



US\$18.72bn Market cap	16.4% Free float	US\$10.67mn Avg. daily volume
Target price	43.60	20.44% over current
Consensus price	51.70	42.8% over current
Current price	36.20	as at 26/4/2011

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Underweight **Neutral** **Overweight**

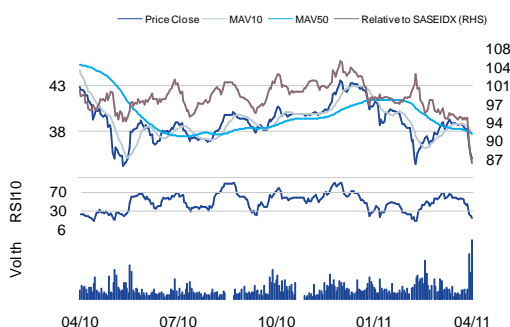
Key themes

We expect mobile to outperform fixed-line telecoms in Saudi Arabia over the next few years. Growth in 3.5G mobile broadband threatens the DSL market dominated by STC. We regard STC overseas expansion as confused and think that Mobily in particular has taken advantage of STC's distraction to strengthen its position in the domestic market.

Implications

With questions about its strategy and slow near-term earnings prospects, STC lacks catalysts for a major upside potential. Though, for the time being, we see the current level as a good buy

Performance

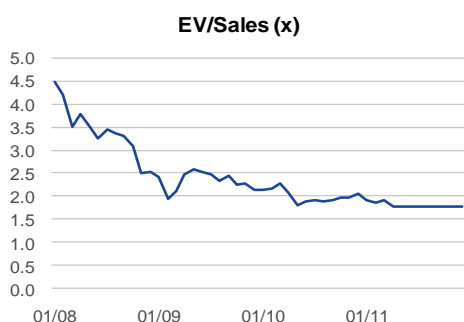


Earnings

Period End (SAR)	12/10A	12/11E	12/12E	12/13E
Revenue (mn)	51,787	53,045	55,196	58,039
Revenue Growth	2.0%	2.4%	4.1%	5.2%
EBITDA (mn)	19,625	20,180	21,953	23,506
EBITDA Growth	-4.8%	2.8%	8.8%	7.1%
EPS	4.72	3.87	4.68	5.03
EPS Growth	-13.1%	-18.1%	20.9%	7.5%

Source: Company data, Al Rajhi Capital

Valuation



Source: Company data, Al Rajhi Capital

STC

Attractive at current level

This report follows our flash comment on 20th April. STC's Q1 results supported our view that STC is showing improvement from a very weak period last year in H1 2010. While the operating performance is encouraging, we are concerned over the high financial costs and increased hedging losses due to international operations. As a result, we have trimmed our forecasts a bit and have marginally cut our target price. However, STCs price have fallen to a level where we see it as attractive and thus we upgrade our rating on the stock to Overweight. This implies an upside potential of 20.4%.

Respectable sales growth: STC reported a year-on-year sales growth of 4.4%; compared to Q4 growth of 3.2%. We think that STC is recovering gradually from the weak period and this positive revenue growth reflects its continuing expansion in foreign markets. For the first time STC has provided a break down of its domestic and international sales. The company has also provided its revenue on each business. One encouraging sign from the breakdown of sales is that data and mobile revenues have shown decent year- on- year growth of 7.5% and 6.7% respectively. We have been arguing that the telecom sector relies on mobile and data revenues for growth.

EBITDA & Operating profit also grew: EBITDA of SAR4, 814mn, was up 7.9% from a weak Q1 2010 period. This was below our estimated EBITDA of SAR5, 015mn. The growth in EBITDA was capped by higher salary payments to comply with the Royal Decree announcements of two salary bonus to its employees. EBITDA margin was at a healthy 36.8%, up by 1.2% percentage from Q1 last year. We expect margins to remain close to this level for STC in the coming quarters as well.

Net profit growth capped by higher provisions: While STC operating performances were satisfactory, the net profit growth was offset by provisions and exchange rates fluctuations. Net profit declines by 11% year on year, due to extra bonus payments and hedging losses of SAR355mn in Q1 2011. The financial costs too rose to SAR435mn in Q1. Looking ahead, we think financial costs will be high as debt levels have increased.

Capex is moderate, Debt increased further: Capex expenditure in Q1 stood at SAR2, 113mn or 16% of sales, which is mainly related to network expansions; domestic and internationally. STC gross debt increased this quarter at SAR23.5bn and we suspect that debt will increase if the company raises its stake in NTS Indonesia (from 51% to 80%) for which it has already promised for a US\$81mn loan, and followed by another loan of US\$290mn. STC also has plans to bid for Syrian license, and in case it becomes successful in gaining the license, we expect the debt levels will move sharply up. We have not included this in our estimates for the time being but this will surely increase financial costs and weigh on its net profits.

Valuation and conclusion: We have trimmed our revenue and earnings forecasts for 2011 only and have cut our target price to SAR43.6. We like STCs dividend yield which now stands at 5.5% and a pretty strong balance sheet. On this basis the stock offers 20.4% upside potential. We are now Overweight.



Corporate summary	Share information	Valuation
STC is the largest telecoms operator in the GCC region, with a market value of US\$20bn. STC completely dominates the Saudi fixed-line telecoms market and retains the highest share of the mobile market by revenues. STC is committed to expansion by investment abroad and acquisition, and has made major investments in Turkey, Malaysia, South Africa and elsewhere. These investments account for around one-quarter of its value.	<p>Market cap (SAR/US\$) 73.40bn / 19.57bn 52-week range 34.30 - 43.60 Daily avg volume (US\$) 10.88mn Shares outstanding 2,000mn Free float (est) 16.4%</p> <p>Performance: 1M 3M 12M Absolute -5.7% -10.3% -13.9% Relative to index -8.8% -10.7% -11.2%</p> <p>Major Shareholder: Public Investment Fund 70% Gen. Organisation for Social Insce. 7%</p>	<p>Period End 12/10A 12/11E 12/12E 12/13E</p> <p>Revenue (SARmn) 51,787 53,045 55,196 58,039 EBITDA (SARmn) 19,625 20,180 21,953 23,506 Net Profit (SARmn) 9,440 7,736 9,356 10,055 EPS (SAR) 4.72 3.87 4.68 5.03 DPS (SAR) 3.00 2.00 2.08 2.22 EPS Growth -13.1% -18.1% 20.9% 7.5% EV/EBITDA (x) 4.8 4.8 4.3 3.8 P/E (x) 7.8 9.5 7.8 7.3 P/B (x) 1.6 1.5 1.4 1.2 Dividend Yield 8.2% 5.4% 5.7% 6.0%</p> <p>Source: Company data, Al Rajhi Capital</p>
	Source: Bloomberg, Al Rajhi Capital	

Figure 1. STC: Q1 & Q2 results (actual and our estimates)

(SAR) mn	2010Q1A	2011Q1E	2011Q1A	YOY % chg.	2010Q2A*	2011Q2E	YOY % chg.
GSM	7,327.9	8,444.7	7,816.3	6.7%	8,796.5	9,069.8	3.1%
Fixed Line	3,514.4	2,640.3	3,468.3	-1.3%	2,052.4	2,149.5	4.7%
Data	1,603.9	1,708.5	1,723.9	7.5%	1,742.3	1,870.8	7.4%
Un-allocated	73.4	0.0	67.8	-7.6%	0.0	0.0	
Total Revenues	12,519.6	12,793.4	13,076.3	4.4%	12,591.2	13,090.1	4.0%
EBITDA	4,459.8	5,015.0	4,814.4	7.9%	4,503.9	4,895.7	8.7%
EBITDA margin (%)	35.6%	39.2%	36.8%		35.8%	37.4%	
Operating profit	2,353.3	2,877.9	2,668.7	13.4%	2,344.8	2,624.5	11.9%
Operating profit margin (%)	18.8%	22.5%	20.4%		18.6%	20.0%	
Net Income	1,772.0	2,253.2	1,573.1	-11.2%	2,062.0	1,856.8	-9.9%
Capex	1,914.8	2,901.8	2,112.8	10.3%	3,232.3	3,022.1	-6.5%
% of sales	15%	23%	16%		26%	23%	
Net Debt (bn)	22.5	22.8	21.9	-2.7%	24.2	26.3	8.7%
Net Debt/EBITDA	5.0	4.5	4.5		5.4	5.4	

* Our approximated figures.

Source: Company data, Al Rajhi Capital



We expect sales growth to gradually pick up from now on

Income Statement (SARmn)	12/09A	12/10A	12/11E	12/12E	12/13E
Revenue	50,780	51,787	53,045	55,196	58,039
Access Charges	(7,494)	(8,086)	(7,876)	(8,073)	(8,416)
Employee Costs	(6,772)	(6,590)	(6,326)	(6,237)	(6,384)
Government Charges	(5,664)	(5,710)	(6,056)	(5,961)	(6,210)
S.G. & A. Costs	(7,614)	(7,110)	(7,173)	(7,451)	(7,719)
Repairs & Maintenance Costs	(2,623)	(4,665)	(5,436)	(5,520)	(5,804)
Operating EBIT	12,814	10,981	11,275	12,822	13,789
Cash Operating Costs	(30,168)	(32,162)	(32,866)	(33,242)	(34,533)
EBITDA	20,612	19,625	20,180	21,953	23,506
Depreciation and Amortisation	(7,799)	(8,645)	(8,904)	(9,131)	(9,717)
Operating Profit	12,814	10,981	11,275	12,822	13,789
Net financing income/(costs)	(1,023)	(1,497)	(778)	(940)	(934)
Forex and Related Gains	642	372	(355)	-	-
Provisions	(811)	(606)	(762)	(808)	(808)
Other Income	(178)	1,005	(119)	-	-
Other Expenses					
Net Profit Before Taxes	12,130	10,983	9,261	11,075	12,047
Taxes	(977)	(939)	(947)	(1,006)	(1,093)
Minority Interests	(290)	(604)	(578)	(713)	(900)
Net profit available to shareholders	10,863	9,440	7,736	9,356	10,055
Dividends	(6,000)	(6,000)	(4,000)	(4,150)	(4,441)
Transfer to Capital Reserve	-	-	-	-	-

We expect dividend to rise gradually after drop in 2011

	12/09A	12/10A	12/11E	12/12E	12/13E
Adjusted Shares Out (mn)	2,000	2,000	2,000	2,000	2,000
CFPS (SAR)	9.48	9.34	8.61	9.60	10.34
EPS (SAR)	5.43	4.72	3.87	4.68	5.03
DPS (SAR)	3.000	3.000	2.000	2.075	2.220

Operating profit fell for 2009 & 2010, but we expect it to pick up from now on

Growth	12/09A	12/10A	12/11E	12/12E	12/13E
Revenue Growth	7.0%	2.0%	2.4%	4.1%	5.2%
EBITDA Growth	-5.2%	-4.8%	2.8%	8.8%	7.1%
Operating Profit Growth	-16.4%	-14.3%	2.7%	13.7%	7.5%
Net Profit Growth	-1.6%	-13.1%	-18.1%	20.9%	7.5%
EPS Growth	-1.6%	-13.1%	-18.1%	20.9%	7.5%

The EBITDA margin shrank by 2.8 percentage points in 2010, but we expect it to expand over the next three years

Margins	12/09A	12/10A	12/11E	12/12E	12/13E
EBITDA margin	40.6%	37.9%	38.0%	39.8%	40.5%
Operating Margin	25.2%	21.2%	21.3%	23.2%	23.8%
Pretax profit margin	23.9%	21.2%	17.5%	20.1%	20.8%
Net profit margin	21.4%	18.2%	14.6%	17.0%	17.3%

ROIC remains well above cost of capital; STC is generating economic profits

Other Ratios	12/09A	12/10A	12/11E	12/12E	12/13E
ROCE	16.6%	13.5%	12.9%	13.8%	13.8%
ROIC	18.4%	14.0%	13.5%	14.4%	15.0%
ROE	27.3%	21.7%	16.6%	18.3%	17.8%
Effective Tax Rate	8.1%	8.5%	10.2%	9.1%	9.1%
Capex/Sales	30.8%	28.3%	23.7%	24.0%	22.8%
Dividend Payout Ratio	55.2%	63.6%	51.7%	44.4%	44.2%

Valuation Measures	12/09A	12/10A	12/11E	12/12E	12/13E
P/E (x)	6.8	7.8	9.5	7.8	7.3
P/CF (x)	3.9	3.9	4.3	3.8	3.6
P/B (x)	1.7	1.6	1.5	1.4	1.2
EV/Sales (x)	1.9	1.8	1.8	1.7	1.6
EV/EBITDA (x)	4.6	4.8	4.8	4.3	3.8
EV/EBIT (x)	7.4	8.7	8.6	7.3	6.5
EV/IC (x)	1.3	1.3	1.2	1.1	1.0
Dividend Yield	8.2%	8.2%	5.4%	5.7%	6.0%

Source: Company data, Al Rajhi Capital



STC's balance sheet is expanding as a result of investment overseas

Balance Sheet (SARmn)	12/09A	12/10A	12/11E	12/12E	12/13E
Cash and Cash Equivalents	7,710	5,904	6,125	9,359	12,752
Current Receivables	11,461	8,847	9,148	12,284	12,769
Inventories	710	732	807	838	871
Other current assets	2,782	3,183	3,671	3,671	3,671
Total Current Assets	22,663	18,666	19,751	26,151	30,061
Fixed Assets	52,737	55,135	59,793	65,048	69,714
Investments	2,533	2,540	2,573	2,573	2,573
Goodwill	-	-	-	-	-
Other Intangible Assets	29,222	31,806	31,090	29,960	28,830
Total Other Assets	2,433	2,561	3,154	3,154	3,154
Total Non-current Assets	86,924	92,043	96,610	100,734	104,270
Total Assets	109,587	110,709	116,360	126,886	134,331
Short Term Debt	8,579	8,452	8,436	8,436	8,436
Trade Payables	20,762	18,190	19,176	23,733	24,591
Dividends Payable	-	-	(1,500)	(1,500)	(1,500)
Other Current Liabilities	(0)	0	-	(0)	(0)
Total Current Liabilities	29,341	26,642	26,112	30,668	31,527
Long-Term Debt	22,711	21,736	23,532	23,532	23,532
Other LT Payables	3,859	5,868	6,265	6,265	6,265
Provisions	2,844	2,995	3,029	3,029	3,029
Total Non-current Liabilities	29,414	30,599	32,826	32,826	32,826
Minority interests	8,798	8,469	9,033	9,746	10,645
Paid-up share capital	20,000	20,000	20,000	20,000	20,000
Total Reserves	22,035	24,998	28,390	33,646	39,333
Total Shareholders' Equity	42,035	44,998	48,390	53,646	59,333
Total Equity	50,833	53,468	57,423	63,392	69,978
Total Liabilities & Shareholders' Equity	109,587	110,709	116,360	126,886	134,331

STC's financial ratios are mostly healthy

Ratios	12/09A	12/10A	12/11E	12/12E	12/13E
Net Debt (SARmn)	23,580	24,284	25,843	22,609	19,216
Net Debt/EBITDA (x)	1.14	1.24	1.28	1.03	0.82
Net Debt to Equity	46.4%	45.4%	45.0%	35.7%	27.5%
EBITDA Interest Cover (x)	20.1	13.1	25.9	23.4	25.2
BVPS (SAR)	21.02	22.50	24.20	26.82	29.67

Cashflow Statement (SARmn)	12/09A	12/10A	12/11E	12/12E	12/13E
Net Income before Tax & Minority Interest	12,130	10,983	9,261	11,075	12,047
Depreciation & Amortisation	7,799	8,645	8,904	9,131	9,717
Decrease in Working Capital	(3,671)	175	(2,188)	1,390	341
Other Operating Cashflow	(302)	(1,024)	(713)	(1,006)	(1,093)
Cashflow from Operations	15,956	18,780	15,264	20,590	21,013
Capital Expenditure	(15,637)	(14,677)	(12,575)	(13,256)	(13,252)
New Investments	-	(75)	3	-	-
Others	2,094	1,706	227	-	-
Cashflow from investing activities	(13,542)	(13,046)	(12,345)	(13,256)	(13,252)
Net Operating Cashflow	2,413	5,734	2,919	7,334	7,760
Dividends paid to ordinary shareholders	(5,943)	(6,109)	(4,500)	(4,100)	(4,368)
Proceeds from issue of shares	-	-	-	-	-
Effects of Exchange Rates on Cash	-	-	-	-	-
Other Financing Cashflow	3,874	(329)	316	-	-
Cashflow from financing activities	(2,764)	(7,540)	(2,404)	(4,100)	(4,368)
Total cash generated	(351)	(1,806)	515	3,234	3,393
Cash at beginning of period	8,061	7,710	5,904	6,125	9,359
Implied cash at end of year	7,710	5,904	6,419	9,359	12,752

While capex has exceeded 30% of sales for three years, expect investment to moderate from now on

Ratios	12/09A	12/10A	12/11E	12/12E	12/13E
Capex/Sales	30.8%	28.3%	23.7%	24.0%	22.8%

Source: Company data, Al Rajhi Capital



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1. Explanation of Al Rajhi Capital's rating system

Al Rajhi Capital uses a three-tier rating system based on absolute upside or downside potential for all stocks under its coverage except financial stocks and those few other companies not compliant with Islamic Shariah law:

"**Overweight**": Our target price is more than 15% above the current share price, and we expect the share price to reach the target on a 6-9 month time horizon.

"**Neutral**": We expect the share price to settle at a level between 5% below the current share price and 15% above the current share price on a 6-9 month time horizon.

"**Underweight**": Our target price is more than 5% below the current share price, and we expect the share price to reach the target on a 6-9 month time horizon.

2. Definitions

"**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.

"**Fair value**": We estimate fair value per share for every stock we cover. This is normally based on widely accepted methods appropriate to the stock or sector under consideration, e.g. DCF (discounted cash flow) or SoTP (sum of the parts) analysis.

"**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.

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