Saudi Telecom Sector

Telecommunications – Industrial
Saudi Arabia
15 November 2015

الراجحي المالية
Al Rajhi Capital

Research Department
Pritish Devassy, CFA
Tel 966 11 211 9370, devassyp@alrajhi-capital.com

Key themes

Of late, the telecom sector has lost its significance in the TASI as a result of the various competitive and company specific issues plaguing the sector. We believe 2016 could be the time for a relook at the sector because of three reasons – the defensive nature of telecom sector, stability in voice + data revenues and a weakened pricing competition after almost 65% cut in mobile voice prices

Implications

STC is likely to lead the sector as it has been doing in the past. Mobily has been looking to cut its non-recurring expenses which has been ongoing in the past few quarters and is likely to be successful in 2016. Zain KSA has been showing improvement in operating metrics on the whole.

What do we think?

Stock	Rating	Price Target
STC	Overweight	SAR80.0
Mobily	Neutral	SAR30.0
Zain KSA	Neutral	SAR9.5

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Green shoots

In the recent years, the telecom sector has been in all sorts of turmoil with uneven growth, falling profitability, pricing competition, entry of new players (virtual operators), accounting issues and arbitration related to Zain and Mobily. However, we believe 2016 could signal the start of an early change in fortunes for the sector for three reasons. Firstly, in a weakened macroeconomic backdrop, Telecom sector becomes more attractive given its defensive nature in a relative context. Not just being defensive, there is scope for growth as an increasingly large number of pilgrim tourists are expected to visit the Kingdom, benefitting the telecom players. When companies across the Kingdom are looking to slash budgets, STC committed to invest SAR3.9bn into its network for H2 2015. Secondly, for the past three years, wireless segment revenue has been declining as growth in data revenues was unable to offset the decline in voice revenues. CITC annual report reveals a flat y-o-y performance in wireless revenues for 2014. A simple extrapolation of this trend seen in the past three years points to a growth in the future. Lastly, post the cuts in voice pricing with domestic call rate now at 19halalas for Mobily and Zain KSA, we think there is less chance for further significant price cuts. Though the telecom sector is unlikely to see a radical transformation soon, we think these are early recovery signs for the sector. In any case, the benefits will accrue the most to STC, which is cushioned with a high dividend yield.

Better than a normally defensive sector: With the fall in oil prices, there are increasing investor concerns about the macro environment. Govt. expenditure, GDP, loan growth etc., are all expected to decline in 2016. Telecom, being a defensive sector, is likely to be relatively less affected than other sectors. Infact, not just being resilient, the sector is likely to benefit from an increase in the number of visitors to the country. As per the Hajj ministry, overall visas issued for Umrah is expected to increase from 6mn in 2014-15 to 10m by 2016. With the expansion of the Holy Mosque, there is expected to be a boost in the number of hajj pilgrims as well. This we believe would be a meaningful addition to the total number of mobile subscribers estimated at 54m for the sector. The visitors, especially the Hajj pilgrims have a significant effect on the revenues of the telecom firms as shown by the seasonality in revenues observed during the period. STC has an advantage over the others as it has an international presence that would help attract pilgrims/customers in using STC's network. More so when companies in the Kingdom are looking to slash budgets, STC committed to invest SAR3.9bn into its network for H2 2015.

Waiting for the inflection point: With the subscriber penetration saturated in the Kingdom, telecom sector has been seeing a decline in revenues due to intense competition. The common theme from the results of the three telecom companies so far has been the increase in data revenues not being able to offset the decline in voice revenues. However, as per CITC data , wireless revenues (mobile voice and data) in 2014 remained flat y-o-y, which means data could possibly begin to drive growth for the "sector", though not substantial yet. 2015 will be an exception as there have been pricing cuts by the mobile players. Growth for the sector will not necessarily mean growth for all the companies as the whole pie is now shared by an increased number of players. Given that the competition is likely to be at the lower end of the pricing curve, we think the effect will be most visible for STC which has the highest call prices and has a sticky customer base.

Disclosures Please refer to the important disclosures at the back of this report.
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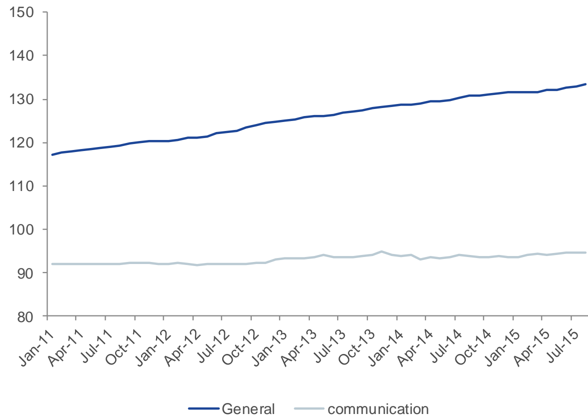
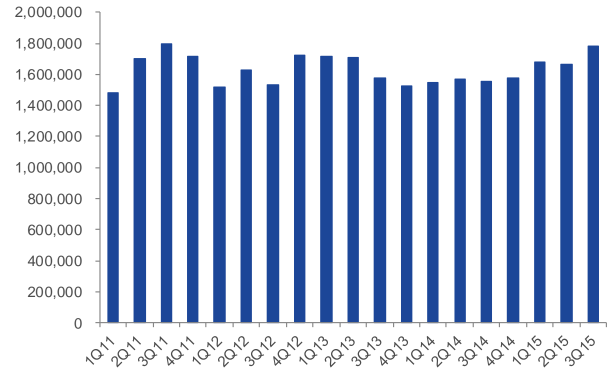
Figure 1 Communication sector price trend vs General inflation



Source: SAMA

Figure 2 Zain Quarterly revenue trend(SAR'000)

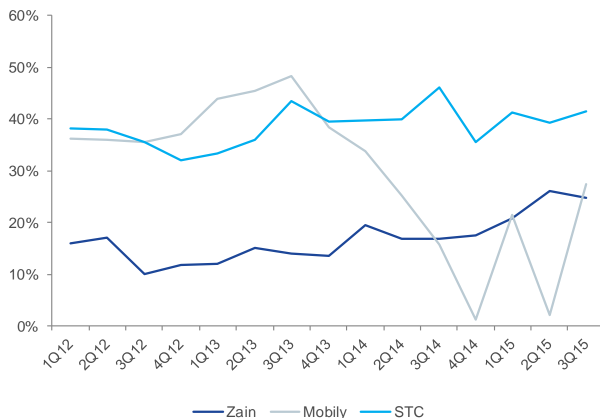


Source: Company data, Al Rajhi Capital

Infact STC reported an increase in ARPU for the first time this year, also helped by its FTTH segment.

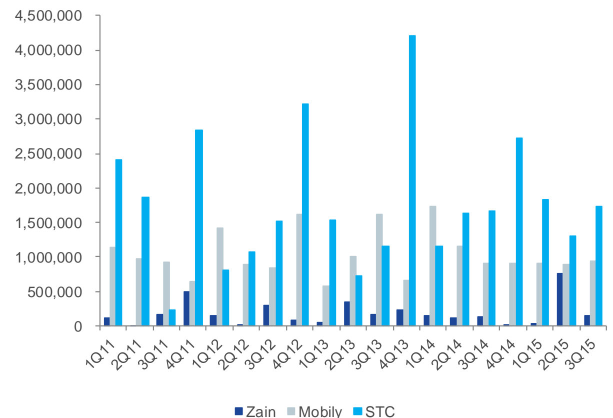
Low possibility of further significant price cuts: Telecom was the only sector in the Kingdom which saw stagnation in prices in 2014 (Figure 1). In 2015 as well, a pricing cut for domestic calls was initiated by Zain KSA in May 2015, followed by Mobily within three weeks. This was after CITC decided to reduce mobile termination rates by 40%. As a result of the 65% cut in prices (from 55 halalas to 19 halalas for Mobily and from 35 halalas to 19halalas for ZainKSA), call rates are much closer to the global average rates and are thereby likely to stabilize at this level. Despite the significant cut in interconnection rates, no major benefit was accrued to Zain KSA in the form of lower interconnection expenses, implying that a large proportion of domestic calls are made on the same network in the Kingdom (on-net calls). STC did not revise its prices lower because of its sticky subscriber base, in our view. Notably, being the incumbent they have the highest market share of high ARPU post paid subscribers.

Figure 3 EBITDA margins of the three telecom players in Saudi Arabia



Source: Company data, Al Rajhi Capital

Figure 4 STC's capex is higher than its competitors(in SAR '000)



Source: Company data, Al Rajhi Capital

KPIs improving for companies: Since the end of last year, Mobily has been facing troubles – accounting adjustments/errors, arbitration with Zain, changes to management, massive provisions, re-adjustments to financial statements etc. Though Q3 was expected to be the first quarter without any provisions for Mobily, Mobily disappointed with one off losses,

leading the stock to drop by 10% post announcement of results. We think it is likely to turn positive in 2016. As per the management, profitability is not expected to be too far. On the other hand, Zain KSA has been posting a more convincing improvement in its topline than shown in the past. The topline grew to SAR1.785bn from SAR1.55bn a year ago in Q3 2015. However, it is still below its peak revenue achieved in Q3 2011. Figure 2 highlights the long term revenue trend. Zain reported operating profits for the first time in Q2 2015. The key in our view is the improvement shown in EBITDA margins (Figure 3). STC has premium pricing and thereby has higher margins.

STC in a league of its own: STC has been clearly the strongest player in the sector and is in a league of its own. Its domestic performance is improving and it is also looking to optimize its foreign investments. STC is looking to sell its majority holding in Cell C, to further optimize its investments, after turning to cleaner reporting standards . While companies in the Kingdom are looking to slash budgets, STC committed to invest SAR3.9bn into its network for H2 2015. This corresponds to a significant 28% of estimated sales for H2 2015. Already STC has been out-investing its rivals in networks (Figure 4) and we expect this lead to continue, helping STC to cater to additional data demand while its competitors with huge debt and losses would not be able to invest as much. STC also increased its dividend payments from SAR 0.75/share before H2 2014 to SAR1/share per quarter. Zain does not pay dividends and Mobily has suspended its dividend payments as well.

STC's new dividend policy: Recently, STC's Board has approved a new dividend policy for three years starting from Q4 2015. We had emphasized in all our reports that there is a strong possibility for STC to raise its dividends. As per the press release, the dividend policy was approved by the board on 10 November but remains subject to ratification at the next Annual General Meeting (AGM). The company will consider and pay additional dividends on a quarterly basis, subject to the board's assessment and determination of the financial situation, outlook and capital expenditure requirements. Additional dividends are likely to vary quarter on quarter.

Outlook for 2016: While there is a possibility of early signs of recovery for the sector, there are risk factors to be considered as well. **STC** has been growing its topline at a decent pace but its net income has been extremely volatile owing to one offs such as currency costs, write offs in its foreign investments and fluctuating G & A expenses. In Q3 2015, the stock declined post the announcement of its results due to a non-recurring expenses that saw its net income decline by 30%. The lack of sufficient clarity in such non-recurring expenses is likely to disappoint investors. For **Mobily**, investors' long await to see the company report a stable set of numbers without provisions is still continuing. Since its accounting revisions in the last year, the company has been reporting one-off items on a regular basis. Among the other key factors for the company would be its debt renegotiations allowing it to extend the maturity of its debt. Mobily is likely to continue reporting a y-o-y decline in the coming quarters because of its pricing cut for voice calls in the first half of 2015. A successful tower sale could be a positive trigger to the stock. Lastly, **Zain KSA** on the whole has been improving. We believe there are two ways to look at Zain – an improvement in performance especially its EBITDA margins (Figure 3) pointing to a recovery. In another angle, liabilities such as zakat and income tax liabilities, royalty fee liabilities, declining equity due to accumulated losses in its balance sheet is a big concern. Overall, we are overweight on STC at SAR80/share, Neutral on Mobily at SAR30/share and Neutral on ZainKSA as well at SAR9.5/share.

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"Neutral": **We expect the share price to settle at a level between 10% below the current share price and 10% above the current share price on a 6-9 month time horizon.**

"Underweight**": Our target price is more than 10% below the current share price, and we expect the share price to reach the target on a 6-9 month time horizon.**

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"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.**

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"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.

Contact us

Pritish Devassy, CFA
Senior Research Analyst
Tel : +966 1 211 9370
Email: devassyp@alrajhi-capital.com

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