



US\$19.09bn Market cap
16.4% Free float
US\$10.45mn Avg. daily volume

Target price **43.60** 23.16% over current
Consensus price **51.70** 46.0% over current
Current price **35.40** as at 01/08/2011

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Underweight

Neutral

Overweight

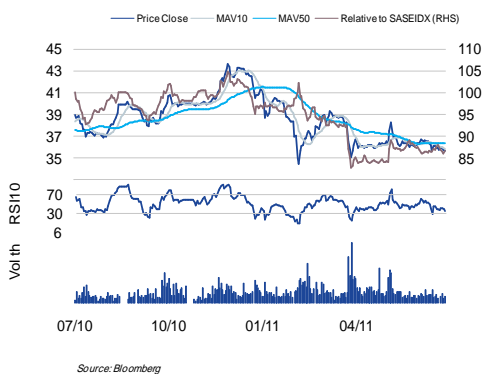
Key themes

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. Off late, STC has been doing the right thing in concentrating on the lucrative domestic market and the GCC region for growth opportunities.

Implications

We think a decent dividend yield of 5.6% coupled with overseas expansion should drive the share price in the near term. STC trades at a PE of 8.0x and looks attractive at current price.

Performance

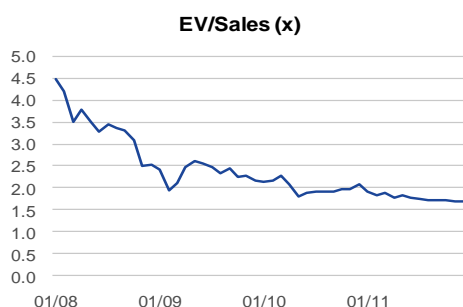


Earnings

Period End (SAR)	12/10A	12/11E	12/12E	12/13E
Revenue (mn)	51,787	56,006	58,678	60,376
Revenue Growth	2.0%	8.1%	4.8%	2.9%
EBITDA (mn)	19,625	21,447	23,342	24,452
EBITDA Growth	-4.8%	9.3%	8.8%	4.8%
EPS	4.72	4.68	5.55	5.63
EPS Growth	-13.1%	-0.8%	18.5%	1.5%

Source: Company data, Al Rajhi Capital

Valuation



Source: Company data, Al Rajhi Capital

STC Q2: Decent growth with concerns

Driven by broadband revenues in domestic market and expansion in international operations, STC results for Q3 were solid with revenues and net profit growth of 10.2% and 9.4% respectively. While the operating performance was encouraging, higher financial costs following the adoption of IAS 39 and lower dividend disbursements are concerning. In our view, it is clear that STC is currently focussing on growth, but the dividend cut has dampened the sentiments of investors. We have revised our revenues and profit forecasts to factor in the full consolidation of NTS. We maintain our target price of SAR43.6, thus remaining Overweight.

Sales growth showing improvement: Revenues in Q2 witnessed a robust year on year growth of 10.2% to SAR13.8bn, above our expectation of 4.0% growth. This strong increase was mainly driven by mobile & broadband revenues (fixed and mobile) where STC is doing well in bundling packages including voice, data, and digital television. For instance, the Blackberry service is now offered at SAR49 a month. We believe that these attractive promotions have definitely helped STC in maintaining its growth in the Saudi market. In our view, STC is realizing the potential of the lucrative broadband internet and hence targeting young population and executives, the key users of smart phones and tablets.

Gross margins have slipped; net margins stable: Gross margins shrank from 58.3% in Q2 2010 to 57.3% in Q2 2011. We believe this decline is due to aggressive pricing strategy adopted by all telecom companies, including STC, to out rival each other in the market. Operating margins, on the other hand, improved to 20.1% from 18.6% achieved for the same period last year on account of a firm control on SG&A costs (down 3% y-o-y) and employee costs (down 10% y-o-y). Net margins, however, fell slightly to 16.3% from 16.4% on account of higher financial costs recorded in the quarter.

Debt level has increased: STC reported SAR32.8bn of gross debt, up around 6.6% from last year. This increase has been largely due to NTS acquisition in March, with commitment from STC to provide a debt of US\$1.2bn for tenure of 7.5 years. That said, STC's balance sheet remains healthy at a respectable Net Debt/ EBITDA level of 1.2x.

Lower dividends a dampener: The fact that the company has now reduced its dividend payments to SAR0.5/quarter impacted the share price in Q2. With the current dividend yield of 5.6%, we believe the stock is no longer offering an attractive investment for passive investors looking for stable cash flows. That said, in our view, a decent dividend yield coupled with overseas expansions should drive the share price.

Valuation & Conclusion: The modest increases we have done to our forecasts do not affect our long-run valuation significantly. We are positive on the coming quarters which coincide with the holy Ramadan as well as the Hajj season which see a significant rise in religious tourism to the Kingdom. We have thus left our target price unchanged at SAR43.6. STC is financially healthy and offers now a decent dividend yield of 5.6%. STC trades at a PE of 8.0x and a EV/EBITDA of 4.4x which makes it one of cheapest investment options in the market. We remain Overweight.



Corporate summary

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.

Share information

Market cap (SAR/US\$)	70.40bn / 18.77bn		
52-week range	34.50 - 43.60		
Daily avg volume (US\$)	9.22mn		
Shares outstanding	2,000mn		
Free float (est)	16.4%		

Performance:	1M	3M	12M
Absolute	-3.3%	-3%	-7.9%
Relative to index	-0.5%	1.8%	-9.6%

Major Shareholder:	
Public Investment Fund	70%
Gen. Organisation for Social Insc.	7%

Source: Bloomberg, Al Rajhi Capital

Valuation

Period End	12/10A	12/11E	12/12E	12/13E
Revenue (SARmn)	51,787	56,006	58,678	60,376
EBITDA (SARmn)	19,625	21,447	23,342	24,452
Net Profit (SARmn)	9,440	9,367	11,100	11,268
EPS (SAR)	4.72	4.68	5.55	5.63
DPS (SAR)	3.00	2.00	2.40	2.57
EPS Growth	-13.1%	-0.8%	18.5%	1.5%
EV/EBITDA (x)	4.7	4.3	3.7	3.4
P/E (x)	7.5	7.5	6.3	6.2
P/B (x)	1.6	1.4	1.2	1.1
Dividend Yield	8.5%	5.7%	6.8%	7.3%

Source: Company data, Al Rajhi Capital

Below we present our forecasts for Q3 2011:

Figure 1. STC: Q2 & Q3 results (actual and our estimates)

(SAR) mn	2010Q2A	2011Q2E	2011Q2A	YOY % chg.	2010Q3A*	2011Q3E	YOY % chg.
GSM	7,377.5	9,069.8	8,430.6	14.3%	NA	9,039.9	
Fixed Line	3,442.7	2,149.5	3,606.9	4.8%	NA	3,633.7	
Data	1,713.8	1,870.8	1,741.3	1.6%	NA	1,778.7	
Un-allocated	57.3	0.0	101.0	76.3%	NA	39.6	
Total Revenues	12,591.2	13,090.1	13,879.7	10.2%	13,232.4	14,491.8	9.5%
EBITDA	4,503.9	4,895.7	5,085.6	12.9%	5,417.3	5,807.5	7.2%
EBITDA margin (%)	35.8%	37.4%	36.6%		40.9%	40.1%	
Operating profit	2,344.8	2,624.5	2,782.9	18.7%	3,254.9	3,549.0	9.0%
Operating profit margin (%)	18.6%	20.0%	20.1%		24.6%	24.5%	
Net Profit	2,062.0	1,856.8	2,256.4	9.4%	3,316.8*	2,840.8	-14.4%
Adj. Net Profit	2,062.0	1,856.8	2,256.4	9.4%	2,588.8	2,840.8	9.7%
Capex	3,232.3	3,022.1	2,159.5	-33.2%	6,097.6	3,632.2	-40.4%
% of sales	26%	23%	16%		46%	25%	
Net Debt (bn)	24.2	26.3	25.0	3.3%	24.3	23.7	-2.4%
Net Debt/EBITDA	1.3	1.3	1.2		1.1	1.0	

Source: Company data, Al Rajhi Capital

** Net Profit in Q3 2010 includes a one time cash flow of SAR728mn earned on account of sale of mobile tower to Benariang.



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	56,006	58,678	60,376
Access Charges	(7,494)	(8,086)	(8,307)	(8,579)	(8,754)
Employee Costs	(6,772)	(6,590)	(6,833)	(6,631)	(6,641)
Government Charges	(5,664)	(5,710)	(6,294)	(6,337)	(6,460)
S.G. & A. Costs	(7,614)	(7,110)	(7,243)	(7,922)	(8,030)
Repairs & Maintenance Costs	(2,623)	(4,665)	(5,881)	(5,868)	(6,038)
Operating EBIT	12,814	10,981	12,424	14,069	14,582
Cash Operating Costs	(30,168)	(32,162)	(34,558)	(35,337)	(35,924)
EBITDA	20,612	19,625	21,447	23,342	24,452
Depreciation and Amortisation	(7,799)	(8,645)	(9,024)	(9,273)	(9,870)
Operating Profit	12,814	10,981	12,424	14,069	14,582
Net financing income/(costs)	(1,023)	(1,497)	(1,693)	(1,591)	(1,405)
Forex and Related Gains	642	372	(303)	-	-
Provisions	(811)	(606)	(578)	(586)	(586)
Other Income	(178)	1,005	700	858	858
Other Expenses					
Net Profit Before Taxes	12,130	10,983	10,549	12,751	13,449
Taxes	(977)	(939)	(770)	(903)	(1,259)
Minority Interests	(290)	(604)	(412)	(749)	(922)
Net profit available to shareholders	10,863	9,440	9,367	11,100	11,268
Dividends	(6,000)	(6,000)	(4,000)	(4,800)	(5,136)
Transfer to Capital Reserve	-	-	-	-	-

We expect dividend to rise gradually

	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	9.40	10.56	11.03
EPS (SAR)	5.43	4.72	4.68	5.55	5.63
DPS (SAR)	3.000	3.000	2.000	2.400	2.568

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%	8.1%	4.8%	2.9%
EBITDA Growth	-5.2%	-4.8%	9.3%	8.8%	4.8%
Operating Profit Growth	-16.4%	-14.3%	13.1%	13.2%	3.6%
Net Profit Growth	-1.6%	-13.1%	-0.8%	18.5%	1.5%
EPS Growth	-1.6%	-13.1%	-0.8%	18.5%	1.5%

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%	38.3%	39.8%	40.5%
Operating Margin	25.2%	21.2%	22.2%	24.0%	24.2%
Pretax profit margin	23.9%	21.2%	18.8%	21.7%	22.3%
Net profit margin	21.4%	18.2%	16.7%	18.9%	18.7%

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%	14.0%	14.6%	14.1%
ROIC	18.4%	14.0%	15.3%	16.6%	16.1%
ROE	27.3%	21.7%	19.8%	20.9%	19.0%
Effective Tax Rate	8.1%	8.5%	7.3%	7.1%	9.4%
Capex/Sales	30.8%	28.3%	21.4%	23.6%	22.6%
Dividend Payout Ratio	55.2%	63.6%	42.7%	43.2%	45.6%

STC now trades at an attractive PE of 8.0x.

Valuation Measures	12/09A	12/10A	12/11E	12/12E	12/13E
P/E (x)	6.5	7.5	7.5	6.3	6.2
P/CF (x)	3.7	3.8	3.7	3.3	3.2
P/B (x)	1.7	1.6	1.4	1.2	1.1
EV/Sales (x)	1.8	1.8	1.6	1.5	1.4
EV/EBITDA (x)	4.4	4.7	4.3	3.7	3.4
EV/EBIT (x)	7.1	8.4	7.4	6.2	5.8
EV/IC (x)	1.3	1.2	1.2	1.1	1.0
Dividend Yield	8.5%	8.5%	5.7%	6.8%	7.3%

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	9,152	13,360	16,720
Current Receivables	11,461	8,847	9,831	13,291	13,283
Inventories	710	732	867	906	906
Other current assets	2,782	3,183	3,857	3,857	3,857
Total Current Assets	22,663	18,666	23,707	31,414	34,765
Fixed Assets	52,737	55,135	59,508	65,189	70,045
Investments	2,533	2,540	2,601	2,601	2,601
Goodwill	-	-	-	-	-
Other Intangible Assets	29,222	31,806	30,791	29,707	28,623
Total Other Assets	2,433	2,561	2,505	2,505	2,505
Total Non-current Assets	86,924	92,043	95,405	100,002	103,774
Total Assets	109,587	110,709	119,112	131,417	138,540
Short Term Debt	8,579	8,452	6,934	6,934	6,934
Trade Payables	20,762	18,190	20,217	25,273	25,258
Dividends Payable	-	-	-	-	-
Other Current Liabilities	(0)	0	0	(0)	(0)
Total Current Liabilities	29,341	26,642	27,151	32,207	32,192
Long-Term Debt	22,711	21,736	25,895	25,895	25,895
Other LT Payables	3,859	5,868	5,215	5,215	5,215
Provisions	2,844	2,995	3,042	3,042	3,042
Total Non-current Liabilities	29,414	30,599	34,152	34,152	34,152
Minority interests	8,798	8,469	7,958	8,707	9,629
Paid-up share capital	20,000	20,000	20,000	20,000	20,000
Total Reserves	22,035	24,998	29,851	36,351	42,567
Total Shareholders' Equity	42,035	44,998	49,851	56,351	62,567
Total Equity	50,833	53,468	57,809	65,057	72,196
Total Liabilities & Shareholders' Equity	109,587	110,709	119,112	131,417	138,540

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	23,677	19,469	16,109
Net Debt/EBITDA (x)	1.14	1.24	1.10	0.83	0.66
Net Debt to Equity	46.4%	45.4%	41.0%	29.9%	22.3%
EBITDA Interest Cover (x)	20.1	13.1	12.7	14.7	17.4
BVPS (SAR)	21.02	22.50	24.93	28.18	31.28

Cashflow Statement (SARmn)	12/09A	12/10A	12/11E	12/12E	12/13E
Net Income before Tax & Minority Interest	12,130	10,983	10,549	12,751	13,449
Depreciation & Amortisation	7,799	8,645	9,024	9,273	9,870
Decrease in Working Capital	(3,671)	175	(1,253)	1,557	(6)
Other Operating Cashflow	(302)	(1,024)	(384)	(903)	(1,259)
Cashflow from Operations	15,956	18,780	17,936	22,678	22,055
Capital Expenditure	(15,637)	(14,677)	(11,960)	(13,870)	(13,642)
New Investments	-	(75)	(32)	-	-
Others	2,094	1,706	(175)	-	-
Cashflow from investing activities	(13,542)	(13,046)	(12,167)	(13,870)	(13,642)
Net Operating Cashflow	2,413	5,734	5,768	8,808	8,412
Dividends paid to ordinary shareholders	(5,943)	(6,109)	(4,395)	(4,600)	(5,052)
Proceeds from issue of shares	-	-	-	-	-
Effects of Exchange Rates on Cash	-	-	-	-	-
Other Financing Cashflow	3,874	(329)	(572)	-	-
Cashflow from financing activities	(2,764)	(7,540)	(2,326)	(4,600)	(5,052)
Total cash generated	(351)	(1,806)	3,442	4,208	3,360
Cash at beginning of period	8,061	7,710	5,904	9,152	13,360
Implied cash at end of year	7,710	5,904	9,346	13,360	16,720

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%	21.4%	23.6%	22.6%

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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