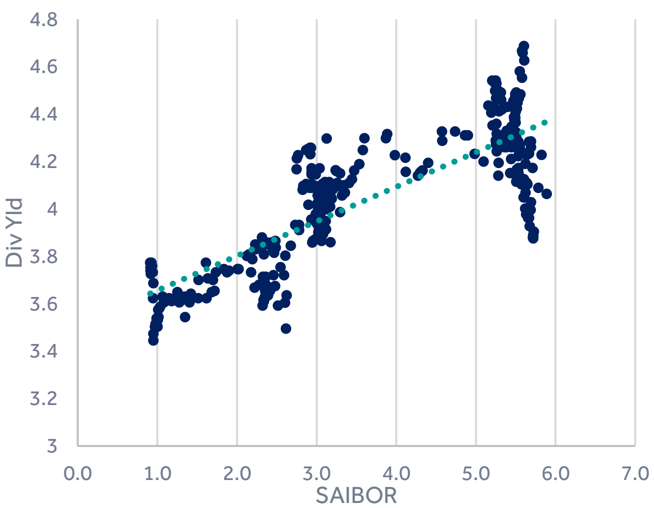
Key Risks to our Valuation

- Higher than expected increasing in receivables and slowing down collection especially from related parties.
- Not achieving the desired synergy from acquisitions.
- As the Enterprise Unit grows there could be more pressure on margins.
- Non-completion of the Tawal deal.

Value, income and upside potential

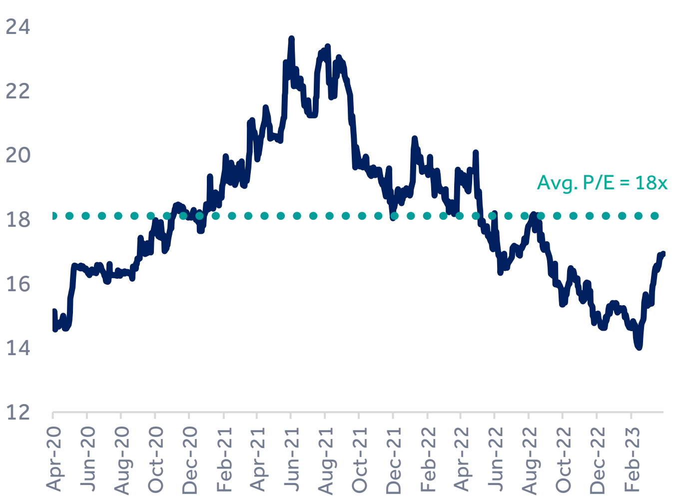
We observe a strong correlation between dividend yield and SAIBOR. When SAIBOR rates were below 1%, the dividend yield ranged between 3% to 3.5% while when SAIBOR rates rose above 5%, the dividends yield was above 4%. The payout ratio is 65%. A retention rate of 35% is necessary in order to push forward the Company strategy for expansion. Hence, we see a huge potential to continue with its growth story. Besides the low payout ratio, STC is trading at a P/E multiple below its 3-year average making it an attractive opportunity for value-oriented investors.

Exhibit 6: STC Dividends yield vs. SAIBOR



Source: Bloomberg, Riyad Capital

Exhibit 7: P/E ratio during the last three years



Source: Bloomberg, Riyad Capital

Discounted Cash Flows (DCF) valuation at SAR 241.5 bln (SAR 48.3/share)

Using our DCF valuation approach, we arrive at an equity value for the company of SAR 239.85 bln or SAR 48.00 per share. The company has a debt of only around 13% of its capital. To calculate the Weighted Average Cost of Capital (WACC), we use a risk-free rate of 4.35% and an equity risk premium of 5.30%. We have used a Beta of 0.95. Therefore, applying the respective weights to cost of equity and cost of debt, we arrive at a WACC of 8.7% and an equity value of SAR 241.5 bln or SAR 48.30 per share.

Table 2: Discounted Cash Flow Valuation

SAR '000	2024 E	2025 E	2026 E	2027 E
EBIT	16,075,306	17,157,443	18,012,843	18,912,892
Plus: D&A	10,424,886	10,568,838	10,826,895	11,132,367
Minus: Increase in NWC	(2,290,214)	(2,172,452)	(2,172,280)	(2,233,856)
Plus: non-cash items	1,650,330	1,685,908	1,718,603	1,751,850
Minus: Capex	(10,649,446)	(11,397,830)	(11,767,626)	(12,149,312)
Cash Flow to the Firm	**15,210,861**	**15,841,907**	**16,618,434**	**17,413,942**
Terminal Value				245,583,079
Total FCFF	**15,210,861**	**15,841,907**	**16,618,434**	**262,997,022**
Discounting Factor	0.92	0.85	0.78	0.72
Discounted Cash Flows	**13,993,791**	**13,408,203**	**12,940,016**	**188,398,353**

Long-term growth rate		1.5%
Enterprise value	228,740,363	
Net Debt	15,293,280	
Non-controlling interest	-2,526,067	
Equity Value	241,507,576	
Number of shares	5,000,000	
Fair Value per Share	48.3	

Source: Riyad Capital

Financial Statements

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

Table 3: Summarized Financials for STC (2021-2027)

	2021	2022	2023E	2024E	2025E	2026E	2027E
Income Statement (SAR mln)							
Sales	63,008	67,432	70,691	73,444	75,986	78,451	80,995
Gross profit	33,794	37,393	38,520	40,376	41,902	43,330	44,806
Operating profit	13,128	15,088	15,033	16,075	17,157	18,013	18,913
Net Income	11,311	12,171	12,763	13,920	14,743	15,329	16,097
Balance Sheet (SAR mln)							
Current Assets	51,468	60,933	66,027	67,843	70,635	72,977	76,021
Non-Current Assets	76,311	76,287	77,377	79,696	81,829	84,893	88,097
Current Liabilities	33,561	36,400	37,873	38,737	39,599	40,382	41,181
Non-Current Liabilities	22,833	24,794	26,566	27,716	28,821	29,862	30,920
Total Liabilities	56,393	61,194	64,439	66,453	68,421	70,244	72,101
Total Equity	71,386	76,026	78,964	81,087	84,044	87,626	92,017
Total Liabilities and Equity	127,779	137,220	143,404	147,540	152,465	157,870	164,118
Cash Flow (SAR mln)							
CFO	11,220	26,354	23,618	24,293	25,567	26,612	27,703
CFI	(1,715)	(8,579)	(10,852)	(13,488)	(10,012)	(12,777)	(10,409)
CFF	(10,235)	(8,256)	(11,036)	(13,222)	(13,294)	(13,343)	(13,394)
Growth							
Sales	6.9%	7.0%	4.8%	3.9%	3.5%	3.2%	3.2%
Gross Profit	-0.5%	10.7%	3.0%	4.8%	3.8%	3.4%	3.4%
Net Income	2.9%	7.6%	4.9%	9.1%	5.9%	4.0%	5.0%
Margins							
Gross Margin	53.6%	55.5%	54.5%	55.0%	55.1%	55.2%	55.3%
EBITDA Margin	36.3%	37.2%	35.9%	36.1%	36.5%	36.8%	37.1%
Net Margin	18.0%	18.0%	18.1%	19.0%	19.4%	19.5%	19.9%
Key Ratio's							
Current Ratio	1.5	1.7	1.7	1.8	1.8	1.8	1.8
Quick Ratio	1.4	1.5	1.6	1.6	1.6	1.6	1.7
ROA	9%	9%	9%	10%	10%	10%	10%
ROE	17%	17%	17%	18%	18%	18%	18%
Operating Ratios (days)							
Inventory Outstanding	11.5	12.4	13.7	13.7	13.7	13.7	13.7
Sales Outstanding	144.0	125.5	125.2	124.8	124.5	124.2	123.9
Payable Outstanding	213.8	254.0	252.5	250.5	248.5	246.5	244.5
Cash Cycle	(58.4)	(116.1)	(113.7)	(112.0)	(110.4)	(108.7)	(107.0)
Operating Cycle	155.5	137.9	138.9	138.5	138.1	137.8	137.5
Per Share (SAR)							
EPS	2.26	2.43	2.55	2.78	2.95	3.07	3.22
BVPS	14.28	15.21	15.79	16.22	16.81	17.53	18.40

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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