

Saudi Telecoms Sector

Telecoms – Integrated/Mobile

Saudi Arabia

25 January 2010

الراجحي المالية
Al Rajhi Capital



US\$ 37.1bn Market cap
29.8% Free float
US\$36.6mn Avg. daily volume

Target mkt cap **SAR149bn** **7.6% over current**
Consensus mkt cap SAR172bn **24.2% over current**
Current mkt cap SAR139bn as at 20/01/2010

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Key themes

We expect the Saudi mobile market to continue to outperform fixed line, driven primarily by mobile data. Consequently we expect robust growth for the next few years, despite the risk of increased pressure on prices. We regard STC's 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

Our preferred stock in the sector is Mobily, which we rate as Overweight. Mobily is performing well operationally and offers strong growth in the near term at a reasonable valuation. STC (Neutral) lacks catalysts for share price performance, although it is modestly valued and offers a generous yield of 6.5%. Zain KSA (Underweight) is performing well for a third operator, but is hobbled by a high debt burden. Even in our most optimistic scenario we regard Zain as overvalued.

What do we think?

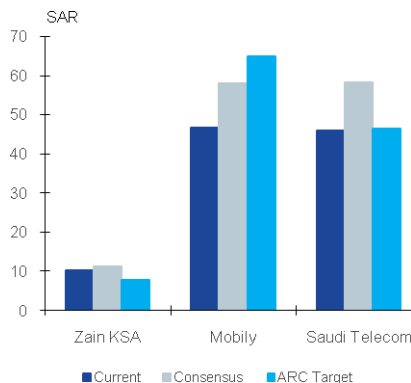
Stock	Rating	Price Target
STC	Neutral	SAR46.4
Mobily	Overweight	SAR64.9
Zain KSA	Underweight	SAR8.0

Why do we think it?

Stock	3 year EBITDA CAGR	2010 EV/EBITDA
STC	7%	5.1x
Mobily	13%	6.8x
Zain KSA	107%	69.3x

* 2009-12 for STC and Mobily, 2010-13 for Zain KSA. Source: Al Rajhi Capital

Where are we versus consensus?



Source Bloomberg, Al Rajhi Capital



Saudi Telecoms Sector: We prefer jam today

The Saudi telecoms market is still booming: we expect 3.5G data to help drive mobile penetration towards 220% within five years. There are risks, but it is too early to prepare for a slowdown. STC's foreign investments thus seem a distraction, even if they may bear fruit in the long run. We prefer Mobily, which is the leader in mobile data and is delivering strong growth. Zain is performing well for a no.3 player, but is hobbled by excessive debt.

Saudi telecoms market: attractive overall. From a top-down perspective, the Saudi telecoms market is attractive. The country benefits from a young and fast growing population and from high GDP/capita. The mobile market, which accounts for 74% of the total, is growing fast and is also relatively concentrated.

Mobile market: data can drive growth further. We expect mobile broadband to help drive mobile penetration in Saudi Arabia towards 220% within five years. We think mobile broadband will fuel incremental growth, rather than replace existing voice revenues; however, it may threaten fixed-line DSL. In our core scenario mobile ARPU only declines modestly, but with RPM high by the standards of emerging markets there is a risk of sharper price falls.

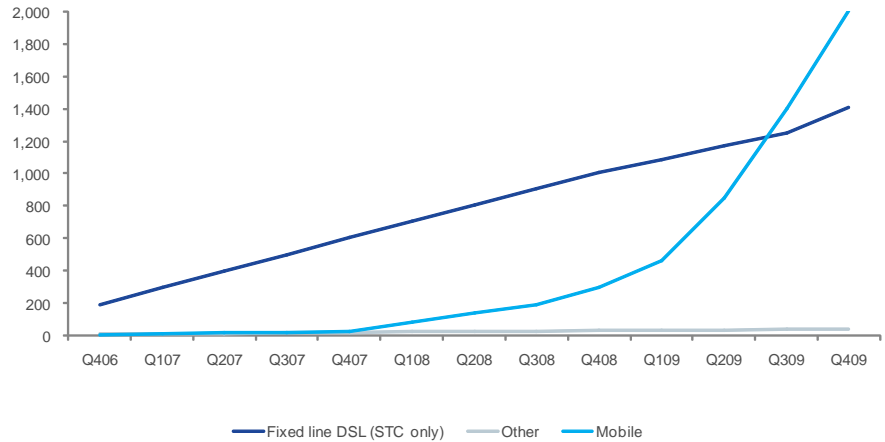
New opportunities: don't be distracted. Comparisons with historical overseas investment plans in the telecoms sector cast doubt on several aspects of STC's expansion strategy. STC's investments may boost growth in the future, but right now we think it has lost its way at home. Mobily is proving the near-term winner in Saudi telecoms; Zain is growing fast but remains in clear third place.

Stock conclusions. STC is inexpensive and its financial stability and dividend yield of 6.5% offer support; however, it lacks catalysts for performance. We rate STC Neutral and set a price target of SAR46.4. Mobily offers strong near-term growth and is not expensive for a fast-growing operator on a PE of 9.3x. We rate Mobily Overweight and set a target price of SAR64.9, implying 39% upside potential. With net debt 2.4x 2010 sales, we think fair value for Zain is more than 20% below the current price and rate it Underweight.



Mobile broadband accounts urging, and set to overtake fixed-line DSL

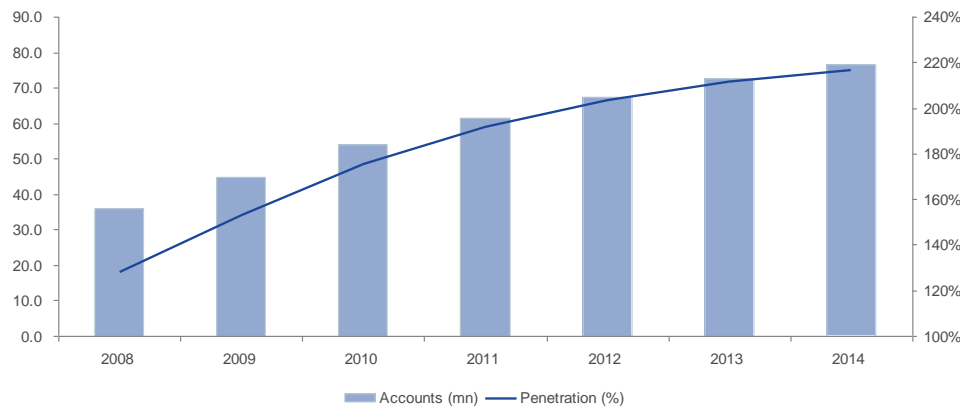
Figure 1. Combined fixed-line and mobile broadband subscriptions in KSA



Source: CITC, operators, estimates by Al Rajhi Capital

We expect mobile penetration to rise towards 200% within five years

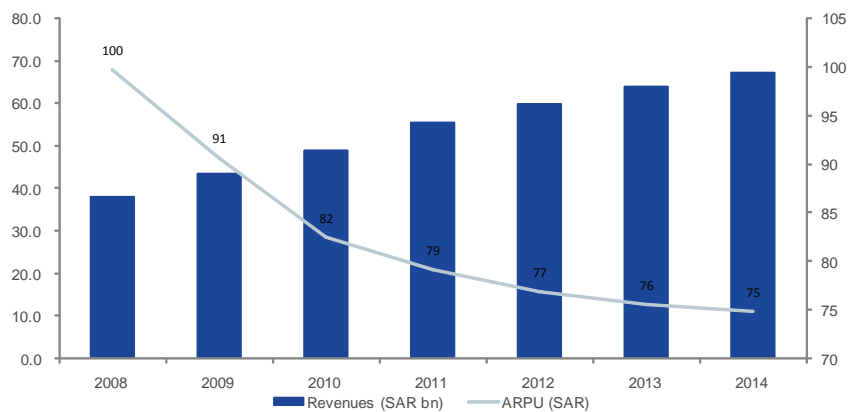
Figure 2. Saudi mobile market: forecasts for penetration and accounts



Source: Companies, CITC, Al Rajhi Capital

But mobile prices are set to fall

Figure 3. Saudi mobile market: forecasts for revenues and ARPU



Source: Companies, CITC, Al Rajhi Capital



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- 4 **Saudi telecoms: attractive overall**
Initiating coverage
In this new report we launch coverage of the three leading Saudi telecoms operators. The demographic profile and high GDP/capita of the Saudi market are favourable; high market concentration is also positive. Strong mobile penetration growth should continue.
- 6 **Mobile: data can drive growth further**
- 6 **Mobile data to push penetration towards 220%**
Mobile penetration in Saudi Arabia is 154%. However, mobile data is surging and will, we think, help drive penetration to 217% by 2014. We expect mobile data to fuel incremental growth, rather than replace existing voice revenues, though it threatens fixed-line DSL.
- 13 **High RPM means prices are at risk**
We have assumed rising pressure on ARPU in our Saudi mobile forecasts, but with ARPU and RPM high by the standards of emerging markets, the operators may be tempted to cut prices further. We think Zain would be most affected by steep price falls in the near term.
- 17 **New opportunities: don't be distracted**
- 17 **STC: expansion abroad a costly distraction**
STC's growth strategy involves acquisition and investment abroad. Comparisons with historical foreign investment plans in the telecoms sector cast doubt on several aspects of STC's strategy. STC's investments may boost future growth, but right now we think it has slightly lost its way at home.
- 23 **Mobily versus Zain: Mobily better-placed**
Zain's imaginative tariff packages have contributed to strong near-term growth. Nevertheless, in terms of strategy and customer perception, we see few substantive differences between Zain and Mobily. Mobily also remains clearly in the lead in the surging mobile data market.
- 27 **2009 results support our stance**
Mobily's results stand out
STC's 2009 results were disappointing, although prospects for 2010 are better. Mobily published strong results which augur well for this year. Zain KSA, while achieving strong growth in market share and revenues, fell slightly short of our expectations.
- 31 **Valuation: Mobily still offers value, yield is STC's chief attraction**
- 31 **STC**
We value STC using both long-run discounted EVA analysis and sum-of-the-parts analysis. We set a price target of SAR46.4 based on an average of fair value under the two methods. We rate STC Neutral but note that it is modestly valued and offers a dividend yield of 6.5%.
- 36 **Mobily**
Mobily offers strong near-term growth and is not expensive for a fast-growing telecoms operator on a 2010 EV/EBITDA ratio of 6.8x and a PE of 9.3x. We rate Mobily Overweight and set a target price of SAR64.9, implying 39% upside potential.
- 37 **Zain KSA**
We expect Zain to achieve impressive gains in market share and profitability over this decade. However, with a high debt burden (we expect net debt of 2.4x sales for 2010), we think fair value for Zain is more than 20% below the current price and rate it Underweight.
- 39 **Company summaries and financial data**



Saudi telecoms market: attractive overall

In this report, we launch coverage of the three important Saudi telecoms operators: the incumbent operator STC, and its rivals Mobily and Zain KSA. STC is the largest telecoms operator by value in the GCC region, with a market capitalisation of US\$24bn (just ahead of Etisalat of the UAE, its closest rival). However, Mobily and Zain KSA are also sizable companies with market capitalisations of US\$8bn and US\$4bn respectively.

Figure 4. GCC telecoms operators

Company	Country	Share price (local currency)	No. of shares (SRm)	Market capitalisation (local curr. mn)	Market capitalisation (US\$ mn)	Free float (%)	Bloomberg code
STC	Saudi Arabia	44.10	2,000	88,200	23,520	16	STC AB
Mobily	Saudi Arabia	43.40	700	30,380	8,101	36	EEC AB
Zain KSA	Saudi Arabia	10.15	1,400	14,210	3,789	56	ZAINKSA AB
Etisalat	UAE	11.00	7,187	79,061	19,965	40	ETISALAT UH
Q-Tel	Qatar	145.10	147	21,282	5,847	3	QTEL QD
Turk Telecom	Turkey	4.56	3,500	15,960	10,640	15	TTKOM TI
Orascom Telecom	Egypt	25.12	899	22,593	4,123	48	ORTE EY
Mobinil	Egypt	240.48	100	24,048	4,388	29	EMOB EY
Telecom Egypt	Egypt	18.10	1,707	30,898	5,638	20	ETEL EY
Oman Telecom	Oman	1.30	750	975	2,614	30	OTEL OM
Wataniya Telecom	Kuwait	1,540.00	501	772	2,699	24	NMTC KK
Zain Kuwait	Kuwait	1,020.00	4,272	4,358	15,237	64	ZAIN KK
Turk Cell	Turkey	10.60	2,200	23,320	15,547	34	TCELL TI

Date: 31/12/2009

Source: Operators, CITC, Al Rajhi Capital

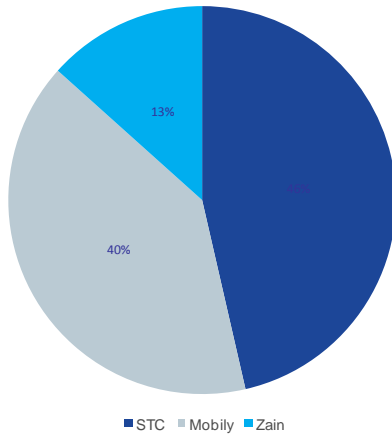
Demographic profile and high GDP/capita very favourable
High market concentration is also positive

From a strategic or “top-down” perspective, the Saudi telecoms market has much to recommend it. The country benefits from a young and fast growing population: nearly 40% of Saudis are under 15 years of age. Continued population growth should help ensure further growth in demand for telecoms services, despite high headline rates of mobile penetration in particular. Moreover, high GDP/capita of around US\$20,500 in 2008, combined with the presence of a substantial expatriate population (about 20% of the total), helps ensure that Saudis have money to spend on telecoms services; this is one of the factors behind the country’s high levels of ARPU (average revenue per user).

It is also important to note that the Saudi telecoms market is quite concentrated. Market concentration is often measured using the Herfindahl-Hirschman Index (HHI), which represents the sum of the squares of the market shares of the participants. While poor data complicate analysis, we calculate the HHI score for the Saudi mobile market at around 3,950. Although this is much less concentrated than, say, the Chinese mobile market (for which we calculate the HHI score at over 5,900), this is more than double the level of 1,800 that is used by the US Department of Justice as the threshold of a concentrated market in assessing M&A transactions. The smaller Saudi fixed-line telecoms market is much more concentrated than the mobile segment and remains heavily dominated by STC. High market concentration usually helps to support high profit margins and returns on capital.



Figure 5.1 Saudi mobile market share (12/09 est.)



Source: Company data, Al Rajhi Capital

Figure 5.2 HHI Index

Company	Sum of square of mkt. shares
STC	2,154
Mobily	1,618
Zain	179
HHI score	3,950

Source: Company data, Al Rajhi Capital

We expect strong penetration growth in Saudi Arabia to continue, though a sudden slowdown cannot be ruled out

However, a slightly closer look at the market reveals potential grounds for concern. Probably the key issue for the Saudi telecoms operators is the outlook for the domestic mobile market, which has been the predominant source of growth in the sector over the past few years. By our estimate, domestic SIM penetration stood at 154% at the end of 2009, reflecting continued strong growth in second and third SIMs and demand for 3G and mobile broadband service. This is higher than penetration in most emerging markets and, indeed, many developed markets, although still below some of the neighbouring countries in the GCC region. The first section of this report asks for how long penetration in Saudi Arabia can continue to expand. We conclude that strong penetration growth in the Saudi mobile market can persist for several quarters, driven primarily by demand for mobile broadband service. That said, it is very difficult to estimate the upper limit on SIM penetration and so there is clearly a risk of a sudden, sharp slowdown.

Another important issue is the fact that Saudi mobile ARPU and RPM (revenue per minute), though comparable to levels in many developed countries and elsewhere in the GCC region, are high by the standards of emerging markets. To an extent this is simply a natural reflection of high Saudi GDP/capita. However, the fact that ARPU and RPM are high compared to other emerging markets in absolute terms means that operators have significant scope to compete on price should they so choose, raising the spectre of a steep decline in mobile prices at some point. In the first section of this report we also assess the scale of this risk and the damage it might cause.

Saudi telecoms operators face a strategic dilemma

The combination of high reported penetration and the possibility of significant pressure on prices confronts the Saudi operators with a strategic dilemma. Should they focus on boosting market share and improving service in the domestic market, in the hope that they will be better placed to defend their share of customers and revenues in case growth slows down? Alternatively, should they look for new growth opportunities in different sectors or markets? In simple terms, Mobily and Zain appear to have chosen the first path, while we would argue that STC has chosen the second with a strategy focused on expansion through international expansion and acquisition. The second section of the report analyses the three companies' strategies, but with a particular focus on the strengths and weaknesses of STC's expansion policy.

To assess the attractions of stocks as investment opportunities, we must naturally consider valuation as well as strategy and market position. This is the subject of the third section of this report. The primary method of valuation that we have employed to judge the three Saudi telecoms operators is long-run discounted economic profit valuation, which is a variation on discounted cash flow. However, we also consider comparative valuation, i.e. comparisons with operators in other markets and with each other, on measures such as EV/EBITDA, PE, price/book value and dividend yield. Comparative valuation is particularly important for STC, given the scale of its overseas operations.



Mobile market: data can drive growth further

Mobile data to push penetration towards 220%

Poor information complicates analysis of the Saudi telecoms market

Any discussion of the Saudi telecoms market must start with the warning that paucity of information complicates analysis. This is not simply a facile statement: disclosure of operating data by the Saudi telecoms operators is the poorest that the chief author of this report has seen in sixteen years as a telecoms analyst in markets around the world. The operators do not even regularly publish mobile or fixed-line subscriptions, and ARPU and MoU (minutes of use) data are still harder to find. With poor disclosure by the operators and limited information from the regulatory authorities, analysis of the Saudi telecoms market carries a significant margin of error.

But there is no doubt that recent growth in mobile service has been very strong

Mobile accounts for 74-75% of the Saudi telecoms market

This caveat notwithstanding, there is little doubt that recent growth in the Saudi telecoms market has been brisk. This growth has been driven by mobile service, which now accounts for a substantially greater portion of the overall telecoms market than fixed-line service. As reported by the national regulator, the CITC (Communications and Information Technology Commission), there were 41.2mn mobile accounts in Saudi Arabia at the end of Q3 2009, more than double the level of 19.7mn at the end of 2006. By contrast, fixed-line connections grew from around 3.8mn to 4.1mn over the same period. (Note: our own estimates of telecoms subscriptions at the end of Q3 2009 differ slightly from the CITC's figures.) Fixed-line growth has actually been quite respectable, considering that fixed-line connections are stagnant or declining in many countries; nevertheless, it is clearly far below the growth rate of mobile.

Figure 6. Growth in subscriptions

	Dec-06	Mar-07	Jun-07	Sep-07	Dec-07	Mar-08	Jun-08	Sep-08	Dec-08	Mar-09	Jun-09	Sep-09
Mobile subscriptions (mn)	19.7	21.9	24.4	27.2	28.3	29.7	31.2	33.8	35.9	37.7	39.7	41.4
Fixed-line subscriptions (mn)	3.8	3.9	3.9	4.0	4.0	4.1	4.1	4.1	4.1	4.1	4.2	4.2
Mobile as % of total	83.8%	84.9%	86.1%	87.3%	87.7%	87.9%	88.4%	89.1%	89.7%	90.1%	90.4%	90.8%
Fixed-line as % of total	16.2%	15.1%	13.9%	12.7%	12.3%	12.1%	11.6%	10.9%	10.3%	9.9%	9.6%	9.2%

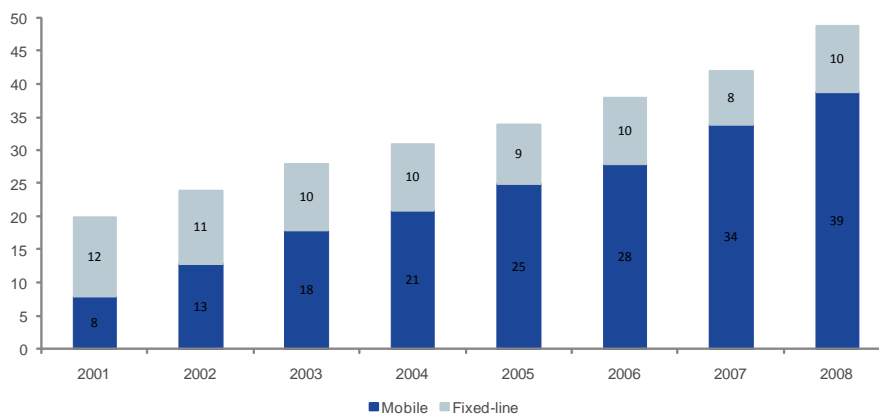
Source: Operators, CITC, Al Rajhi Capital

Fixed-line market is clearly smaller than mobile

While the fixed-line market is more important in terms of value than its share of subscriptions would suggest, it is still clearly smaller than mobile. According to the CITC, aggregate telecoms sector revenues in Saudi Arabia in 2008 were SAR59.9bn. Since this figure included SAR10.1bn in overseas revenues (overwhelmingly generated by STC), domestic telecoms revenues were SAR48.8bn (US\$13.0bn), up by 28% from SAR38.0bn in 2006 and by 94% from SAR20.0bn in 2001. Mobile communications revenues amounted to nearly SAR39bn in 2008, and so represented around 80% of total telecoms revenues in that year. By contrast, mobile communications accounted for only about 40% of the market in 2001, although this proportion had already risen to 74% by 2006.



Figure 7. Total value of Saudi telecoms market (SAR bn)



Source: CITC

Even for STC, mobile is rather more important than fixed line; and STC accounts for 70% of the mobile market by revenues

The CITC's figures correspond reasonably well with estimates we have carried out on a "bottom-up" basis, i.e. from data published by the operators. Bottom-up estimation of the value of the Saudi fixed-line and mobile markets is complicated by the fact that STC stopped publishing a breakdown between domestic fixed and mobile revenues in 2008; it switched instead to a segment presentation including overseas revenues. However, it is worth noting that we estimate domestic mobile revenues net of internal interconnect expenses for STC at SAR26.7bn in 2008, compared to combined fixed-line and data revenues of SAR12.9bn (again net of internal interconnect expenses). In other words, even for STC – the only one of the three Saudi operators with material fixed-line operations – mobile revenues were roughly double fixed-line revenues in that year. We have combined our estimates for STC with total revenues for Mobily and Zain to give bottom-up estimates of the aggregate value of the Saudi telecoms market in 2008 and 2009 in the chart below. Note that by our calculation STC accounted for 70% of the total mobile market by revenues in 2008 – a far higher proportion than its 53% share of mobile subscriptions at the end of that year. For 2009, we estimate that STC accounted for 63% of the mobile market by revenues, compared to a 46% share of subscriptions at the year end. This higher share of revenues reflects STC's domination of the higher-value postpaid segment of the market.

Figure 8. Bottom-up estimated value of Saudi telecoms market (SAR bn)

	FY2008	FY2009	FY2008 % of total	FY2009 % of total
Mobile				
STC	26.7	27.2	52.1%	46.7%
Mobily	10.8	13.1	21.1%	22.4%
Zain	0.5	3.0	1.0%	5.2%
Total mobile	38.0	43.3	74.2%	74.3%
Fixed line and data				
STC	12.9	14.6	25.2%	25.0%
Other (est.)	0.3	0.4	0.6%	0.7%
Total fixed-line and data	13.2	15.0	25.8%	25.7%
Total	51.2	58.3	100.0%	100.0%

Source: Company data, Al Rajhi Capital

We estimate the value of the Saudi telecoms market at around SAR58bn in 2009

As the table shows, on a bottom-up basis we estimate the value of the mobile market in 2008 at SAR38.0bn, which is very close to the CITC's figure. Our estimate of the value of the fixed-line market in that year is higher than the CITC's. We do not know the reason for this; it may possibly be that the CITC's definition excludes data. For 2009, we estimate the total value of the Saudi telecoms market at SAR58bn, split between mobile on SAR43bn and fixed line (including data) on SAR13bn. Overall, we believe that mobile communications accounts for 74-75% of the Saudi telecoms market by value. Broadband DSL revenues seems to have grown strongly in 2009, offsetting stagnant or declining fixed-line voice revenues. DSL is the main reason why combined fixed-line and data revenues grew at a similar rate to mobile in 2009. However, we have some doubt about the sustainability of strong DSL growth.



3.5G broadband is the new growth driver in mobile

For the moment, growth in the Saudi mobile market continues. As shown in Figure 6. above, we estimate that mobile subscriptions increased from 35.9mn at the end of 2008 to 41.4mn at the end of Q3 – an increase of 5.4mn or 15% in just nine months. We calculate that reported penetration increased from 128% to 143% over that period. Continuing growth in subscriptions – particularly for mobile broadband service - seems to have been an important factor in the strong Q3 2009 revenues reported by Mobily in particular, but by the other operators also. As we discuss in greater detail later, we believe that mobile growth accelerated further in Q4 2009, with total subscriptions rising to around 45.3mn and headline penetration to 154%.

Before proceeding, we should state our opinion that penetration data for Saudi Arabia are rather suspect. The last census was conducted in 2004, so official population figures strike us as rather out of date. According to the official data, the population stood at 22.7mn at the end of 2004; however, the CIA Factbook shows an estimate of 28.7mn for July 2009 (including 5.7mn resident foreign nationals). We have calculated the population by extrapolation between the two sources. This is the basis of our estimate of 154% penetration by the end of 2009.

Penetration is based on SIM cards, not on human users

Penetration figures are, of course, based on numbers of SIM cards, not numbers of people; this is the reason why throughout this report we refer to mobile subscriptions or accounts, rather than subscribers. If mobile penetration exceeds 150%, there can be only two explanations. The first is that subscriptions data are broadly correct, and that large numbers of people hold more than one SIM card. This is true in many or most mobile markets around the world, especially those where prepaid service accounts for the bulk of subscribers (as is the case in Saudi Arabia, where we estimate that the market is about 83% prepaid). The second explanation is that subscriptions data are dubious, and that active subscriptions are well below the headline figure.

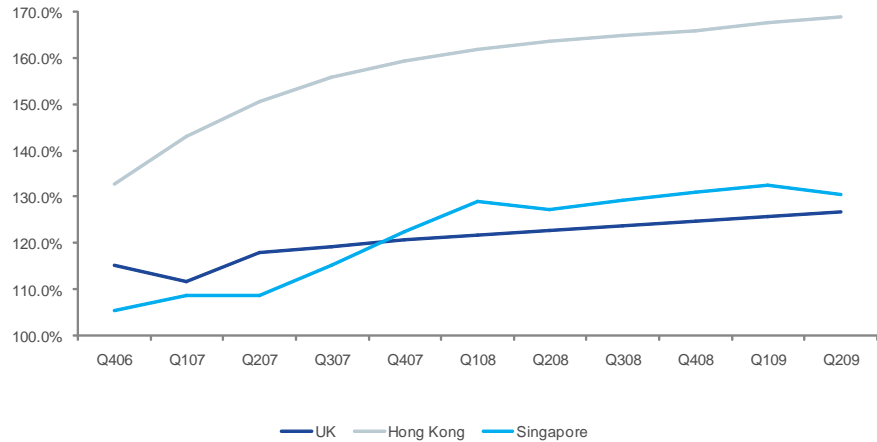
Many Saudi residents hold several mobile accounts; equally so, inactive accounts are clearly high

Actually in Saudi Arabia we think that both explanations are valid. It seems clear that many Saudi residents have more than one mobile account. This includes both wealthy Saudi nationals and expatriate businessmen with Blackberries and i-phones besides their standard phones at the high end of the market, and lower-income Saudis or foreign guest workers with several prepaid cards at the other. The emergence of 3.5G mobile service as an alternative to copper-based fixed-line DSL (“digital subscriber line”) technology for home broadband use is another factor behind multiplication of SIM cards; demand for mobile broadband service really seems to have taken off over 2009. With regard to active versus inactive accounts, we have heard claim and counter-claim from the Saudi telecoms operators about how their subscriptions data are accurate but their rivals’ figures are not. One reputable source has even suggested to us that active SIM penetration is below 100%, compared to our estimate of headline penetration of 154%. We do not propose to discuss this topic in detail in this report. However, the fact that Mobily has the lowest mobile ARPU of the three Saudi operators suggests to us that it has the highest proportion of inactive accounts overall. STC’s high ARPU reflects the unquestioned fact that it enjoys the greatest number of high-value postpaid mobile subscriptions in the market; judging what proportion of its prepaid subscriptions is inactive is very difficult. As we discuss later in this report, we are concerned that some of Zain’s new tariff packages may attract lower-quality users, suggesting that inactive subscriptions could increase.

Even if active penetration is below 100% - and we doubt that the figure is this low – there is little doubt that Saudi Arabia has genuinely high mobile penetration. While no one knows for certain what is the upper limit on mobile penetration, there are several examples of high-penetration markets where growth has slowed down significantly. We show three below: the UK, Hong Kong and Singapore. Current reported penetration for these three markets varies between about 125% and 170%, and so is comparable to Saudi Arabia. As the chart below shows, penetration growth in the UK mobile market has slowed from late 2007 onwards, while Singapore has stagnated after strong growth in late 2007 and early 2008. Despite having the highest penetration, the Hong Kong market continues to grow, but very slowly.



Figure 9. Penetration growth in three developed mobile markets



Source: Ofcom (UK), OFTA (Hong Kong), IDA (Singapore), calculations by Al Rajhi Capital

Three factors are necessary to boost mobile penetration further in Saudi Arabia

One could argue that the UK, Hong Kong and Singapore are simply three developed markets with no particular relevance to Saudi Arabia other than the coincidence of high penetration. However, high penetration surely is more than a coincidence. In all three markets, and indeed in the majority of mobile markets, the reasons for high reported penetration are similar: multiplication of mobile devices at the high end, and multiplication of SIM cards at the low end. To be confident that reported penetration can continue to grow in Saudi Arabia from 143% now, we think it is necessary to assume one or all of three things:

- 1) strong further multiplication of SIMs among low-income Saudis and guest workers,
- 2) significant growth in demand for new mobile devices, e.g. the i-iphone and the Blackberry,
- 3) significant growth in the mobile broadband market, partly at the expense of fixed-line DSL

In the absence in Saudi Arabia, of competition from a fourth licensed mobile operator or from MVNOs (“mobile virtual network operators”, which so far in the GCC region exist only in Oman), we think it unlikely that the first of these factors alone can push penetration up to, say, 175% or 200%. We discuss the second and third possibilities very shortly.

It would be more legitimate, in our view, to point to continued population growth as a key difference between Saudi Arabia and the UK, Hong Kong and Singapore. The total population in Saudi Arabia appears to have been growing at 4-5% per annum over the past few years. In our market forecasts we have conservatively assumed that population growth slows to 3-4% per annum over the next five years. However, such a growth rate is sufficient to help drive net additions in the mobile market of approximately 6mn between 2009 and 2014. While on this basis headline growth in the mobile market should remain eye-catching, growth will be driven in part by further expansion in the youth population and to an extent also by foreign guest workers. To ensure that mobile service is affordable in these segments, tariffs are likely to have to fall, meaning that value growth in the market will be weaker than subscriptions growth.

As suggested, one potential driver for further penetration growth in the Saudi mobile market is demand for new mobile devices. The i-iphone and similar so-called smartphones are certainly popular in Saudi Arabia; the author of this report can testify to how quickly i-phones sell out as soon as they appear in mobile operators’ outlets in Riyadh. However, even in a wealthy market like Saudi Arabia, we expect demand from the likely purchasers of additional mobile devices – wealthy businessmen and high-end consumers – to prove relatively limited. While there is significant evidence from other markets that use of smartphones contributes to strong growth in mobile data volumes, in Saudi Arabia we do not yet have sufficient evidence to prove this. It could conceivably turn out that proliferation of new mobile devices at the high end of the market simply spreads an existing user’s ARPU among several SIMs, meaning that reported penetration rises but that value growth in the market is limited.



The biggest potential driver of further growth is mobile broadband, which has surged over the past couple of quarters

Surging mobile broadband set to overtake fixed-line DSL

To our mind, the more interesting question is the potential for further growth in mobile broadband – or, more specifically, in 3.5G HSPA service, which offers an effective alternative to fixed-line DSL. There is strong demand for internet access in Saudi Arabia, not least because the internet is an important medium of entertainment in a country where opportunities for entertainment are few. Fixed-line broadband in Saudi Arabia is almost exclusively DSL; there is no access via cable TV (which does not exist in the Kingdom), and direct fibre connections are thus far confined essentially to large corporate users. While penetration remains low, both DSL and mobile broadband have grown strongly over the past couple of years, especially recently. Indeed, mobile broadband subscriptions appear to have accelerated rapidly over the last couple of quarters. This is very difficult to demonstrate due to poor disclosure of mobile broadband subscribers by the operators. Official CITC statistics showed 1.84mn broadband accounts in Saudi Arabia at the end of H1 2009, of which fixed-line DSL accounted for 1.16mn and broadband mobile (including WiMAX) and other services for the remainder, i.e. for 0.68mn. By the end of Q3 2009, according to CITC data published on 19th December, total broadband accounts had risen to 1.99mn, split between 1.24mn DSL subscriptions and 0.75mn subscriptions to broadband mobile, WiMAX and other services.

Historically, the CITC's figures for DSL tally well with the indications provided by STC in its quarterly and annual results. Based on the official figures from the CITC and indications from all three Saudi operators, we accept that there were indeed around 1.84mn broadband accounts in Saudi Arabia at the end of H1 2009, split between DSL on 1.16mn and all other services (mostly 3.5G mobile) on 0.68mn. However, according to the statement accompanying the release of STC's Q3 results to the Saudi stock exchange, the company had 2.3mn combined broadband subscriptions at the end of Q3. Even assuming significant DSL growth, this suggests that STC had at least 1.0mn broadband mobile subscriptions by the end of Q3 – compared to the CITC's figure of 0.75mn for the whole market!

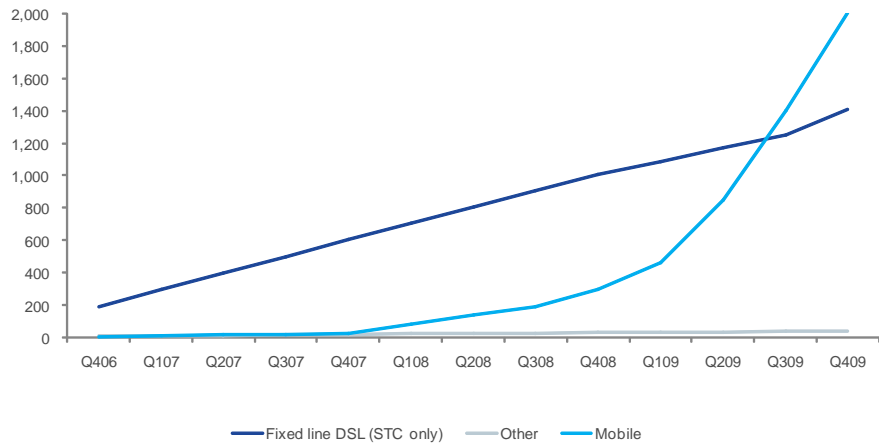
We cannot explain the discrepancy between the CITC's figures and the indications from STC and the other operators. Nevertheless, we believe that mobile broadband accounts surged in Q3, and suspect that the CITC's figures understate mobile broadband accounts at the end of both H1 and Q3. Moby reported 600,000 HSPA subscriptions for the end of H1 and 800,000 for the end of Q3. STC does seem to have made a big push in mobile broadband in recent months, while for its part Zain KSA staged a soft launch of HSPA service over the summer and we believe that it had won around 200,000 customers by the end of Q3. Based on our estimates, combined broadband subscriptions reached 2.06mn at the end of Q2 and 2.69mn at the end of Q3, including 0.85mn and 1.40mn mobile broadband subscriptions respectively. While DSL has continued to grow at a steady pace, mobile broadband seems to have taken off.

We estimate that mobile broadband accounts jumped from 0.85mn at end Q2 2009 to 2.00mn by end Q4 2009

We believe that the acceleration in Q3 2009 continued in Q4. Moby announced at the end of December that it had reached 1.0mn mobile broadband accounts. We do not have good indications for STC, but estimate that it had reached the 0.6mn mark. Zain KSA, which had around 4.4mn accounts at the end of Q3, must have seen very strong growth in over the first two months of Q4, since the company announced in a statement in December that it had won over 6.0mn subscriptions by the end of November. The key factor behind this growth appears to have been Zain's launch of a popular new international calling package. However, we think mobile broadband subscriptions also grew strongly, and consider that Zain's launch of pay per day broadband service on 12th December will have further boosted demand. On this basis we estimate that total mobile broadband accounts surged to 2.00mn by the end of Q4 2009, and that combined broadband accounts including DSL and other services reached 3.45mn.



Figure 10. Combined fixed-line and mobile broadband subscriptions in KSA



Source: CITC, operators, estimates by Al Rajhi Capital

Before proceeding, it is worth noting two points. Firstly, as Figure 10 above clearly illustrates, we believe that mobile broadband overtook fixed-line DSL in Q3 2009, and that it pulled further ahead in Q4. Secondly, until recently Mobily claimed market share of mobile broadband accounts of over 80%. While Mobily remains the clear market leader, we believe that its market share had dropped to 50-55% by the year end.

We expect strong latent demand for broadband service in Saudi Arabia to be met primarily by 3.5G mobile

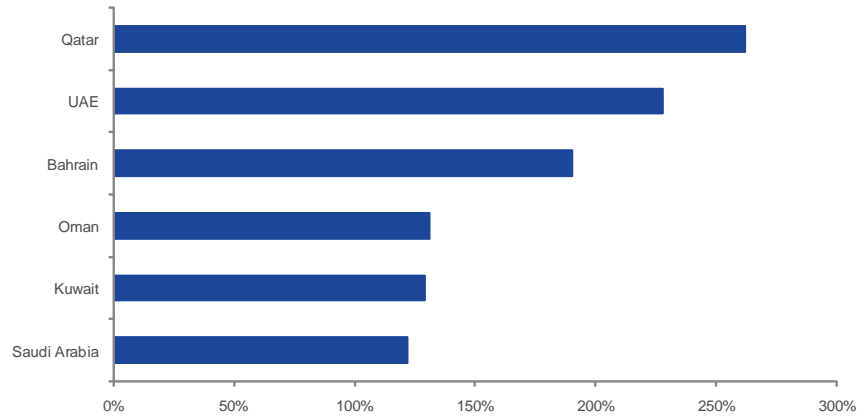
How fast can mobile broadband service continue to grow? In Saudi Arabia, we believe that it can grow much further, principally because fixed-line DSL is still relatively underdeveloped. By our calculation, there were 1.25mn DSL connections at the end of Q3 2009, a figure which is very close to the CITC data; we estimate that DSL accounts reached 1.41mn by the end of Q4 (an estimate which appears to be supported by STC's recently published 2009 results). Figure 10 above understates the importance of broadband DSL relative to broadband mobile in one important respect, since one DSL line can serve a household rather than an individual. Households in Saudi Arabia are large by international standards, with 5-6 members on average, although household size appears to have been declining steadily (it was around 10 thirty years ago). Comparing our estimate of 1.41mn DSL connections currently to our estimate of 5.11mn households in the kingdom suggests a current DSL penetration rate of 28%. While this is a much higher figure than DSL penetration relative to the population as a whole of just 5% or so, it still means that a large segment of the population is unserved by fixed-line broadband. We think that strong latent demand for broadband service from this underserved market will be met primarily by 3.5G mobile.

We forecast headline mobile penetration of 217% within five years

It seems quite reasonable to compare Saudi Arabia with the other countries of the GCC region. According to Zain KSA, mobile penetration rates in the major GCC countries at the end of Q3 2009 varied between 122% for Saudi Arabia at the bottom and 262% for Qatar at the top. We have commented on the reasons for widely varying estimates of mobile penetration in Saudi Arabia and regard Zain's figure for that market as too low. More important, in our view, are the penetration rates for the other countries. By comparison with those markets, we have assumed that headline penetration in Saudi Arabia can rise from our current estimate of 142% to over 200% by the end of 2012 and to 217% by the end of 2014 (i.e. five years from now), before slowing gradually to reach 225% by 2020. In absolute terms, this implies an increase in mobile accounts from 41.4mn at the end of Q3 2009 to 76.7mn by 2014, and to 92.3mn by 2020. We expect mobile broadband to be one of the most important drivers behind this growth.



Figure 11. GCC countries: mobile penetration rates according to Zain



Source: Zain, WCIS 2009

We expect 3.5G to create incremental growth in the mobile market; however, it may cannibalise fixed-line DSL

STC's investment in NGN fixed-line technology should eventually create new growth opportunities...

...but for the next few years we think fixed-line service will continue to lose ground to mobile

A key point to stress about mobile broadband is that we expect it to create incremental growth in the mobile market, i.e. growth that would not otherwise have materialised. In telecoms and other industries, “cannibalisation” is the term used to describe the replacement of revenues from one product or service by revenues from a newer product or service. We do not expect mobile broadband to cannibalise existing voice and simple data (largely text messaging) revenues; rather, we expect all three services to grow together. If mobile broadband does cannibalise an existing telecoms service, it will be fixed-line DSL. The company which has most to fear from potential slowdown in DSL is, of course, STC, which is the only of the three large operators to offer fixed-line service in a major way.

Our argument here is contentious. STC completely dominates the fixed-line broadband market in Saudi Arabia, and this is very unlikely to change significantly for some time. Moreover, in common with many other incumbent telecoms operators STC has ambitious plans to strengthen its position in the fixed-line market by investment in a “next-generation network” (NGN). This involves phased replacement of existing fixed-line infrastructure over a four year period between 2009 and by 2012. On completion, the NGN should permit substantial operating cost savings as the new network equipment will require less expenditure on repairs. It should also facilitate both the delivery of faster broadband speeds – potentially up to 100 gigabytes per second – and the introduction of new services such as IP-TV.

We have little doubt that the NGN will create new growth opportunities for STC from about 2012 onwards. Fixed-line technology is much better-suited than mobile technology to the transmission of data at very high speeds, and so it will probably always be superior to mobile for high-bandwidth applications such as video and television. Only STC, therefore, is likely to be able to offer such applications in bulk; and this is one reason why STC should remain the telecoms provider of choice for large business and public-sector customers and for very high-end consumers. On the other hand, the fixed-line market today is considerably smaller than the mobile market, and in a developing market like Saudi Arabia we see only a very limited potential market for new and expensive services such as IP-TV for the next few years. We expect the domestic fixed-line voice market to shrink steadily as traffic volumes are lost to mobile; moreover, although we presently forecast strong growth in fixed-line data due to DSL, there is a risk that this growth will not materialise if mobile broadband cannibalises DSL sufficiently. In other words, we think prospects for the fixed-line market are more likely to deteriorate than improve over the next few years. In the near term, we continue to see mobile service as the winner.



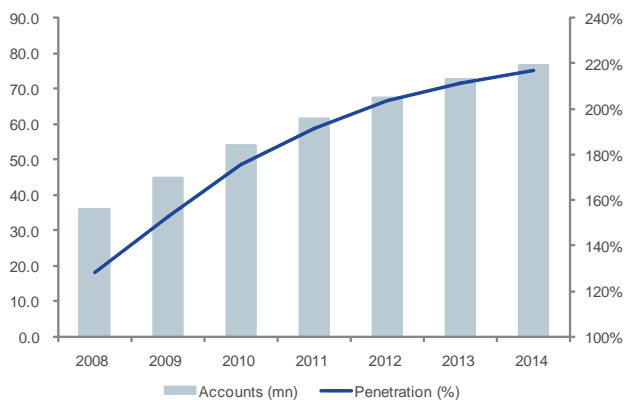
High RPM means prices are at risk

Our statement above that we expect mobile broadband to create incremental revenue growth in the wireless segment of the telecoms market implies that we do not expect the spread of mobile broadband in itself to result in dilution of ARPU. This contrasts with growth in headline penetration achieved through proliferation of SIM cards at the low end of the mobile market. In this case, one customer's usage is simply spread among several accounts, meaning that ARPU is diluted and that total market value is unchanged.

We expect mobile market ARPU to decline over the next few years

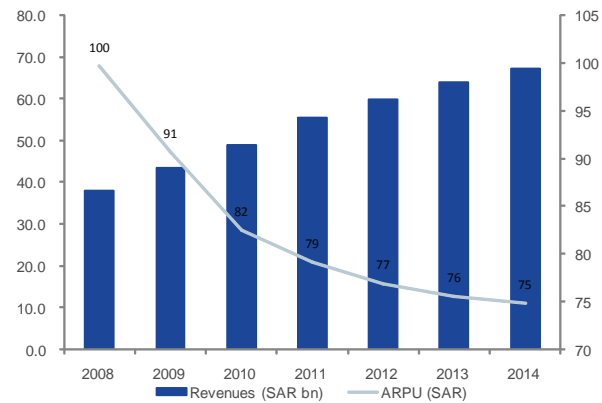
That said, we do expect aggregate mobile market ARPU to decline over the next few years. We expect the contribution from mobile broadband and modest volume growth in voice service resulting from price reductions (in economic terms, elasticity of demand benefits) to drive compound annual revenue growth of 9-10% in the Saudi mobile market between 2009 and 2014, compared to our estimate of 14% growth for 2009 over 2008. However, we expect growth in accounts and price reductions to push down ARPU from our estimates of SAR100 and SAR91, for 2008 and 2009 respectively, to SAR82 in 2010, and from that level to SAR75 by 2014.

Figure 12.1 Saudi mobile market: forecasts for penetration and accounts



Source: Companies, CITC, Al Rajhi Capital

Figure 12.2 Saudi mobile market: forecasts for revenues and ARPU



Source: Company data, CITC, Al Rajhi Capital

Saudi mobile pricing is high by the standards of developing markets

The discussion of ARPU leads us to another important issue: Saudi mobile pricing is high by the standards of developing markets. Mobile pricing is traditionally measured by ARPU, and usually calculated on a monthly basis. Multiplication of SIM cards around the world has reduced the reliability of ARPU data, since they are calculated on a per-SIM rather than a per-user basis. As noted, we estimate aggregate ARPU for the Saudi telecoms market at SAR100 (US\$26.7) for 2008 and at SAR91 (US\$24.2) for 2009. While not high by the standards of developed countries, this is well above the level of many or most emerging markets. For example, ARPU in China is only around US\$11, while in India it is just US\$4-5. On the other hand, ARPU in the various UAE countries, Kuwait and Qatar is substantially higher than in Saudi Arabia, at US\$36-60.

High ARPU in the GCC countries naturally partly reflects high GDP per capita in the region. The tables and charts below show the relationship between ARPU and GDP/capita in a selection of developed and emerging markets. ARPU ranges from 0.4% of GDP in Qatar – the country with the second highest GDP per capita in the world after Liechtenstein on a purchasing power parity basis – to 2.2% in China. Globally, ARPU/GDP per capita ratios have converged as telecoms tariffs have fallen, especially in emerging markets; three or four years ago, the ratio might have been 4-5% or even higher in a number of developing markets, e.g. Indonesia. Based on our estimate of 2009 ARPU data, the ratio for Saudi Arabia was 1.4%, which is slightly above the line of best fit in the chart of ARPU versus GDP per capita by country below (see chart 9). This is a prima facie indication that Saudi mobile tariffs still have room to fall, though not by a great degree.

More significantly, STC has by far the highest ARPU of the three Saudi operators at SAR111 (US\$29.6) by our estimate for 2009, compared to SAR66 (US\$17.6) for Mobily and SAR71



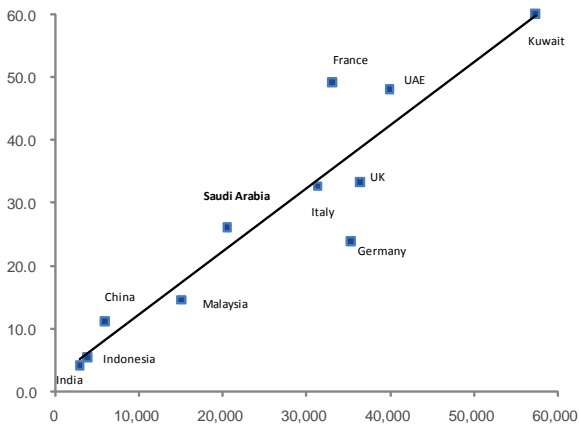
(US\$18.9) for Zain. This substantial premium reflects STC's dominance of the high-value segment of the market. If in the chart of ARPU versus GDP per capita we were to replace Saudi Arabia by STC, Saudi mobile prices would appear more expensive. Chart 14 below at right illustrates this point.

Figure 13. ARPU as a % of GDP per capita (selected countries)

	GDP/capita 2008 (purchasing power parity basis)	2009 est. ARPU (US\$)	ARPU/GDP per capita (%)
Qatar	110,700	36	0.4%
Kuwait	57,400	60	1.3%
UAE	39,900	48	1.4%
UK	36,500	33	1.1%
Germany	35,400	24	0.8%
France	33,200	49	1.8%
Italy	31,300	33	1.3%
Saudi Arabia	20,500	25	1.5%
Malaysia	15,200	15	1.2%
China	6,000	11	2.2%
Indonesia	3,900	5	1.6%
India	2,900	4	1.7%

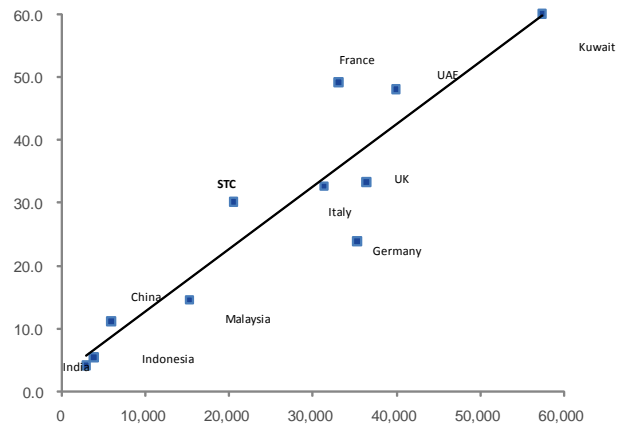
Source: CIA World Factbook for GDP/capita, Al Rajhi Capital for ARPU estimates and calculations

Figure 14.1 ARPU versus GDP per capita (1)



Source: Companies, Al Rajhi Capital

Figure 14.2 ARPU versus GDP per capita (2)



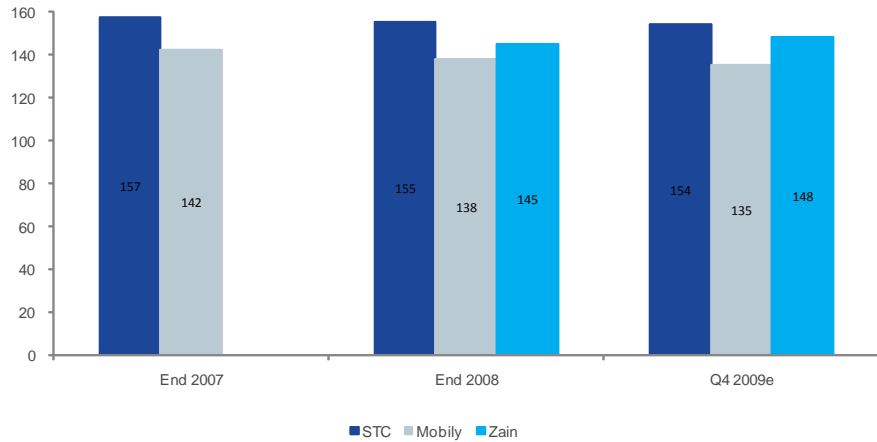
Note. We have excluded Qatar from the charts due to its outlying GDP/capita.

We prefer RPM to ARPU as a guide to mobile price levels

For many reasons we prefer RPM (“revenue per minute”) to ARPU as a guide to price levels. Calculating RPM for Saudi Arabia is difficult, since the operators disclose very little information about MoU. From market sources and our own estimates, we believe that blended MoU, i.e. weighted average MoU for postpaid and prepaid subscribers, varies between about 120 minutes and 160 minutes. We think STC is at the top of this range, since it has the largest and longest-established base of postpaid customers, including corporate and other high-end subscribers. We think Mobily is at the bottom, since it has a larger base of prepaid users than STC and, as a longer-established operator, probably has a greater portion of inactive users than Zain. (This helps explain why by our calculation Mobily had headline market share by mobile accounts of 41%, but revenue market share of only 32% in Q3 2009.) That said, the gap between the three operators does not appear to be huge; and we consider that it is less significant than the gap between postpaid and prepaid usage for each of the three companies. For example, in the case of STC we estimate blended MoU in Q4 2009 at 154 minutes. On the assumption that prepaid usage was 80% of the blended total, we estimate that postpaid users generated MoU of 295 minutes, while prepaid users generated MoU of 123 minutes.



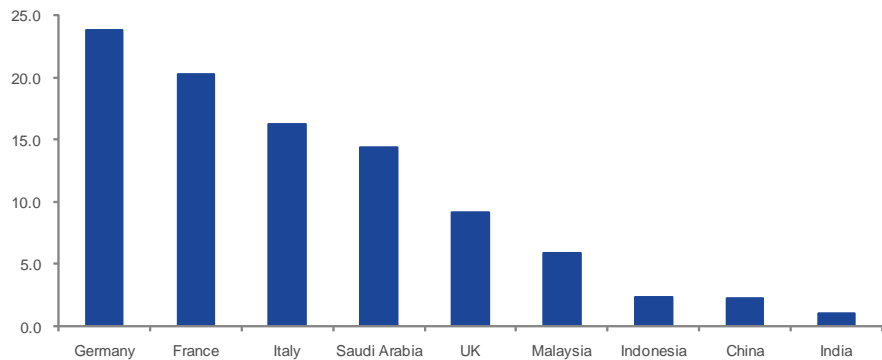
Figure 15. Estimated blended MoU for the three Saudi operators



Source: Estimates by Al-Rajhi Capital. (NB Zain did not launch service until Q3 2008)

Based on our estimate of MoU for the three operators, we calculate that aggregate RPM in the Saudi mobile market stood at around SAR0.60 in 2008, or about 16.0 US cents. By Q4 2009 we estimate that aggregate RPM had slipped to SAR0.53, or about 14.1 US cents, with a significant gap between STC on around SAR0.64 and Mobily and Zain on around 0.41. (Note: over the first three quarters of 2009, we estimate that Zain achieved RPM of SAR0.43-0.46, which is a noticeable premium to Mobily. However, we believe that RPM for Zain declined to SAR0.41 in Q4 as a result of continuing promotional activity, e.g. its new international call package.) Again, Saudi RPM is comparable to the levels of developed countries, and is high by the standards of most emerging markets. To give an extreme example, we estimate that RPM in India fell to around 1 US cent in 2009, having been driven down by a fierce price war in the Indian mobile market.

Figure 16. RPM (US cents, 2009 est.) in various developed and developing markets



Source: Operators, national regulatory bodies, calculations by Al Rajhi Capital

High absolute RPM means that there is room for Saudi mobile tariffs to fall

As should be clear from the discussion so far, the fact that Saudi RPM is 14-15x Indian RPM does not necessarily reveal anything, since Saudi GDP/capita of US\$20,500 is seven times Indian GDP/capita of US\$2,900. However, the fact that Saudi RPM is high in absolute terms is another prima facie indication that there is room for prices to fall – room which an aggressive operator may feel tempted to exploit.



Zain and STC may have an incentive to cut prices

Zain KSA is a young operator which is currently generating substantial start-up losses, and which – unusually for a no.3 mobile operator – does not have the lowest ARPU in the market. As such, Zain has a strong near-term incentive to cut prices in order to win new customers. Zain's rivals claim that the company has been cutting prices quite heavily – something that Zain denies, although promotions such as its one-rate roaming plan are clearly a form of discounting. If price-cutting has been Zain's strategy, then to some extent the strategy may be paying off; Zain claims to have taken around 60% of gross additions in the Saudi mobile market over 2009. Paucity of data makes Zain's claim very hard to verify. We estimate that Zain won 2.29mn net additions over the first nine months of 2009, or 43% of the market total; taking account of Zain's strong Q4, we estimate these figures at 4.04mn and 43% respectively for 2009 as a whole. Depending on the company's churn or cancellation rate it is conceivable that Zain's share of gross additions was considerably higher than its share of net additions.

STC may be forced to cut prices to defend its prepaid customer base

Looking forward, we think that STC in particular may have an incentive to cut prices significantly if it feels that its market share is under significant threat. As noted, STC has the highest ARPU of the three operators due to its dominance of the high-value postpaid segment of the mobile market. STC is in little danger of losing its postpaid customers, given strong network coverage and high attention to customer retention. However, we estimate that STC also has around 16.7mn prepaid subscriptions (as at the end of Q3 2009). We further estimate that those prepaid accounts generate ARPU of SAR77 – a premium of 64% to our estimated prepaid ARPU of SAR47 for Mobily and of 51% to our estimate of SAR51 for Zain. Low-end prepaid customers have little brand loyalty and are highly price-sensitive; we suspect that the main factors tying prepaid customers to STC are inertia and superior network coverage (especially in rural or outlying parts of the country). In other words, we regard this segment of STC's customer base as vulnerable and price cuts may be the most effective way to defend it.

But Zain would probably be most damaged by a steep fall in prices in the near term

If price levels in the Saudi mobile market do start to fall significantly, what will be the impact? In the medium to long run, the impact might not be negative. This is because Saudi MoU of 120-160 minutes per month is modest by international standards. A few countries are lower, e.g. Germany in which MoU is below 100, but there are plenty of developed and developing markets with much higher usage: for example, the US, China and India all have MoU of over about 500. Over time, we are confident that lower prices would stimulate volume growth, although estimating elasticity of demand in the Saudi market is extremely difficult given the scarcity of data. However, the near-term impact of a significant fall in prices could easily be highly disruptive, with a sharp slowdown in revenue growth and pressure on margins. In this event, we believe that Zain would be the worst affected operator, given that the company is still suffering start-up losses. Cutting prices too heavily might therefore prove a self-defeating strategy.



New opportunities: don't be distracted

We are optimistic that mobile broadband service in particular can drive further significant growth in the Saudi mobile market. However, the combination of 1) the possibility of a sharp slowdown in penetration growth from current high reported levels and 2) the possibility of significant pressure on mobile pricing confronts the Saudi operators with a strategic dilemma. Should they focus on boosting market share and improving service in the domestic market, in the hope that they will be better placed to defend their share of customers and revenues in the event that growth slows down? Alternatively, should they look for new growth opportunities in different sectors or markets?

STC: expansion abroad a costly distraction

STC's strategy is rather different from that of Mobily and Zain. STC describes its strategy as FORWARD, described in the chart below. This aims to achieve growth both domestically and internationally, with domestic growth locally coming from 3G mobile, ADSL, the NGN, enterprise (i.e. business customers) and wholesale operations. We regard the most important of these planks as 3G mobile, ADSL and the NGN and we have already discussed them in varying levels of detail.

Figure 17. STC: FORWARD strategy

What it stands for?	Strategy
F Fulfil personal communication potential	By broadly deploying 3.5G technology, expanding convergence offerings and providing top-class customer experience
O Offer wholesale services	By pursuing wholesale growth opportunities, by expanding reach and broadening service offering in both the national and regional markets
R1 Reinvent home communication	By offering advanced video and information communication services through promptly introducing retail broadband to the residential sector via rapid deployment and multi-play applications
W Win enterprise customers	By achieving distinction across the business sector by broadening enterprise customer base through tailoring integrated and managed communication solutions
A Achieve external growth	By having confidence in achieving external growth through pursuing telecom-related non-organic growth opportunities inside and outside Saudi Arabia
R2 Re-align for customer excellence	Through keenness on customer Excellence by building customer-centric operating model with aligned people, processes and systems
D Derive operational efficiencies	By optimizing costs and improve efficiency through shared services implementation, and manpower, network and IT optimization

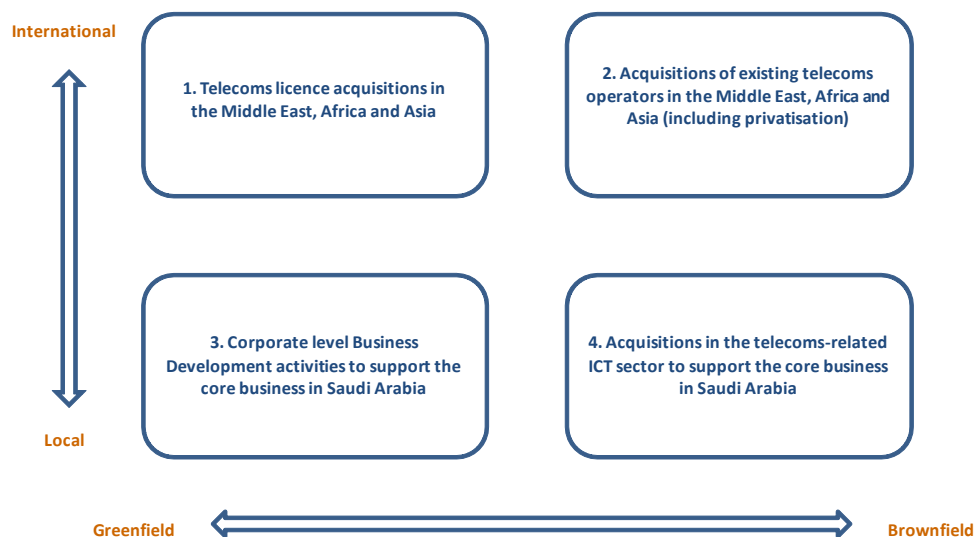
Source: STC annual report, 2008

The aspect of STC's strategy which interests is most is point A in the table above, which appears to commit STC to expansion by acquisition and foreign investment. STC has already made major overseas investments; it has also invested in new telecoms-related ventures at home. STC would deny that its intention in making these investments was to guard against the possibility of significant slowdown in the domestic telecoms market, especially the mobile market. However, we believe that, in effect, the investment strategy serves such a hedging purpose.

The matrix diagram below illustrates STC's strategy for growth more fully:



Figure 18. STC strategy for growth



Source: STC Investor Relation Presentation (September 2009)

STC has invested US\$6.8bn so far in overseas ventures

While STC's growth strategy expressly encompasses both domestic and international acquisitions, so far the company has directed its attention mostly to purchases abroad. STC's foreign expansion started in Q2 2007 with its investment in Binariang, the private parent company of Maxis, the Malaysian mobile operator. STC's other major investment was the purchase of 35% of Oger Telecom, another private company whose major assets were majority holdings in Turk Telekom and Cell C of South Africa. Altogether, STC has invested around US\$6.8bn (SAR25.5bn) in overseas ventures:

Figure 19. STC: overseas investments

	Ownership %	Consolidation method	Time of investment	Major markets	Amount invested (US\$ mn)	Amount invested (SAR mn)
Binariang	25.0%	Proportionate	Jun 07	Malaysia, India, Indonesia	3,100	11,625
Kuwaiti Telecom Company	26.0%	Full	Nov 07	Kuwait	900	3,375
Oger Telecom	35.0%	Proportionate	Q2 08	Turkey, South Africa	2,560	9,600
Bahrain third mobile licence	100.0%	Full	Jan 09	Bahrain	230	863
Total invested					6,790	25,463

Source: STC, Al Rajhi Capital

We see five key rules for success in overseas investment in the telecoms sector

Over the past two decades or so, the global telecoms sector has provided many examples of right and wrong strategies for international expansion. Certain telecoms operators have invested abroad very successfully, while others have failed badly. (Companies in the latter category include, for example, NTT DoCoMo, the Japanese mobile operator, which made major overseas investments in the early 2000s and ended up writing off around JPY1,500bn or over US\$16bn at current exchange rates.) To state our conclusion right at the start, in our view the historical experience suggests the following rules for success in overseas expansion:

- A focus on a particular region makes sense
- Close cultural links with the target markets nearly always help
- It is always better to aim for control than for minority stakes
- Operators should avoid investing in minor players
- Synergies between the investing company and its new affiliates are often overstated



Telefonica's focused expansion in Latin America was highly successful

Case study: Telefonica

Telefonica is the incumbent telephone operator in Spain. Telefonica's focused expansion in one well-defined region, Latin America, provides one of history's most successful examples of overseas expansion by a telecoms operator. Starting in 1990 in Chile and Argentina, but continuing until the mid-2000s, Telefonica steadily acquired majority ownership of numerous operators in the major markets of Latin America, with which Spain has strong historical, cultural and linguistic links. Telefonica acquired both mobile and fixed-line assets, effectively setting itself up as the incumbent operator in several markets. Altogether, the company has invested over €75bn (US\$101bn) in the region. Today, in terms of both absolute revenues and customers and the contribution that it makes to national GDP, Telefonica is particularly important in the following countries: Peru, Chile, Venezuela and Argentina.

Figure 20. Telefonica's contribution to national GDP

Country	TEF's contribution to GDP (%)
Europe	
Spain	1.8
Czech Republic (incl. Slovakia)	1.7
Latin America	
Peru	1.8
Chile	1.6
Venezuela	1.2
Argentina	1.1
Panama	1.0
Colombia	0.9
Ecuador	0.8
Brazil	0.8
Uruguay	0.8

Source: Telefonica's 2008 annual report

Many of the countries in which Telefonica has invested have undergone periods of severe political and economic turmoil. Today, despite generally reasonably stable conditions in Latin America, Telefonica faces strong competitive challenge in several of its markets, notably Brazil. Nevertheless, Telefonica's careful and focused expansion in Latin America has contributed to a history of consistent earnings growth which has been reflected in one of the best long-term share price performances of any European telecoms operator.

During the 2000s, Telefonica also expanded heavily in Europe. This process started in 2000, when the company spent heavily on 3G licences in markets outside Spain, notably Germany. As was the case for many other operators, this was a failure and Telefonica was forced to write down many of its investments within a few years. More recently, in 2005, Telefonica acquired Cesky Telecom in the Czech Republic in central Europe, while the following year it purchased the mobile operator O2 in a major take-over. O2 had strong positions in the UK, Germany and Ireland, all of which passed under Telefonica's control. Telefonica has also made a few investments in regions other than Latin America: for example, in 2005 it acquired 5% of China Netcom. The chief author of this report is more doubtful about the strategic rationale behind Telefonica's second wave of investment in Europe. While Europe is much closer to home, in European markets Telefonica arguably lacks the intimate cultural understanding that it enjoys in Latin America. Nevertheless, it should be stressed that the company's management execution remains strong, and that the share price has continued to perform well.

Case study: Vodafone

The history of Vodafone of the UK is probably the best-known example of international expansion in the telecoms sector. Starting in 1994, Vodafone pursued a policy of first regional (i.e., European) and then global expansion in mobile communications. Milestones in Vodafone's international expansion included:

- The merger with the US company AirTouch in June 1999, giving Vodafone control of a large base of customers in the US, although its chief purpose was to take control of AirTouch's European assets.
- The acquisition of the former Mannesmann in Germany in April 2000, through which Vodafone gained control of both the number two mobile network in Germany and a large operation in Italy, and raised its indirect holding in the French mobile operator SFR.

Vodafone is probably the world's most global telecoms operator



- The acquisition of Airtel Movil in Spain in December 2000.
- The acquisition of the mobile and fixed-line operations of the former J-Phone/Japan Telecom group in a series of transactions between mid-1999 and October 2001.
- The acquisition of Hutchison Essar, the no.3 mobile operator in India, in May 2007, as part of a new strategy of a delivering strong growth in emerging markets while stimulating revenues and reducing costs in its home markets in Europe.

Today, Vodafone has ownership interests in mobile operators in 27 countries across five continents, and has a total proportionate customer base of 323mn (as at 30 September, 2009). Vodafone is recognised as the world's leading mobile operator alongside the largest overall by customers, China Mobile.

During the early phase of its international expansion, Vodafone always strove to invest in either the first-ranked or second-ranked operator in its new markets. Vodafone argued strongly that scale creates major benefits in the mobile business – for example, in terms of spreading distribution or advertising costs across a larger base of customers, and because within the individual markets these benefits accrue largely to the number one and number two operators. One of Vodafone's few purchases of a third-ranked player was widely regarded as one of its biggest failures, namely the purchase of J-Phone in Japan (see below). More recently, Vodafone has been willing to drop its traditional attachment to no.1 or no.2 operators in return for exposure to growth. This was the case in India, a market with seven or eight major players, where for various reasons it would have been difficult or impossible to purchase the no.1 or no.2 operators.

While Vodafone's international expansion over the past 11-12 years has been striking, it has been possible to criticise the company's strategy on several grounds:

Lack of control.

Vodafone's policy was generally to seek majority control of its investments, and on the whole it succeeded. However, Vodafone was not always able to attain control, perhaps partly because its deals were so ambitious. In two key instances (the US and France), the company had to settle for a large minority stake.

Inadequate strategic rationale for investment.

This applied especially to Vodafone's purchase of the J-Phone group in Japan. Vodafone argued that it required a presence in what was then the world's most advanced mobile data market, and that it could put the experience of mobile data that it would gain there to good use elsewhere. However, Vodafone did not adequately explain why it could not achieve such experience by simply buying a laboratory in Japan or by setting up some form of joint venture with one of the existing operators, rather than by taking the risk involved in acquiring a large business in a country culturally very different from its home markets. It is probably no surprise that Vodafone ended up selling its Japanese operations to Softbank in 2006.

Pursuit of exaggerated global synergies?

This is an issue that arouses much debate. That significant scale benefits exist in the mobile communications business within individual countries is widely accepted. However, Vodafone tended to argue that it could achieve additional savings through procurement of infrastructure equipment and mobile handsets on a global scale, together with other synergies such as spreading the cost of development of data platforms across a larger base of customers. Other large telecoms operators pursuing international expansion have made similar claims. However, the evidence for such synergies is very mixed, and it has rarely been conclusively demonstrated that large international telecoms groups enjoy tangible benefits of this kind.

High price.

Although this is less relevant to our present discussion, it is worth adding that Vodafone had the misfortune of making some of its major acquisitions at the height of the global TMT bubble of 1999-2001. As a combined result of overpayment for acquisitions and overpayment for European 3G licences, Vodafone had to make large write-downs of intangible assets (principally goodwill and capitalised licence fees) in the middle years of this decade. Then again, Vodafone paid for most of its big acquisitions with its own (with hindsight) overvalued shares, so in cash terms the company's losses were smaller.

Despite Vodafone's overall success, its expansion strategy can be criticised on several grounds



We applaud STC's interest in markets with strong cultural links to Saudi Arabia, but in other respects its strategy scores poorly

STC's position relative to its affiliates resembles that of Telefonica or Vodafone

Implications of the case studies for STC

What are the implications of the historical case studies for STC? We would make the following points regarding STC's international expansion :

Lack of regional focus.

In contrast to Telefonica's initial expansion into Latin America, STC has invested in three regions: the Middle East (Turk Telekom through Oger and the third mobile licences in Kuwait and Bahrain), south-east Asia (the Maxis group), and southern Africa (Cell C, again through Oger). The key disadvantage of lack of regional focus is that it increases the complexity of managing overseas operations, resulting in unnecessary diversion of senior management's time and attention. In Latin America, Argentina and Venezuela, for example, are of course clearly distinct markets, but they are probably less different than Malaysia and South Africa.

In response to our point concerning lack of focus, STC would argue that it has made all its investments in locations which are among the top ten destinations for Saudis tourists, and that there is huge traffic between Saudi Arabia and those countries, in particular Indonesia, India and Turkey. This reflects not only tourist movements, but also the number of foreign workers in the Kingdom (about 7mn in all). However, the fact that STC's investments are widely geographically spread still stands.

Cultural links help.

In this respect, STC scores highly. Nearly all the markets in which STC has invested are Islamic countries, linked to Saudi Arabia by religion, culture and language (at least in some cases), as well as by tangible connections such as Hajj and Umrah pilgrimages by visitors from the overseas markets. Cultural appreciation of the markets where it has invested should help STC to make good decisions there. The chief exception in this regard is South Africa, to which STC became exposed accidentally through its investment in Oger.

Control is best.

In this respect, STC scores poorly. STC owns 35% of Oger and 25% of Binariang. In practice, we believe that it will be difficult for STC to assert management control over its foreign operations without majority ownership. This does not necessarily matter as long as the company's foreign markets are still experiencing significant growth (which most of them are), but it could become a major issue in the future.

Why do we think this? It is because STC's position in relation to its foreign affiliates is very different from that of Telefonica and Vodafone. Rather, it resembles the position of Singapore Telecom (SingTel), which has a portfolio of 20-50% holdings in operators in various south-east Asian markets, notably India (Bharti), Indonesia (Telkomsel) and Thailand (AIS); the only foreign market in which SingTel has majority control is Australia through its subsidiary Optus. While SingTel's affiliates view the company as an important strategic partner, we have never had the impression that SingTel enjoys significant influence over the day-to-day running of its foreign operations other than Optus, still less veto rights regarding major strategic decisions. As a slightly smaller operator (STC's market capitalisation is US\$24bn compared to US\$34bn for SingTel) based in a less developed market, we suspect that STC's affiliates view the company as a less important strategic partner than do SingTel's.

Our concerns on this point may be overdone. STC has shared management agreements with Maxis and Oger despite only owning a minority holding; it is represented on their boards; and it hires some of their CEOs and CFOs. However, SingTel has similar arrangements with many of its affiliates. We continue to believe that majority control is necessary to allow a telecoms operator truly to create value from overseas investments.

Avoid investing in minor players.

The reason for this is that telecoms markets, especially mobile markets, tend to be dominated by between one and three large players (as is the case in Saudi Arabia itself). We see little point in investing in small operators in fragmented and competitive emerging markets. History suggests that smaller operators in such markets will either be absorbed by larger, stronger players or – if they are less lucky – simply go bankrupt. How valuable STC's foreign operations are depends in large part on the market position of its associates. STC's most valuable foreign markets are Malaysia, where Maxis ranks as no.1 in the mobile market, and Turkey, where Turk Telekom ranks as no.1 in the fixed-line market and no.3 in the mobile market. We would argue that STC's position in its other markets varies from medium to very weak. This is especially true in Indonesia, a market with three sizable operators and a long tail of small players which has seen price reductions of 70-90% over the past two years. We



are also dubious about STC's greenfield investments in Kuwait and Bahrain, where the company is starting from a position behind well-established rivals with no customer base or distribution chain.

Figure 21. STC: overseas investments (2)

Associate of STC	Major subsidiary	Countries where present	Segment of telecoms mkt	Mkt. posn.	No. of subscribers (mn)	ARC assessment of market position
Binariang	Maxis	Malaysia	Mobile	1	11.5	Strong
	Maxis (Aircel)	India	Mobile	5	25.6	Medium
	Maxis (Axis)	Indonesia	Mobile	4	5.6	Very weak
Kuwaiti Telecom Company	n/a	Kuwait	Mobile	3	0.6	Weak
Oger Telecom	Turk Telekom	Turkey	Fixed line	1	16.8	Strong
	Avea*	Turkey	Mobile	2	12.0	Medium
	Cell C	South Africa	Mobile	3	7.5	Weak
Bahrain third mobile licence	n/a	Bahrain	Mobile	3	0.0**	Medium

* Mobile subsidiary of Turk Telekom. ** Service not yet launched

Source: STC, Al Rajhi Capital

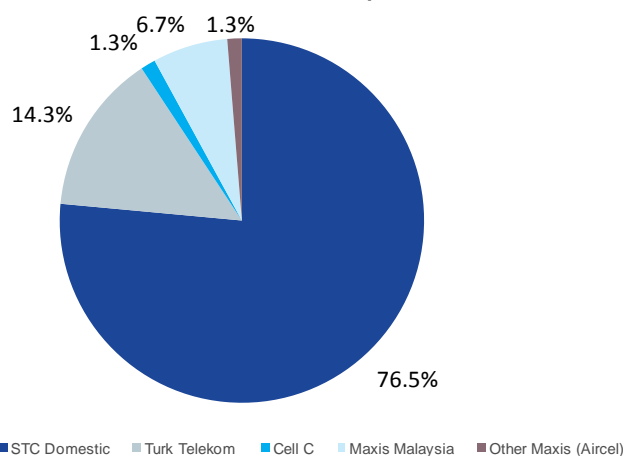
Synergies are often overstated.

STC's investment strategy should create certain tangible synergies. For example, we accept STC's argument that overseas investment should help to boost revenues by increasing telephone traffic between Saudi Arabia and its target markets. Likewise, we accept that overseas investment will reduce roaming charges between Saudi Arabia and STC's target markets. However, we are much more sceptical about savings in operating expenditure resulting from closer integration and sharing of support functions, or about savings in capital expenditure resulting from greater economies of scale and sharing of vendor contracts. It has been hard enough for Vodafone or SingTel to demonstrate such savings. We think it will prove even harder for STC, especially given its limited control over its foreign operations.

We think STC's overseas investments may have diverted its attention from the domestic market

It should by now be clear that we harbour considerable doubts about STC's strategy for overseas investment. Even if our doubts are mistaken or overstated, however, there is a simpler reason for concern about STC's overseas expansion: it may have diverted STC's attention from developments in the domestic market for insufficient gain. As we discuss further in the valuation section of this report, we estimate that STC's overseas investments represent only 23% of the company's fair enterprise value. Turkey accounts for approximately 14% of the total, and Malaysia for 6%; the other foreign markets are almost immaterial.

Figure 22. STC: breakdown of estimated fair enterprise value



Source: Al Rajhi Capital. NB Turk Telekom and Maxis are shown here at estimated fair enterprise value rather than market enterprise value.



Despite US\$7bn of investment abroad so far, we think Saudi Arabia accounts for three-quarters of fair value for STC

Mobily aims to offer superior choice and service to its competitors in mobile

Mobily is also trying to position itself for new directions in the overall telecoms market

Mobile operators with no fixed-line capability will be disadvantaged

Note.

We have not included STC's investment in a content company or in other domestic affiliates in the above chart. There are two reasons for this. Firstly, we believe that the overseas operations are much more valuable. Secondly, we believe that these investments serve principally to enhance the long-run value of STC's domestic businesses, which we have included in the valuation.

In other words, despite nearly US\$7bn of investment overseas to date, we believe that Saudi Arabia still accounts for around three-quarters of fair value for STC. If such is the case, then STC's strategic priority should probably be to defend its position at home. In our opinion, diversion of attention abroad helps explain why, for example, STC has allowed Mobily to take a strong initial lead in the mobile broadband market. We consider that has considerable work to do to fight back against Mobily and Zain in the domestic mobile market, and to a lesser extent to guard against potential new entrants in the domestic fixed-line market.

Mobily versus Zain: Mobily better placed

Mobily is operating a two-part strategy

In stark contrast to STC, Mobily has made no moves towards international expansion. This is natural enough, for two reasons. Firstly, Mobily is much smaller than STC, with a market capitalisation of only around US\$8bn; and secondly, Mobily is a subsidiary of Etisalat of the UAE, and so forms part of an international group in which expansion strategy is ultimately decided at the top. Nevertheless, it is worth stating our view that Mobily has made a conscious decision to concentrate on strengthening its position in the domestic market rather than engaging in any form of expansion which risks diverting its attention from its core business.

In simple terms, we believe that Mobily is operating a two-part strategy. On the one hand, Mobily is aiming to offer superior choice and service to its competitors, STC and Zain KSA, in the mobile market where it started business. As noted earlier in this report, a particular facet of this strategy has been Mobily's strong focus on mobile broadband, where we believe that Mobile is the clear leader. Another important aspect of this strategy has been large-scale outsourcing of business operations. Traditionally, telecoms companies regarded network operation as their core competence; incumbent operators thus often gave the impression that they were run by engineers. Bharti, the Indian mobile company, was one of the first large operators to abandon this concept; Bharti regards its core competence as customer management and entrusts management of its network to large telecoms equipment manufacturers. Mobily too regards customer management as its core competence and has outsourced both network operation and many distribution and support functions.

On the other hand, Mobily is trying to position itself for likely new directions in the telecoms market by modest investment outside pure mobile service. This explains Mobily's acquisition of Bayanat Al-Oula for SAR1.5bn in mid-2008, followed by a smaller investment in the Saudi ISP Zajil international Telecom for US\$80mn later in that year. The key attractions of Bayanat Al-Oula for Mobily were its ownership of a fixed-line data licence and its 12,000km national fibre optic network. The first benefit of the acquisition – and an important one – is that it has helped Mobily to reduce its dependence on STC by allowing Mobily to route a greater portion of its mobile traffic over its own network. We believe that nearly all of Mobily's long-distance traffic is now directed over its own backbone facilities, increasing reliability and reducing equipment rental fees paid to STC. Looking forward, we believe that another advantage of ownership of fixed-line assets is that it will help Mobily to broaden its service offering, and so increase its attraction to corporate customers in particular.

We do not believe that Mobily is aiming to be a full-service telecoms provider; nor do we believe that the company should aim to become that. However, we believe that telecoms markets are steadily moving towards convergence, and that the already blurred distinctions between the four major market segments (fixed voice, mobile, broadband internet, and pay-TV and content) will eventually disappear. We thus believe that STC is right to be planning NGN investment to facilitate provision of converged services; we simply do not think that STC's investment will pay off for several years.

If telecoms markets do develop as we expect, then mobile operators with no fixed-line capability at all will be increasingly disadvantaged. Mobily is very explicit that it does not intend to challenge STC in the fixed-line DSL market. This makes obvious sense, given the high capital expenditure burden that such a move would entail. However, through the Bayanat Al-Oula acquisition Mobily has, for example, been able to complement its mobile



Zain KSA's strategy partly reflects the ambitious vision of its parent group

service with a WiMAX service offering speeds of 2 Mbps. Though hardly an impressive speed – Mobily's 3.5G mobile HSPA service can itself offer 7.2Mbps, although in practice most customers will receive considerably lower speeds – the ability to offer WiMAX strengthens Mobily's position in areas where mobile coverage is still weak and provides a back-up in the event of technical problems on its mobile network. In the future, Mobily should be able to use its data licence to offer a much broader range of services at faster speeds. This will entail additional investment, especially on direct fibre-optic connections to large corporate customer; however, we expect revenues from new services to compensate for the outlay.

Zain's strategy typical of a young, pure-mobile operator

Zain is the smallest of the three mobile operators in the Saudi market, having only launched service in 2008. However, it is part of the much larger Kuwait-based Zain group of mobile operators, which has a market capitalisation of US\$15.2bn compared to \$3.8bn for Zain KSA. Any analysis of Zain KSA's strategy requires some understanding of the vision of its parent company, the Zain group, and of Zain KSA's relationship with its parent.

The Zain group is an emerging telecoms player operating in 24 emerging markets in the Middle East and Africa, serving over 69.5 million active customers; it is the leading mobile operator in 14 of its markets, while five are in second position. The group is based in Kuwait, and is officially called Mobile Telecommunications Company (MTC) KSC. The Zain group and consortium partners were awarded the third Saudi GSM licence in 2007 with a high bid of SAR SAR22.9bn (USD 6.1bn). Zain KSA itself was listed by IPO in February 2008. While Zain KSA is a very young company, it is important because it is already the largest operator within the Zain group by revenues.

The Zain group has a bold ambition to become one of the top ten mobile operators globally by executing its "3x3x3" expansion plan by 2011. The 3x3x3 plan seeks to make Zain a global player in three stages: regional, international and global. As part of a group with such a bold overall vision, it is little surprise that Zain KSA also has bold targets. Zain KSA is targeting market share of 30% by 2020, and aims to achieve this by capitalising on the following perceived strengths:

- Recognition of the Zain brand (already well-known in Saudi Arabia even before Zain KSA launched service),
- Innovative pricing plans and commercial offers,
- A highly efficient, lean distribution platform,
- The experience of the Zain group in launching greenfield mobile operations

We would add another pillar to Zain KSA's strategy:

- Maximum outsourcing of operations: notably, Zain Kuwait is contracted to provide management, technical and operational services to Zain KSA, including key management personnel. In this respect, Zain resembles Mobily.

Zain's strengths are those of a pure mobile operator

It is worth pointing out that several of the perceived strengths listed above are those of a pure mobile operator. As a young company owned by a transnational mobile group, it is not surprising that Zain KSA is concentrating more explicitly on pure mobile service than its rivals. According to Zain, the company will consider investment in fixed-line projects, but only where they would clearly support an existing mobile project, for example by enhancing service to a specific large corporate customer. This implies that any fixed-line investment by Zain KSA will be very small and that it is unlikely, for example, to purchase a fixed-line data provider in the way that Mobily has done.

Zain has gained attention through new tariff packages

We have little doubt, for example, that Zain KSA does enjoy high brand recognition, or that it does have a lean and efficient distribution platform. However, rather more concrete discussion is required of Zain's pricing plans and commercial offers. Below we list some of the main tariff packages and promotional tools that Zain has used, or is using, to widen its customer base and boost revenue. In our view, Zain's packages may be characterised as both innovative and aggressive.

1. "One month on you... One month on us" offer

Zain's well-publicised launch offer gave the company's first 500,000 customers (predominantly prepaid) a 50% discount on their bills. What customers spent during one



month on total usage, Zain returned to them the following month; more simply, customers receives a discount equivalent to their expenditure in the earlier month. This offer covered all services provided by Zain such as local and international calls, text messages, and data transfer without limitation. Zain reached its target of 500,000 customers in the first week of the offer, and extended it for several weeks afterwards.

2. “One network” offer

Zain’s “One network” offer has also been well-publicised. Zain is able to offer this as a result of its membership of the Zain group with its presence in many different countries. The “One network” plan allows Zain KSA customer roaming on Zain group networks overseas to receive calls at local rates, and to make calls at the local rates applicable to the country in which they find themselves. The plan is available in the following countries: Jordan, Bahrain, Iraq, Sudan, Saudi Arabia, Uganda, Burkina Faso, Republic of Congo, Democratic Republic of Congo, Gabon, Chad, Tanzania, Kenya, Malawi, Nigeria. Among these countries, Bahrain in particular is a major destination for Saudi businessmen and tourists.

3. International package: “choose your favourite number”

This is a prepaid package that permits customers to connect to one favourite international number in India, Bangladesh, Pakistan, the Philippines, Nepal or Indonesia at a very favourable tariff. Launched within the last few months, this service has proved very popular with – we assume – foreign migrant workers in particular. The success of this package appears to be the key reason why Zain increased mobile subscriptions from around 4.3mn at the end of Q3 2009 to around 6.0mn by the end of November.

4. “Pay per day” broadband

Zain launched its “pay per day” broadband service on 12th December, 2009. Current subscribers can enjoy the service on their handset using their existing SIM card; alternatively, they can purchase a “pay per day” data SIM to be used with a Zain USB high speed modem on their personal computer. As the launch was so recent, Zain has not yet offered any indications how this service is faring. In our opinion, however, the “pay per day” concept is ideal for low-end customers, and we have assumed in our models that the service has already contributed to a significant increase in broadband mobile subscriptions for Zain.

5. “One minute on you...two minutes on us” offer

For every Saudi riyal that Zain customers spend during the weekend, Zain will return two riyals to them to spend during weekdays (i.e. from Saturday to Wednesday). This weekend package applies to prepaid lines only.

6. “You Pay... we pay” prepaid

This package offers prepaid customers a full month of free usage on their Zain lines. The value of the free usage is equal to the value spent during the month that precedes the free month.

7. Zain sponsors Saudi Professional Football League

This is not a price offer but a deliberate promotional campaign. Zain recently signed a deal to sponsor the Saudi professional football league for 5 years with a value of SAR300mn. This sponsorship is aimed at increasing Zain’s profile among generally soccer-obsessed young Saudi males, who constitute one of the largest population segments. HRH Hussam bin Saud bin Abdulaziz Al Saud, Chairman of Zain KSA, stated: “The creation of the Zain Saudi Professional Football League was a big leap for Saudi Arabian sports and a milestone in the history of Zain in the Kingdom.”

To sum up our discussion on Zain KSA so far, we think that the company launched service with bold targets and that it has devised several innovative tariff plans which are helping to win customers. Nevertheless, we question how unique Zain’s strategy really is. While we are less sure about STC, Mobily would claim many similar strengths to Zain, with the additional benefit of being the longer-established operator with a stronger distribution chain and broader network coverage. (This is the reason why Zain customers roam on Mobily’s network when they are out of Zain’s coverage range, although Mobily does not offer Zain the roaming service on 3G.) In our view, the key challenge for Zain is to differentiate itself from Mobily.

On the surface, we think that the two operators probably look quite similar to their customers. Both companies initially targeted mass prepaid customers, and both now claim to be trying to move upwards in the market by targeting higher-ARPU and postpaid customers. Zain’s aggressive initial promotions attracted considerable attention and helped to push down ARPU across the Saudi mobile market. However, we suspect that both Mobily and STC

Zain’s international package seems to have been an especial success

But the key challenge for Zain is to differentiate itself from Mobily



Monily has some interesting tariff packages too

We are concerned that Zain's recent successes have been concentrated at the low end of the market

Mobily currently ranks ahead of Zain by market share, revenues and profitability; it also enjoys a stronger position in mobile data

responded more fiercely than they are apt to claim publicly. All three operators at least advertise heavily, as is evident to anyone driving around the streets of Riyadh.

Mobily offers several packages that are essentially parallel to Zain's. For example, Mobily's "Hala Plus" prepaid package matches Zain's "You Pay...we Pay" package in that, for any recharged amount of SAR10 or above, customers are entitled to receive a bonus amount equal to the sum recharged. Likewise, Mobily offers an appealing 50% discount to new postpaid subscribers for the first three months of subscription to the following tariff packages: "Khatty", "Khatty Plus", "Najma" and "Blue Wave". If there is little distinction between Mobily and Zain on price, new customers are likely to be attracted more by considerations such as quality of service, network coverage and network quality. On most such measures, we think Mobily is at least equal to Zain – and clearly superior on network coverage.

It is worth commenting further on some of Mobily's more interesting tariff packages. Mobily is targeting young females – another important population segment – with its "Najma" package, which offers calls on Mobily's mobile network and to the fixed network from 7pm to 7am with a call price of 20 halala (SAR0.20) per minute. Mobily's Blue Wave postpaid package has been designed for all Mobily customers but with a special flavour for Al-Hilal football club fans. This package allows Al-Hilal fans to make calls at a price of 20 halala per minute, and in addition provides subscribers with free promotional offers every time Al-Hilal wins a match. At the top end of the market, Mobily offers a special package to very high-usage postpaid customers called "Mobily RAQI". Though superficially very expensive with a basic monthly fee of SAR800 (US\$213), it offers 2000 free minutes per month and allows customers to transfer their free minutes forward to the next three month period. In addition, customers need only pay 10% of their bill initially and can defer the remaining amount.

While we regard the differences between the two operators' pricing plans as modest, we think that Mobily has a superior image overall; we also think that Mobily's offering to postpaid customers is superior. Here we should point out that some of Zain's most successful recent tariff packages have been directed at the very low end of the market, notably its "choose your favourite number" international offering and the "pay per day" broadband package – the company's claims to be moving upwards in the market notwithstanding. We therefore have some concerns about the quality of the subscriber base that Zain is currently attracting, and are also starting to wonder whether Zain's ARPU premium over Mobily will ultimately prove sustainable, although in our models we have not yet gone so far as to assume that Mobily's ARPU rises above Zain's.

In our view, Zain has greater overall media exposure than Mobily, probably due to a more explicit focus on brand recognition and the need for the third-placed operator to increase its customer base rapidly. Besides the Saudi professional football league, Zain has sponsored many important events such as the "Smart Cities" conference and an inaugural conference on "Saudization" and job creation; the company has also supported various charities on Saudi "Poverty Day" under the heading of social responsibility.

At this point we should note that STC enjoys quite high media exposure. This partly reflects the fact that STC is the official sponsor of four important local soccer clubs: Al Ahli, Al Ittihad, Al Naser and Alshabab. In addition, STC sponsors two top international clubs: Real Madrid and Manchester United. While Zain's media profile may be greater than Mobily's, it is not necessarily greater than STC's.

Challenging Mobily effectively will be hard for Zain

Superior media exposure alone is insufficient, in our view, to give Zain a definite edge over Mobily. In terms of strategy and customer perception, we see few substantive differences between the two companies; but on balance Mobily's market position and market image seem superior. For a number three operator, Zain has been very successful so far in terms of building up customer base and revenues. Nevertheless, Mobily currently ranks well ahead of Zain by market share, revenues and profitability. Moreover, Mobily enjoys a significantly stronger position in the broadband segment of the mobile segment than Zain – and this is where we expect growth to be concentrated over the next several years. We conclude that Mobily is better-placed strategically than Zain, and that it will be hard for Zain to challenge Mobily effectively.



2009 results support our stance: Mobily stands out

The three Saudi operators have just published results for 2009. While we do not yet have full details from all the operators, the results appear to support our views on the three companies. In brief summary, we believe STC's results were not as strong as they appear to be first sight; Mobily published strong results which augur well for this year, even though we anticipate a clear slowdown in growth in 2010 from the high level of 2009; and Zain KSA, while achieving strong growth in markets share and revenues, fell slightly short of our expectations.

We have updated our earnings estimates and fair values for the three operators to reflect their 2009 results. We comment on the results in slightly greater detail below.

STC

STC has published both full results for 2009 and partially restated results for 2008. We have updated our models to reflect the 2009 results and revised our earnings forecasts, but have not yet adjusted our models to reflect the restatements for 2008. While doing so may require us to make further changes to our forecasts and our valuation of STC, at this point we expect any such changes to be minor.

As reported, domestic mobile subscriptions grew by 8% year-on-year to 21.0mn. This was a slower rate of growth than for either Mobily or Zain; we estimate that STC's share of domestic mobile accounts fell over 2009 from 53% to 46%, although its share of mobile revenues remains higher at well over 60%. We do not yet have any firm indication of broadband mobile accounts, but estimate 0.6mn. Fixed-line broadband DSL accounts rose by 40% year-on-year to 1.4mn. This is impressive and confirms STC's dominance of this important market.

For 2009 as a whole, revenues grew by 6.9%; Q4 revenues of SAR12,999mn were up by 5.5% year-on-year. This represents a robust turnaround from Q3, in which revenues fell by 4.5% - a surprisingly weak figure given STC's overseas expansion. While Q4 was stronger than Q3, we had forecast sales growth of 7.0% for Q4. STC's segment presentation - which includes the overseas operations - shows growth in mobile revenues of 6.8% for the full year, and a fall in PSTN (fixed-line voice) revenues of 6.2%. Much more impressive is the 53.0% year-on-year rise in data revenues, which we consider largely reflects DSL growth in Saudi Arabia.

Operating profit in Q4 fell by 8.9% from a restated figure for Q4 2008 to SAR2,588mn. Not only was this figure a decline from a very weak quarter in Q4 2008, but also it was the weakest quarterly operating profit over 2009, representing just 20% of the total for the year. Higher investment in markets such as Turkey, India and Indonesia is pushing up depreciation charges, while greater volumes of telecoms traffic are pushing up access charges. Even so, we continue to be surprised by the weakness in STC's operating results when most of the company's markets - not least Saudi Arabia itself - are still immature and growing.

Headline Q4 net profit of SAR2,941mn was up by over 150% from the level of Q4 2008. However, this largely reflected a capital gain of SAR684mn as a result of the IPO of Maxis Malaysia in Q4. Excluding this gain, we calculate that net profit would have been SAR2,257mn - double the level of Q4 2008, but down by 6% from the level of Q3 2009.

Mobile growth relatively dull;
fixed-line DSL sparkling

We find the weakness of STC's
operating results hard to
explain

Net profit exceeded forecasts
due to capital gains



Figure 23. STC

(SAR mn)	Q4 2008 actual	Q4 2009 actual	% chg.	Q4'09 ARC est.	Comment
Mobile subscriptions (000s)	19,100	21,000	9.9%	21,100	Weaker growth than for the other operators
Subscriptions market share (%)	53.2%	46.4%	-6.8pp	47.0%	We think Zain in particular gained market share in 2009
Revenues	12,326	12,999	5.5%	13,218	Strong turnaround from -4.5% in Q3
Gross profit	n/a	n/a	n/a	n/a	Very close to our forecast
EBITDA	n/a	4,768	n/m	5,485	Our calculation for Q409; we have not yet recalculated Q408
EBITDA margin (%)	n/a	36.7%	n/m	41.5%	As above
Depn. & amortisation	-1,748	-2,180	24.7%	0	Rising due to overseas investment
Operating profit	2,818	2,588	-8.2%	3,738	Not impressive compared to a weak outcome in Q408
Financing cost	-417	-352	-15.6%	-391	Close to our forecast
Other (incl. minority interests)	-1,128	967	n/m	0	Large forex losses in Q408, large capital gains in Q409
Net income before tax	1,273	3,203	151.6%	3,347	Only up so strongly due to capital gains
Tax and zakat	-117	-262	n/m	-218	N/m
Net profit	1,156	2,941	154.4%	3,129	Only up so strongly due to capital gains
Capex	-673	-2,962	340.1%	-3,940	Return to a normal level from a very low level in Q408
Capex/sales (%)	5.5%	22.8%	17.3pp	29.8%	As above
Net debt	23,845	23,893	0.2%	26,026	Very little change over the year
Net debt/annualised EBITDA (x)	n/a	1.3	n/m	1.2	This is a very healthy gearing level

Source: STC, ARC estimates

We think 2010 will be stronger than 2009

We expect STC to achieve revenue growth of 6-7% in 2010, similar to the level of 2009. However, we remain hopeful that overseas expansion will start to contribute more positively to the company's results, and so forecast a 10% increase in operating profit after the 17% drop (as restated) last year. Financially, STC remains very stable, with strong operating cash flows and a healthy net debt/EBITDA ratio of around 1.2x.

Mobily: strong performance reflected growth in mobile data and a solid Hajj season

Mobily: very strong performance

Overall, Mobily's results for Q4 2009 clearly exceeded both consensus forecasts and our own. Mobile subscriptions of 18.2mn slightly exceeded our estimate, due mainly to strong expansion in data service; Mobily ended the year with around 1.0mn 3.5G mobile broadband accounts. Revenue growth of 13.8% year-on-year was slightly below our forecast, and Q4 showed the lowest growth of the year; revenue growth exceeded 20% over each of the first three quarters. However, Q4 is usually the strongest quarter for the Saudi telecoms operators due to revenue from religious visitors during the Hajj season. The Hajj season was very strong in 2008, with around 3.0mn visitors – a number which fell to around 2.5mn in 2009. Against that background, Mobily's performance was actually quite strong; and Mobily believes that it significantly increased its market share among Hajj visitors.

While revenue growth was below our forecast, Q4 EBITDA growth of 22.2% year-on-year was well above our forecast. Cost of sales was close to our estimate, and so the impressive EBITDA growth largely reflects lower SG&A costs than we had assumed. The Q4 EBITDA margin was 43.0%, again well above our forecast. The strong growth in EBITDA drove net profit growth of 35% year-on-year. We see Mobily's performance as strong vindication of the telecoms operators' claim that mobile data service carries higher margins than mobile voice service – partly, in our view, because marketing costs are lower. Note, however, that total data volumes on Mobily's network increased by over 160% to more than 50 terabytes in 2009. Strongly rising data volumes imply increased capacity requirements on the network. This is the key reason why we do not expect a sharp near-term reduction in capital expenditure for the Saudi operators.



Figure 24. Mobily

(SAR mn)	Q4 2008 actual	Q4 2009 actual	% chg.	Q4'09 ARC est.	Comment
Subscriptions (000s)	14,800	18,200	23.0%	18,054	Very strong figure, driven by 3.5G mobile in particular This is our estimate. We think Zain gained markets strongly, but mainly at the expense of STC rather than Mobily.
Subscriptions market share (%)	41.2%	40.2%	-1.0pp	40.2%	
Revenues	3,109	3,537	13.8%	3,699	Lowest quarter by sales growth in the year, and below our forecast, but still strong
Gross profit	1,818	2,115	16.3%	2,127	Very close to our forecast
EBITDA	1,245	1,521	22.2%	1,387	Well above our forecast, reflecting lower SG&A costs than we had assumed. This is confirmation that data service carries higher margins than voice, partly because marketing costs are lower
EBITDA margin (%)	40.0%	43.0%	1.0pp	37.5%	As above
Depn. & amortisation	-364	-435	19.5%	-481	Downward trend in effective depreciation rate seems to be continuing
Operating profit	881	1,086	23.3%	905	Reflects strong EBITDA and lower depreciation than our forecast
Financing cost	-121	-40	-66.9%	-54	Close to our forecast
Other	18	5	-72.2%	0	N/m
Net income before tax	778	1,051	35.1%	851	Reflects strong EBITDA, lower depreciation and lower financial expenses
Tax and zakat	0	1	n/m	-21	N/m
Net profit	778	1,052	35.2%	830	Reflects strong EBITDA, lower depreciation, lower financial expenses and low tax Above our forecast. Network coverage is now very high, but we suspect that capacity requirements will prevent capex from falling significantly in the near term
Capex	-1,292	-906	-29.9%	-851	
Capex/sales (%)	41.6%	25.6%	-18.6pp	23.0%	As above
Net debt	7,476	7,660	2.5%	7,075	Net debt was above our forecast due to additional loans taken out over 2009.
Net debt/annualised EBITDA (x)	1.5	1.3	n/m	1.3	Net debt was above our forecast, but so was EBITDA. Overall this is a healthy gearing level

Source: Mobily ARC estimates

2010 will be less strong than 2009, but still impressive

Looking ahead, we expect Mobily to report revenue growth of 14% and net profit growth of 17% in 2010. We expect mobile data to remain the key driver of performance, with the contribution of data to total revenues rising from around 14% in 2009 to 17%. While the growth rates that we anticipate in revenues and net profit will represent a clear slowdown from 21% and 44% respectively in 2009, they remain impressive.

Strong results from Zain, but quality of results is an issue

Zain KSA: strong progress but slightly disappointing

Zain achieved strong progress in Q4 2009 with subscriptions rising and profitability improving. Zain ended the year with over 6.0mn subscriptions; our estimate is 6.05mn. We believe that the company won 1.75mn new accounts in Q4; this represents the strongest performance among the three operators. The robust customer intake drove up revenues, which more than doubled year-on-year to SAR895mn. While clearly impressive, this figure was well below our estimate of revenues of around SAR1.0bn. The shortfall suggests to us that, while Zain is achieving subscriptions growth, prices are under pressure and the company is finding it hard to attract higher-value customers. We have mentioned our concern that Zain's recent successes appear to have been concentrated at the low end of the market.

Zain has now reached EBITDA break-even

We calculate Zain's EBITDA loss for Q4 at SAR69mn – a substantial and welcome reduction from the EBITDA loss of SAR299mn in Q3. The company reached EBITDA break-even in November and December, giving us confidence that profitability will improve rapidly from now on. On the other hand, we were surprised by the 45% quarter-on-quarter increase in financial costs to SAR221mn. This was the main reason why Zain's Q4 net loss of SAR657mn was slightly higher than our estimate of SAR615mn.

Cash flow benefited from a large positive movement in working capital

From Zain's balance sheet we calculate net debt at the end of 2009 at SAR11,902mn, a figure little changed from the end of Q3. We think that net debt would have been higher if Zain accounts payable and other liabilities had not increased significantly over the year (implying perhaps that the company is benefiting from long payment periods for accounts due). This fact explains why Zain KSA reported a total positive movement on working capital for 2009 of over SAR1,972mn, of which we calculate that around one-half was generated in Q4. This boost to cash flow from working capital changes many not prove sustainable.



Figure 25. Zain KSA

(SAR mn)	Q4 2008 actual	Q4 2009 actual	% chg.	Q4'09 ARC est.	Comment
Subscriptions (000s)	2,010	6,050	201.0%	6,260	Very strong growth in Q4 with over 1.7mn net additions; however, we suspect some of these were of low quality.
Subscriptions market share (%)	5.6%	13.4%	7.8pp	13.8%	Zain has achieved the strongest gains in market share recently, mainly in our view at the expense of STC
Revenues	424	895	111.2%	1,050	Strong growth but from a low base and well below our forecast. While Zain is achieving subscriptions growth, we think prices are under pressure and the company is finding it hard to attract higher-value customers.
Gross profit	31	356	1046.9%	443	Below our forecast, because revenues were weaker.
EBITDA	-474	-69	-85.4%	-84	Slightly above our forecast, indicating good control of SG&A costs. Zain achieved EBITDA break-even on a monthly basis by the end of the year.
EBITDA margin (%)	-111.8%	-7.7%	n/m	-8.0%	As above
Depn. & amortisation	-309	-366	18.6%	-425	Below our estimate, which with hindsight was too high
Operating profit	-783	-435	-44.4%	-509	Better than we had forecast, though still heavily negative
Financing cost	-160	-221	38.3%	-107	Well above our forecast, and up by 46% from the level of Q3. The effective interest rate being paid by Zain has increased substantially
Other	14	0	-100.0%	0	N/a
Net income before tax	-929	-657	-29.3%	-616	Below our forecast due to the increase in financial costs
Tax and zakat	0	0	n/m	0	N/a
Net profit	-929	-657	-29.3%	-616	As above
Capex	-466	-727	56.1%	-224	Capex was much higher than we had expected in Q4, suggesting Zain is spending heavily to catch up with its rivals in terms of network coverage and quality
Capex/sales (%)	109.9%	81.2%	-26.1%	21.3%	As above
Net debt	10,745	11,902	10.8%	13,109	Net debt was below our forecast due in part to a big positive movement on working capital in the cash flow statement which we doubt is sustainable
Net debt/annualised EBITDA (x)	-5.7	-43.1	n/m	-38.8	We forecast net debt/sales of 2.4x for 2010, and net debt/EBITDA of 33.0x. This level of gearing is clearly excessive

Source: Zain KSA, ARC estimates

Zain will achieve strong growth this decade, but its key problem is debt

In 2010, we expect Zain KSA to report revenue growth of 81% year-on-year and to report EBITDA of SAR394mn, implying an EBITDA margin of 7%. Looking further ahead, we expect Zain to report the strongest growth in market share, revenues and profits of the three Saudi operators over the coming decade. However, Zain's key problem is its high debt burden, which we expect to peak in 2010 or 2011. (We forecast a net debt/sales ratio of 2.4x for this year.) As a consequence of its high debt burden and resultant high interest expenses, we do not expect Zain to report a net profit before 2013.



Valuation: Mobily still offers value, dividend yield STC's chief attraction

We use long-run DEP valuation in which all excess returns fade to the cost of capital...

Our key method of valuation for the Saudi telecoms operators is long-run discounted economic profit (DEP), sometimes also called discounted long-run EVA ("economic value added"). This is a simple variation on discounted cash flow and is mathematically equivalent. In our models, we make explicit forecasts for income statement, balance sheet and cash flow out to 2020. We then assume a steady fading of return on invested capital, i.e. excess return, down to the cost of capital over a period of up to 50 years from the present. This approach avoids a common problem in long-run modelling: namely, that the analyst stops forecasting at some arbitrary point when the company in question is still generating high returns. In terms of financial theory this is implausible, and excess returns will eventually disappear through competition, regulation or some other means.

...and assume a 30 year period of competitive advantage

Our DEP valuations are sensitive to many factors, including assumed revenue growth, EBITDA margin and capex/sales ratio in 2020, i.e. the last year of explicit forecasting. Another important variable is the assumed duration of the period of competitive advantage, i.e. the period during which the company generates returns above weighted average cost of capital (WACC). Deciding on the length of the period of the competitive advantage is naturally a subjective exercise. Regarding the mobile telephone business, while many or most established mobile operators around the world generate high returns on capital, the industry only really started in the 1990s, so arguably no operator has been in existence long enough to offer a convincing precedent. We have assumed 30 years for all three Saudi mobile operators, on the grounds that their mobile licences last for 20 years, and that it would take several years after expiry of their licences for rivals to challenge them effectively.

We assume WACCs of 8.5-10.0%

However, as with any DCF-based approach, the factor to which the DEP valuation is most sensitive is WACC. For Mobily and Zain, we have assumed WACCs of 8.5-9.1%, based on an estimation of WACC in Saudi Arabia. For STC, we have assumed a higher WACC of around 10.0% which incorporates estimates of WACC for its various overseas operations. Details of our calculations are discussed below.

WACC is in turn highly sensitive to assumed terminal capital structure. Estimating terminal capital structure is again a rather subjective exercise. Mature telecoms operators typically generate substantial amounts of cash, and so it is legitimate to assume low terminal debt/equity ratios. (Historic experience in the telecoms sector suggests that many operators which build up high cash levels squander it through expensive acquisitions; investment in new generations of technology may also deplete cash reserves. Nevertheless, we think our core assumption is sound.) We have assumed a terminal debt/(debt plus equity) ratio of 30% for STC and Mobily, compared to 36-38% at present. For Zain, we have assumed a ratio of 40%, reflecting the company's much higher current debt level. The higher proportion of debt in WACC in Zain's case reduces its WACC, and so has a positive effect on fair value.

In the case of STC, we use a sum-of-the-parts (SoTP) approach to valuation as well as long-run DEP. Under this approach we use comparisons of valuation measures – notably, EV/EBITDA multiples – with other listed telecoms operators to estimate fair value for both the company's domestic and overseas operations. (Ideally, we should be using long-run DCF or DEP for all STC's operations; however, generally poor disclosure and the fact that many of STC's foreign businesses are unlisted have prevented this.) Comparing the fair value of STC under the long-run DEP approach and the SoTP approach is instructive.

Below we discuss fair value for the three companies in turn.

STC

As noted, we have taken a dual approach for STC. On the one hand, we have valued the company as a coherent whole using our long-run DEP model. This is a perfectly legitimate method, since STC's overseas operations are in the same business sector as its domestic operations and are subject to very similar drivers. Moreover, in practice STC appears to be



We expect STC's international operations to grow faster than its domestic businesses

running itself this way; this is the reason, why, for example, STC includes both domestic and international operations in the segment breakdown in its annual report.

Our key long-run assumptions for STC are straightforward. We assume that the overseas operations – concentrated in Turkey, Malaysia and South Africa, but including India and Indonesia – grow in aggregate faster than the Saudi operations, so their contribution to total turnover rises from our estimate of 24% for 2009 to 34% by 2020. For that year we assume revenue growth of 4%, an EBITDA margin of 39% compared to our estimate of 42% for 2009, and a capex/sales ratio of 23%. The last figure may seem high, but reflects STC's position as a leading operator in emerging markets where we expect investment requirements to be high.

We estimate the WACC of STC's Saudi business at 9.2%. However, it would be inappropriate to value using a purely Saudi WACC, since the cost of financing is different overseas. We have therefore calculated a sliding WACC which is weighted by the estimated contribution that STC's domestic and foreign operations make to revenues each year. We show this below for the next three years only, although we have calculated a sliding WACC out till 2020.

Figure 26. STC: revenue-weighted sliding WACC (%)

WACC by country				
Saudi Arabia	9.2%			
Malaysia	7.4%			
South Africa	14.4%			
Turkey	14.3%			
Weights (revenue split)	FY08	FY09E	FY10E	FY11E
STC Domestic	77.2%	75.9%	75.1%	74.8%
Turk Telekom	20.3%	16.0%	16.3%	15.9%
Maxis	5.6%	5.1%	5.2%	5.1%
Cell C	2.7%	2.7%	3.1%	3.2%
Other	0.0%	0.2%	0.2%	1.0%
Weighted avg. WACC	10.81%	10.06%	10.10%	10.08%

Source: Al Rajhi Capital

The importance of the foreign operations has necessitated a few other changes to our long-run DEP model. Notably, instead of a Saudi tax/zakat (Islamic charity payments) rate of around 2.5%, we have assumed a long-run tax rate for STC of 10.1% based on our estimate that foreign countries with an approximate average tax rate of 25% will account for roughly one-third of STC's revenues by 2020.

On a long-run DEP basis we estimate fair value at SAR52.4

As noted, we have assumed a 30 year period of competitive advantage for STC. On this basis, we estimate fair value per share at SAR50.0. The table below shows fair values assuming different periods of competitive advantage, but with all other long-run assumptions unchanged.

Figure 27. STC: fair value per share assuming different durations of competitive advantage*

	Fair value per share (SAR)
25 years	48.2
30 years (core scenario)	50.0
35 years	51.3
40 years	52.4
45 years	53.0
50 years	53.2

Source: Al Rajhi Capital

The SoTP approach attempts to value the constituent segments of STC separately. In an ideal world, we would use long-run DCF or DEP analysis for all segments of the business. However, doing so is complicated by the fact that Oger, the largest of STC's overseas operations, is unlisted (even though it includes the listed Turk Telekom). Similarly, Binariang in Asia, the direct owner of Maxis, is unlisted. Binariang's largest asset is Maxis Malaysia, which has recently been relisted through an IPO. However, Binariang also includes Maxis's



operations in India and Indonesia, which are unlisted. Financial information on the unlisted portions of STC's overseas operations is limited.

We have therefore decided to value STC's various operations – including its domestic business – on a comparative basis, using aggregate EV/EBITDA multiples for peer companies to estimate a fair enterprise value for STC's constituent parts. This approach may be criticised as being less scientific than a full DCF approach – a criticism which we accept. However, this method provides a practical and speedy way of valuing STC's constituent parts. Incidentally, we have always preferred EV/EBITDA to PE as a valuation measure for telecoms operators, since it is not affected by differences in financial structure or tax rate.

The tables and charts below summarise our comparative valuation of STC.

Saudi domestic business

We have used a selection of incumbent telecoms operators in developed and developing markets in Europe and Asia to provide a base of comparison with STC's domestic telecoms operations. In all cases below, our valuation comparisons are correct as at 31st December, 2009.

Figure 28. STC: comparables for domestic business

Comparables	Bloomberg Ticker	Currency	EV (SAR)	EBITDA (SAR)		EV/EBITDA	
				2009E	2010E	2009E	2010E
TPSA Poland	TPS PW Equity	PLN	38,723	9,293	9,048	4.2	4.3
Telekom Malaysia Berhad	T MK Equity	MYR	16,491	3,275	3,322	5.0	5.0
OTE Greece	HTO GA Equity	EUR	54,450	11,692	11,549	4.7	4.7
MTNL	MTNL IN Equity	INR	-165	116	134	NM	NM
France Telecom	FTE FP Equity	EUR	450,894	92,787	91,426	4.9	4.9
Deutsche Telekom	DTE GR Equity	EUR	519,307	109,811	108,170	4.7	4.8
Telefonica O2 Czech	SPTT CP Equity	CZK	24,963	5,443	5,273	4.6	4.7
Swisscom	SCMN VX Equity	CHF	113,205	17,164	17,018	6.6	6.7
TeliaSonera	TLSN SS Equity	SEK	153,386	18,532	18,997	8.3	8.1
Aggregate			1,371,254	268,113	264,937	5.1	5.2

Source: Bloomberg, Al Rajhi Capital

Turk Telekom

We have used a selection of incumbent telecoms operators in emerging markets in Europe and Asia to provide a base of comparison for Turk Telekom, which is STC's largest overseas business.

Figure 29. STC: comparables for Turk Telekom

Comparables	Bloomberg Ticker	Currency	EV (SAR)	EBITDA (SAR)		EV/EBITDA	
				2009E	2010E	2009E	2010E
Telecom Egypt	ETEL EY Equity	EGP	20,686	3,655	3,677	5.7	5.6
TPSA Poland	TPS PW Equity	PLN	35,681	8,563	8,337	4.2	4.3
OTE Greece	HTO GA Equity	EUR	54,610	11,727	11,583	4.7	4.7
Telekom Malaysia Berhad	T MK Equity	MYR	16,492	3,276	3,322	5.0	5.0
Magyar Telekom Hungary	MTEL HB Equity	HUF	23,531	5,054	4,937	4.7	4.8
BT	BT/A LN Equity	GBP	132,677	33,305	33,773	4.0	3.9
Telefonica O2 Czech	SPTT CP Equity	CZK	24,963	5,443	5,273	4.6	4.7
Aggregate			308,641	71,023	70,902	4.3	4.4

Source: Bloomberg, Al Rajhi Capital

Maxis Malaysia

STC's second biggest foreign investment is Maxis Malaysia, which is a pure mobile business. We have used a selection of Asian operators whose value is wholly or largely derived from mobile communications to provide a base of comparison for this company. Since Maxis Malaysia has recently been relisted, we can also use actual EV in our SoTP valuation for STC. This makes a slight difference because Maxis Malaysia was relisted on a fairly generous



multiple. Using comparisons with other operators, we estimate fair enterprise value for Maxis Malaysia at SAR27.8bn, whereas the actual EV at the end of 2009 was SAR40.3bn.

Figure 30. STC: comparables for Maxis

Comparables	Bloomberg Ticker	Currency	EV (SAR)	EBITDA (SAR)		EV/EBITDA	
				2009E	2010E	2009E	2010E
SingTel	ST SP Equity	SGD	147,835	14,526	15,186	10.2	9.7
Turkcell	TCELL TI Equity	TRY	52,822	7,760	8,506	6.8	6.2
Axiata	AXIATA MK Equity	MYR	40,992	5,576	6,202	7.4	6.6
China Unicom	762 HK Equity	CNY	137,205	34,555	35,612	4.0	3.9
Bharti Airtel	BHARTI IN Equity	INR	105,906	12,943	13,288	8.2	8.0
Reliance Communications	RCOM IN Equity	INR	59,196	7,101	7,847	8.3	7.5
DiGi	DIGI MK Equity	MYR	18,968	2,351	2,484	8.1	7.6
China Mobile	941 HK Equity	CNY	585,640	124,153	128,455	4.7	4.6
Aggregate			1,148,565	208,964	217,580	5.5	5.3

Source: Bloomberg, Al Rajhi Capital

Cell C

STC's third most important foreign operation is Cell C, a mobile operation in South Africa. We have used four African and Middle Eastern operators to provide a base of comparison with this company.

Figure 31. STC: comparables for Cell C

Comparables	Bloomberg Ticker	Currency	EV (SAR)	EBITDA (SAR)		EV/EBITDA	
				2009E	2010E	2009E	2010E
MTN	MTN SJ Equity	ZAR	119,822	24,269	26,137	4.9	4.6
Orascom	ORTE EY Equity	USD	35,518	8,658	9,287	4.1	3.8
Qatar Telecom	QTEL QD Equity	QAR	64,150	11,629	12,613	5.5	5.1
Etisalat	EEC AB Equity	SAR	37,900	4,639	5,180	8.2	7.3
Aggregate			257,390	49,194	53,217	5.2	4.8

Source: Bloomberg, Al Rajhi Capital

In our view, STC's remaining operation of significant value is Airtel, which is the Maxis group's mobile operation in India. We have used Bharti and Reliance Communications, the two largest listed Indian telecoms operators, to provide a base of comparison with Airtel.

Figure 32. STC: comparables for Airtel

Comparables	Bloomberg Ticker	Currency	EV (SAR)	EBITDA (SAR)		EV/EBITDA	
				2009E	2010E	2009E	2010E
Bharti Airtel	BHARTI IN Equity	INR	105,906	12,943	13,288	8.2	8.0
Reliance Communications	RCOM IN Equity	INR	59,196	7,101	7,847	8.3	7.5
Aggregate			165,102	20,044	21,134	8.2	7.8

Source: Bloomberg, Al Rajhi Capital



STC: Sum of the parts (SoTP) valuation

Using the above bases of comparison, we calculate SoTP fair value for STC as follows:

Figure 33. STC: SoTP valuation

(In millions)	Method	EBITDA				Currency	Current		Enterprise Value	
		2009E	2010E	2009E	2010E		Exch. Rate	Interest in EV	2009E	2010E
STC Domestic	Comparables	15,598	15,893	5.1x	5.2x	SAR	1.00	100%	79,775	82,261
Turk Telekom	Comparables	3,941	4,427	4.3x	4.4x	TL	2.48	35%	14,871	16,736
Cell C	Comparables	1,589	1,854	5.2x	4.8x	ZAR	0.47	35%	1,380	1,488
Maxis Malaysia	Comparables	4,632	6,042	5.5x	5.3x	MYR	1.09	25%	6,957	8,715
Other Maxis (Aircel)	Comparables	594	764	8.2x	7.8x	MYR	1.09	25%	1,338	1,631
Total Enterprise Value									104,320	110,831

Other Investments At Book	Method	Ownership	Value	Currency	Exch. Rate	SAR
Kuwait Telecom Company (Viva)	Transaction	26%	50	KWD	13.16	658
Bahrain Third Mobile Licence	Transaction	100%	87	BHD	9.99	866
InvestCo Bahrain	Transaction	51%	26	AED	1.02	26

Enterprise Value at YE 2009	104,320
Net Debt	26,685
Equity Value at YE 2009	77,635
Other Investments	1,550
Total Equity Value	79,185
Shares Outstanding (mn)	2,000
Price per share	39.6

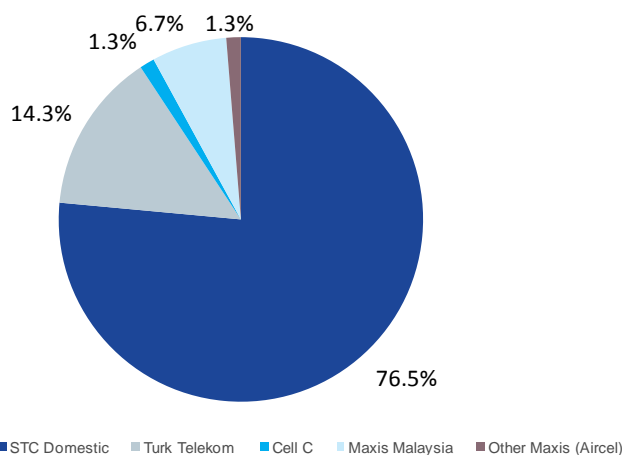
Source: Al Rajhi Capital

On an SoTP basis we estimate fair value at SAR44.6

On a comparative SoTP basis, we thus estimate fair value per share for STC at around SAR40.0. As both Turk Telekom and Maxis are listed, we can replace our estimated fair enterprise values with actual enterprise values in the stock market. As noted above, Maxis is quite generously valued at present. If we use actual market enterprise values, therefore, fair value per share for STC on an SoTP basis rises to SAR42.7. We have taken this number as perhaps a more meaningful estimate of fair value for STC.

The two charts below present a breakdown of fair enterprise value for STC using 1) our estimated fair enterprise values throughout and 2) market enterprise values for Turk Telekom and Maxis. It will be seen that by our estimation foreign operations account for between 23% and 27% of fair enterprise value for the STC group. Note that Figure 34 is intentionally repeated from Figure 22 above.

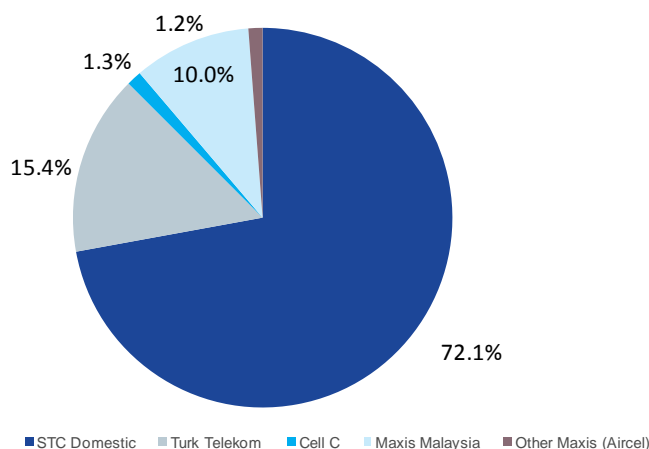
Figure 34. STC: breakdown of estimated fair enterprise value



Source: Al Rajhi Capital. NB Turk Telekom and Maxis are shown here at estimated fair enterprise value rather than market enterprise value.



Figure 35. STC: breakdown of estimated fair enterprise value



Source: Bloomberg, Al Rajhi Capital. NB Turk Telekom and Maxis are shown here at actual market enterprise value.

We set a target price for STC of SAR48.5

In relative terms STC is the most modestly valued of the three Saudi operators; its yield of 8.5% is also attractive

To sum up, we estimate fair value per share for STC on a long-run DEP basis at SAR50.0, but on an SoTP basis at SAR42.7. The two methods are both valid and we cannot state that one is conclusively better than the other. We have therefore taken a simple average of these two estimates as our target price for STC, i.e. SAR46.4.

Since our target price is very close to the current share price, we rate STC Neutral. It is, of course, possible that our valuation of STC has been too harsh. It is worthwhile stressing that, in relative terms, STC is the most modestly valued of the three Saudi telecoms operators, trading on a 2010 EV/EBITDA multiple of 5.1x, a 2010 PE ratio of 7.7x, and with a dividend yield of 6.5%. The dividend is around 1.8x covered by earnings and so appears quite sustainable. STC's high dividend yield is in our view the company's principal investment attraction.

Mobily

In contrast to STC, Mobily has no international operations, so we need only value the Saudi operations. We do this using long-run DEP valuation with WACC of 8.7%, as shown below.

Figure 36. Mobily: WACC (%)

		Source
Risk-free rate	3.4%	US 10 yr Treasury*
Market risk premium	9.1%	Bloomberg
Adjusted Beta	0.9	Reuters
Cost of equity	11.5%	
Pre-tax cost of debt	2.1%	
Effective tax/zakat rate	1.0%	
After-tax cost of debt	2.1%	
Target	30.0%	
WACC	8.7%	

Source: Bloomberg, ThomsonReuters, Al Rajhi Capital

Given the company's greater simplicity, the assumptions that we use for Mobily are simpler than those for STC. Regarding market share, we have assumed in our long-run model for the Saudi mobile telecoms market that STC gradually loses share to Mobily and Zain, so that by 2020 STC's share of total mobile accounts falls from the present 46% (our estimate for the end of 2009) to 39%, whereas Mobily's market share stays fairly constant at 39-40%. (We expect Zain to see a more impressive increase in subscriptions market share than Mobily, but to win its new accounts largely at the expense of STC.) We forecast that Mobily's share of mobile market revenues to rise modestly over the same period, from 30-31% now to 33% by 2020.



Our price target implies 39% upside for Mobily

Looking at Mobily itself, comparing actual figures for 2009 with our estimates for 2020, we assume that revenue growth will slow from 14% to 5%, that the EBITDA margin will expand from 37% to a mature level of 41%, and that the capex/sales ratio will drop from 25% to 16%. This would be closer to what we regard as a maintenance level in a developing market with an expanding population. We also typically assume high long-run capex/sales ratios to reflect investment in future generations of technology; we think that it would be over-optimistic to assume a long-run capex/sales ratio of 10% or below.

Using our core assumption of a period of competitive advantage of 30 years, we estimate fair value per share for Mobily at SAR64.9. We set this as our target price. Since our target implies 39% potential share price appreciation, we rate Mobily as Overweight. The table below shows fair value assuming different periods of competitive advantage, but with all other long-run assumptions unchanged.

Figure 37. Mobily: fair value per share assuming different durations of competitive advantage*

	Fair value per share (SAR)
25 years	62.6
30 years (core scenario)	64.9
35 years	66.7
40 years	68.8
45 years	70.1
50 years	70.9

Source: Al Rajhi Capital

Mobily does not look expensive despite strong share price performance in 2009

In contrast to STC, Mobily showed strong share performance over 2009. Despite the strong performance, for a company which we expect to report 12% growth in revenues and 17% growth in net income in 2010 we do not consider Mobily to be expensive on a 2010 EV/EBITDA ratio of 6.8x and a PE of 9.3x. Based on the announced 2009 dividend, Mobily yields 2.7%, which is lower than 6.5% for STC but certainly not negligible.

Zain KSA

Like Mobily, Zain KSA has no international operations, so we need only value the Saudi operations. We do this using long-run DEP valuation with a WACC of 8.9%, as shown below.

Figure 38. Zain KSA: WACC (%)

		Source
Risk-free rate	3.2%	US 10 yr Treasury*
Market risk premium	9.1%	Bloomberg
Adjusted Beta	0.9	Reuters
Cost of equity	11.3%	
Effective pre-tax cost of debt	5.3%	
Effective tax/zakat rate	0.0%	
After-tax cost of debt	5.3%	
Target	40.0%	
WACC	8.9%	

Source: Bloomberg, ThomsonReuters, Al Rajhi Capital

We expect Zain to achieve impressive market share gains over the coming decade...

Again, the assumptions that we use for Zain are simpler than those for STC. Regarding market share, we have assumed in our long-run model for the Saudi mobile telecoms market that STC gradually loses share to Zain in particular, so that by 2020 Zain's share of mobile market accounts has increased from our present estimate of 13% (for Q4 2009) to 22%. We expect Zain's share of mobile revenues to rise from our estimate of 8% now to 21% by 2020, i.e. by an even more impressive degree.

...and impressive gains in profitability too

Regarding Zain's financial position, we assume that revenue growth will slow from our estimate of 81% for 2010 to 6% in 2020; this is a higher rate than we assume for both STC's Saudi operations and for Mobily. The EBITDA margin stood at -36% in 2009, but we forecast a swing upwards to 7% for 2010; we assume that the margin will expand to a mature level of 42% by 2020. Regarding investment, we assume that the capex/sales ratio will drop from our



estimate of 23% for 2010 to 15%. This would be close to what we regard as a maintenance level in a developing market.

Using our core assumption of a period of competitive advantage of 30 years, we estimate fair value for Zain at SAR8.0 per share. The table below shows fair value assuming different periods of competitive advantage, but with all other long-run assumptions unchanged.

Figure 39. Zain KSA: fair value per share assuming different durations of competitive advantage*

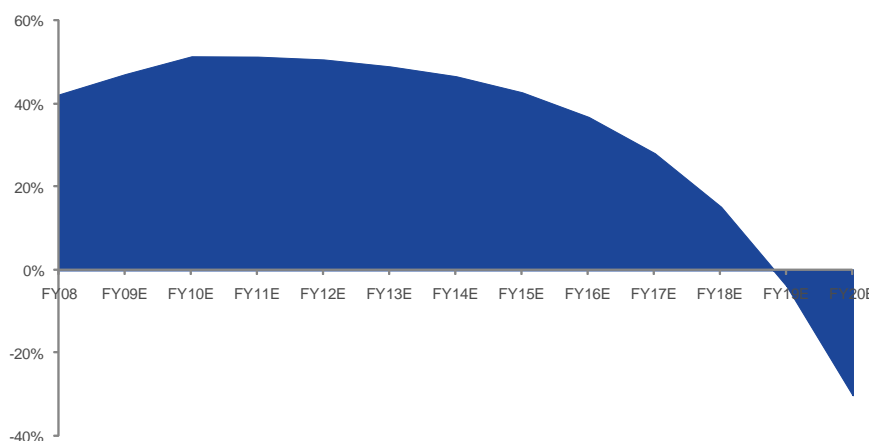
	Fair value per share (SAR)
25 years	7.4
30 years (core scenario)	8.0
35 years	8.5
40 years	8.9
45 years	9.2
50 years	9.4

Source: Al Rajhi Capital

But Zain's high debt burden pushes down fair value

Zain's share price is currently SAR10.2. Thus, despite the strong growth in revenues and earnings that we predict over the coming decade, we believe that Zain is overvalued even in our most optimistic scenario of a 50 year period of competitive advantage. The key reason for this is the company's high debt load, which reduces the portion of Zain's enterprise value (EV) attributable to equity shareholders. At present, we calculate that debt represents approximately 47% of EV for Zain, compared to around 21% for STC (strictly speaking, this is the share of debt and minority interests) and 19% for Mobily. We expect net debt to peak as a proportion of EV at 49-50% in 2010-11, and to decline steadily thereafter, turning negative in 2019, which is the year in which we assume Zain will first show net cash on its balance sheet. By contrast, we expect Mobily to have net cash by 2013.

Figure 40. Zain: net debt as a proportion of EV



Source: Al Rajhi Capital

It is important to note that our estimate of net debt of SAR13.0bn at the end of 2010 (US\$3.5bn) is equal to 2.4x our estimate of 2010 sales of SAR6.2bn. While Zain is performing very well on many measures for a third mobile operator, with a debt burden this high the company cannot afford to make any mistakes. We have taken our estimate of fair value of SAR8.0 as our target price for Zain; this is more than 20% below the current price. Hence our rating of Underweight.



US\$24.50bn Market cap
16.4% Free float
US\$9.20mn Avg. daily volume

Target price **46.37** 1% over current
Consensus price **58.10** 26.6% over current
Current price **45.90** as at 20/1/2010

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Underweight **Neutral** Overweight

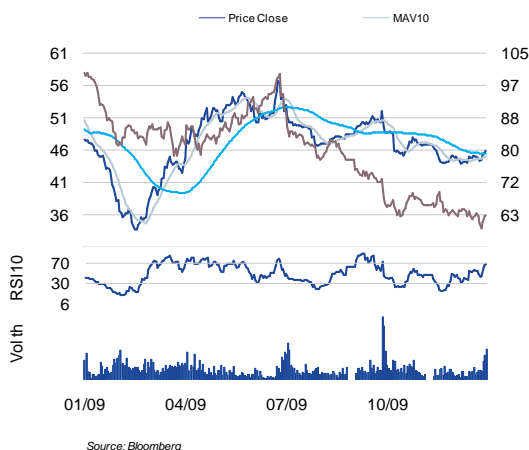
Key themes

We expect mobile to outperform fixed-line telecoms in Saudi Arabia over the next few years. Growth in 3.5G mobile data threatens the DSL market dominated by STC. We regard STC's 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 dull near-term earnings prospects, STC lacks catalysts for share price performance. However, STC is the least expensive of the three Saudi telecoms operators and its 6.5% yield offers support. We rate STC Neutral.

Performance

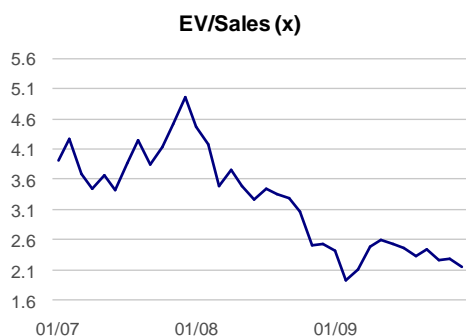


Earnings

Period End (SAR)	12/09A	12/10E	12/11E	12/12E
Revenue (SARmn)	50,750	54,140	58,124	61,592
Revenue Growth	6.9%	6.7%	7.4%	6.0%
EBITDA (SARmn)	20,607	21,939	23,540	24,945
EBITDA Growth	1.5%	6.5%	7.3%	6.0%
EPS	5.41	5.99	6.38	6.72
EPS Growth	-2.0%	10.7%	6.5%	5.3%

Source: Company data, Al Rajhi Capital

Valuation



Source: Company data, Al Rajhi Capital

STC

Jam tomorrow

While STC remains powerful in the Saudi telecoms market, it has allowed Mobily to take the lead in mobile data, which is where we expect growth to be concentrated. STC's foreign investments may pay off in the long run, but in the near term we see them as a distraction. We launch coverage with a Neutral rating and a target price of SAR46.4, which is close to the current share price.

Market: Saudi Arabia is an attractive telecoms market, benefiting from a young and growing population and from high GDP/capita. Mobile communications dominates the market. STC is dominant in the Saudi mobile market, with revenue market share of 61% compared to accounts market share of 46% (our estimates for Q409). However, we think STC lost ground over 2009, especially in the 3.5G mobile data market where Mobily has established a clear lead.

Mobile and data growth: Reported mobile penetration in Saudi Arabia is 154%. However, mobile broadband has taken off recently and will, we think, help drive penetration towards 220% by 2014. Mobile data should fuel incremental growth, rather than replace existing voice revenues; however, we expect it to grow at the expense of fixed-line DSL. If so, the company most at risk is STC, which virtually monopolises fixed-line broadband. STC has achieved strong growth in DSL; and in the long run we think its investment in next-generation fixed-line network will create new growth opportunities. However, over the next few years we think prospects for fixed-line telecoms will stagnate or even deteriorate.

New opportunities: STC is strategically committed to expansion through acquisition and international investment. STC's international investments may boost growth in the future, but in the near term we think it has taken its eye off the ball at home, to the benefit of Mobily and Zain. This helps explain why Mobily has established a clear lead in the mobile broadband market.

Valuation: Using long-run discounted economic profit valuation, we estimate fair value per share for STC at SAR50.0. On a comparative sum-of-the-parts basis, we estimate fair value at SAR42.7. Our target price for STC of SAR46.4 is a simple average of the two estimates. In relative terms STC is the most modestly valued of the three Saudi telecoms operators, trading on a 2010 EV/EBITDA multiple of 5.1x, a 2010 PE ratio of 7.7x, and offering a yield of 6.5%. Dividend cover in 2009 was 1.7x; and we expect EPS growth of 11% in 2009. On this basis we see STC's dividend as quite sustainable.

Stock rating and conclusion: STC is modestly valued, but we see few catalysts for near-term performance. STC's domestic performance has been affected by loss of mobile market share and other factors, while foreign expansion has put pressure on costs. The results for Q4 2009 showed a recovery in sales growth to a robust 5%; operating profit, however, was again below our expectations. STC's overseas investments may pay off in the long run, but represent only around one-quarter of its value. We see STC's 6.5% dividend yield as its chief attraction, although there are several Saudi companies offering higher yields; Jarir Marketing, Qassim Cement and National Shipping, for example, all yield around 7% or higher. We rate STC as Neutral and prefer Mobily, which offers jam today rather than tomorrow.



Corporate summary

STC is the largest telecoms operator in the GCC region, with a market value of US\$24bn. 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\$)	91.80 bn / 24.50bn		
52-week range	33.80 - 56.75		
Daily avg volume (US\$)	9.6 mn		
Shares outstanding	2,000mn		
Free float (est)	16.4%		

Performance:	1M	3M	12M
Absolute	2.9%	-7.5%	-10%
Relative to index	0.2%	-5.1%	-50.4%

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

Source: Bloomberg, Al Rajhi Capital

Valuation

Period End	12/09A	12/10E	12/11E	12/12E
Revenue (SARmn)	50,750	54,140	58,124	61,592
EBITDA (SARmn)	20,607	21,939	23,540	24,945
Net Profit (SARmn)	10,822	11,977	12,755	13,436
EPS (SAR)	5.41	5.99	6.38	6.72
DPS (SAR)	3.00	3.20	3.26	3.33
EPS Growth	-2.0%	10.7%	6.5%	5.3%
EV/EBITDA (x)	5.5	5.1	4.7	4.3
P/E (x)	8.5	7.7	7.2	6.8
P/B (x)	2.2	1.9	1.7	1.5
Dividend Yield	6.5%	7.0%	7.1%	7.2%

Source: Company data, Al Rajhi Capital

STC's overseas investment strategy overlooks several of the rules for success in the sector

Overseas investments

In our opinion, STC is guarding against the possibility of a slowdown in the domestic market by investing heavily in telecoms ventures abroad, including both established operations and start-ups. Altogether, STC has invested around US\$6.8bn (SAR25.5bn) in overseas ventures. We analyse STC's foreign investment strategy in detail in the main body of this report.

Here, let it suffice to say that, while we applaud STC's interest in markets with strong cultural links to Saudi Arabia, in other respects we consider that the company's investment strategy scores poorly, overlooking several of the rules for success in foreign investment that have been established in the global telecoms sector over time. Unlike, say, Telefonica of Spain's focused initial expansion into Latin America, STC has invested in three regions: the Middle East (Turk Telekom through Oger and the third mobile licences in Kuwait and Bahrain), south-east Asia (Binariang and the Maxis group), and southern Africa (Cell C, again through Oger). The key disadvantage of lack of regional focus is that it increases the complexity of managing overseas assets, resulting in diversion of senior management's time and attention. Moreover, STC owns only sizable stakes in its major foreign assets: 35% of Oger and 25% of Binariang. In practice, we believe that it will be difficult for STC to assert management control over its foreign operations without majority ownership.

STC has also overlooked the rule that telecoms operators should avoid investing in minor players. STC's most valuable foreign markets are Malaysia, where Maxis ranks as no.1 in the mobile market, and Turkey, where Turk Telekom ranks as no.1 in the fixed-line market and no.3 in the mobile market. We would argue that STC's position in its other markets varies from medium to very weak. This is especially true in Indonesia, a market with three sizable operators and a long tail of small players which has seen price reductions of 70-90% over the past two years. We are also dubious about STC's greenfield investments in Kuwait and Bahrain, where the company is starting from a position behind well-established rivals with no customer base or distribution chain.

Valuation of STC

We have taken a dual approach to valuation of STC; please see the body of this report for full details. Firstly, we value STC as a coherent whole using a long-run DEP model. Our key long-run assumptions are straightforward. We assume that the overseas operations grow in aggregate faster than the Saudi operations, so that their contribution to total turnover rises from our estimate of 25% for 2009 to 35% by 2020. We use a sliding WACC which is weighted by the estimated contribution that STC's domestic and foreign operations make to revenues each year. Finally, we assume a 30 year period of competitive advantage for STC. On this basis, we estimate fair value per share at SAR50.0.

Secondly, we value STC's various operations – including its domestic business – on a sum-of-the-parts basis, using aggregate EV/EBITDA multiples for peer companies to estimate a fair enterprise value for STC's constituent parts, but taking actual market enterprise values for the listed Turk Telekom and Maxis Malaysia. On this basis, we estimate fair value per share for STC at SAR42.7. We have set a target price for STC of SAR46.4, representing a simple average of the two approaches.

We value STC using both an absolute DEP approach and a comparative SoTP approach



Organic sales growth is running at 6-7% per annum for STC

Income Statement (SARmn)	12/08A	12/09A	12/10E	12/11E	12/12E
Revenue	47,469	50,750	54,140	58,124	61,592
Access Charges	(6,131)	(7,470)	(8,143)	(8,719)	(9,239)
Employee Costs	(6,164)	(6,773)	(7,172)	(7,556)	(8,007)
Government Charges	(5,542)	(5,664)	(5,955)	(6,394)	(6,775)
S.G. & A. Costs	(7,194)	(7,612)	(8,224)	(9,009)	(9,547)
Repairs & Maintenance Costs	(2,128)	(2,623)	(2,707)	(2,906)	(3,080)
Operating EBIT	13,903	12,764	14,074	15,210	16,094
Cash Operating Costs	(27,159)	(30,143)	(32,201)	(34,584)	(36,647)
EBITDA	20,310	20,607	21,939	23,540	24,945
Depreciation and Amortisation	(6,408)	(7,843)	(7,865)	(8,330)	(8,850)
Operating Profit	13,903	12,764	14,074	15,210	16,094
Net financing income/(costs)	894	(1,023)	(731)	(506)	(406)
Forex and Related Gains	(2,293)	638	-	-	-
Provisions	(675)	(1,004)	-	-	-
Other Income	238	708	-	-	-
Other Expenses					
Minority Interests	(172)	(283)	(534)	(735)	(941)
Net Profit Before Taxes	11,910	11,798	12,809	13,969	14,747
Taxes	(872)	(976)	(833)	(1,213)	(1,310)
Net Profit	11,038	10,822	11,977	12,755	13,436
Dividends	-	(6,000)	(6,395)	(6,523)	(6,653)
Transfer to Capital Reserve	-	-	-	-	-

	12/08A	12/09A	12/10E	12/11E	12/12E
Adjusted Shares Out (mn)	2,000	2,000	2,000	2,000	2,000
CFPS (SAR)	8.72	9.33	9.92	10.54	11.14
EPS (SAR)	5.52	5.41	5.99	6.38	6.72
DPS (SAR)	0.000	3.000	3.198	3.262	3.327

Operating profit fell significantly in 2009, but we predict growth of 10% in 2010

Growth	12/08A	12/09A	12/10E	12/11E	12/12E
Revenue Growth	37.8%	6.9%	6.7%	7.4%	6.0%
EBITDA Growth	21.5%	1.5%	6.5%	7.3%	6.0%
Operating Profit Growth	10.2%	-8.2%	10.3%	8.1%	5.8%
Net Profit Growth	-8.2%	-2.0%	10.7%	6.5%	5.3%
EPS Growth	-8.2%	-2.0%	10.7%	6.5%	5.3%

Margins	12/08A	12/09A	12/10E	12/11E	12/12E
EBITDA margin	42.8%	40.6%	40.5%	40.5%	40.5%
Operating Margin	29.3%	25.2%	26.0%	26.2%	26.1%
Pretax profit margin	25.1%	23.2%	23.7%	24.0%	23.9%
Net profit margin	23.3%	21.3%	22.1%	21.9%	21.8%

STC has a higher tax rate than its Saudi rivals due to tax overseas

Other Ratios	12/08A	12/09A	12/10E	12/11E	12/12E
ROCE	18.7%	16.6%	17.0%	16.9%	16.5%
ROIC	26.0%	15.7%	16.0%	15.7%	15.4%
ROE	30.0%	27.1%	26.7%	25.2%	23.5%
Effective Tax Rate	7.3%	8.3%	6.5%	8.7%	8.9%
Capex/Sales	34.3%	31.4%	25.0%	24.8%	24.4%
Dividend Payout Ratio	0.0%	55.4%	53.4%	51.1%	49.5%

Valuation Measures	12/08A	12/09A	12/10E	12/11E	12/12E
P/E (x)	8.3	8.5	7.7	7.2	6.8
P/CF (x)	5.3	4.9	4.6	4.4	4.1
P/B (x)	2.4	2.2	1.9	1.7	1.5
EV/Sales (x)	2.4	2.2	2.1	1.9	1.7
EV/EBITDA (x)	5.6	5.5	5.1	4.7	4.3
EV/EBIT (x)	8.1	8.9	7.9	7.2	6.7
EV/IC (x)	1.5	1.4	1.3	1.2	1.0
Dividend Yield	0.0%	6.5%	7.0%	7.1%	7.2%

Source: Company data, Al Rajhi Capital. Note. We have not restated STC's 2008 results in this report.



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

Balance Sheet (SARmn)	12/08A	12/09A	12/10E	12/11E	12/12E
Cash and Cash Equivalents	8,064	7,422	8,671	10,663	12,892
Current Receivables	8,136	11,471	12,190	12,787	13,550
Inventories	-	-	831	872	924
Other current assets	2,788	3,447	3,447	3,447	3,447
Total Current Assets	18,988	22,340	25,139	27,769	30,814
Fixed Assets	44,412	53,026	58,721	64,800	70,962
Investments	2,466	2,574	2,574	2,574	2,574
Goodwill	-	-	-	-	-
Other Intangible Assets	31,767	28,916	28,916	28,916	28,916
Total Other Assets	2,277	2,417	2,417	2,417	2,417
Total Non-current Assets	80,922	86,932	92,628	98,706	104,869
Total Assets	99,909	109,272	117,767	126,475	135,682
Short Term Debt	3,827	9,061	9,061	9,061	9,061
Trade Payables	19,100	20,457	23,137	24,750	26,102
Dividends Payable	-	-	(300)	(172)	(42)
Other Current Liabilities	(0)	-	0	(0)	(0)
Total Current Liabilities	22,927	29,519	31,898	33,639	35,122
Long-Term Debt	28,081	22,254	22,254	22,254	22,254
Other LT Payables	3,516	3,859	3,859	3,859	3,859
Provisions	2,682	2,844	2,844	2,844	2,844
Total Non-current Liabilities	34,279	28,956	28,956	28,956	28,956
Minority interests	4,937	8,798	9,332	10,067	11,008
Paid-up share capital	20,000	20,000	20,000	20,000	20,000
Total Reserves	17,766	21,999	27,581	33,813	40,596
Total Shareholders' Equity	37,766	41,999	47,581	53,813	60,596
Total Equity	42,703	50,797	56,913	63,880	71,604
Total Liabilities & Shareholders' Equity	99,909	109,272	117,767	126,475	135,682

STC's financial ratios are very healthy

Ratios	12/08A	12/09A	12/10E	12/11E	12/12E
Net Debt (SARmn)	23,845	23,893	22,644	20,652	18,423
Net Debt/EBITDA (x)	1.17	1.16	1.03	0.88	0.74
Net Debt to Equity	55.8%	47.0%	39.8%	32.3%	25.7%
EBITDA Interest Cover (x)	(22.7)	20.1	30.0	46.5	61.4
BVPS (SAR)	18.88	21.00	23.79	26.91	30.30

Capex exceeded 30% of sales in both 2008 and 2009, although we expect it to moderate from now on

Cashflow Statement (SARmn)	12/08A	12/09A	12/10E	12/11E	12/12E
Net Income before Tax & Minority Interest	12,082	12,082	13,343	14,704	15,688
Depreciation & Amortisation	6,408	7,843	7,865	8,330	8,850
Decrease in Working Capital	1,610	(3,941)	1,130	975	538
Other Operating Cashflow	2,094	1,021	(833)	(1,213)	(1,310)
Cashflow from Operations	22,193	17,004	21,505	22,796	23,766
Capital Expenditure	(16,278)	(15,926)	(13,561)	(14,409)	(15,013)
New Investments	-	-	-	-	-
Others	(19,190)	2,282	-	-	-
Cashflow from investing activities	(35,468)	(13,644)	(13,561)	(14,409)	(15,013)
Net Operating Cashflow	(13,276)	3,360	7,944	8,387	8,752
Dividends paid to ordinary shareholders	(8,552)	(5,943)	(6,695)	(6,395)	(6,523)
Proceeds from issue of shares	-	-	-	-	-
Increase in Loans	18,406	(671)	-	-	-
Effects of Exchange Rates on Cash	-	-	-	-	-
Other Financing Cashflow	4,908	3,874	-	-	-
Cashflow from financing activities	14,763	(2,740)	(6,695)	(6,395)	(6,523)
Total cash generated	1,487	620	1,249	1,992	2,229
Cash at beginning of period	7,618	8,064	7,422	8,671	10,663
Implied cash at end of year	9,105	8,684	8,671	10,663	12,892

Ratios	12/08A	12/09A	12/10E	12/11E	12/12E
Capex/Sales	34.3%	31.4%	25.0%	24.8%	24.4%

Source: Company data, Al Rajhi Capital. Note. We have not restated STC's 2008 results in this report.



US\$8.70bn Market cap
56.9% Free float
US\$13.40mn Avg. daily volume

Target price **64.90** 38.9% over current
Consensus price **58.00** 24.2% over current
Current price **46.70** as at 20/1/2010

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Underweight

Neutral

Overweight

Key themes

We expect mobile to continue to outperform fixed-line telecoms in Saudi Arabia over the next few years. Mobily has taken a clear lead in 3.5G mobile data, which is the fastest-growing segment of the market. While Mobily's strong focus on mobile is a clear positive, it is also making selective investments in fixed-line service.

Implications

Our preferred stock in the Saudi telecoms sector is Mobily, which we rate as Overweight. Mobily is performing well operationally and offers strong growth in the near term at a reasonable valuation.

Performance

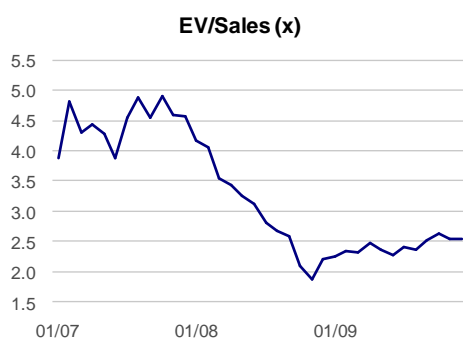


Earnings

Period End (SAR)	12/09A	12/10E	12/11E	12/12E
Revenue (SARmn)	13,058	14,895	16,735	18,171
Revenue Growth	21.0%	14.1%	12.4%	8.6%
EBITDA (SARmn)	4,837	5,640	6,309	6,905
EBITDA Growth	27.5%	16.6%	11.9%	9.4%
EPS	4.93	5.04	5.66	6.12
EPS Growth	23.2%	2.2%	12.2%	8.3%

Source: Company data, Al Rajhi Capital

Valuation



Source: Company data, Al Rajhi Capital

Mobily

Jam today

Mobily's clear lead in the surging mobile data market should ensure further robust growth over the next few years. However, Mobily is also preparing for the future by making selective investments in fixed-line assets. Mobily is not yet expensive despite strong share price performance. We launch coverage with an Overweight rating and a target price of SAR64.9, implying 39% upside.

Market: Saudi Arabia is an attractive telecoms market, benefiting from a young and growing population and from high GDP/capita. Mobile communications dominates the market. STC remains powerful in the Saudi mobile market, with revenue market share of 61% compared to 31% for the no.2 operator, Mobily. However, Mobily has accounts market share of around 40% and has built a strong lead in 3.5G mobile data, which is the fastest growing market segment.

Mobile and data growth: Headline mobile penetration in Saudi Arabia is 154%. However, mobile broadband has taken off over the past few quarters and will, we think, help drive penetration towards 220% by 2014. Mobile data should fuel incremental growth, rather than replace existing voice revenues; however, we expect it to grow at the expense of fixed-line DSL. If so, then the company best-placed to benefit is Mobily, which leads in mobile broadband and has nothing to lose in DSL. We have assumed modest pressure on ARPU in our Saudi mobile forecasts, but with ARPU and RPM high by the standards of emerging markets, there is a risk that the operators may be tempted to cut prices sharply.

New opportunities: We think Mobily is operating a two-part strategy. On the one hand, it aims to offer superior choice and service to STC in its core mobile market. On the other, it is trying to prepare for new directions in the telecoms market by modest investment outside pure mobile service. This explains Mobily's acquisition of Bayanat Al-Oula with its data licence and national fibre optic network in 2008. This kind of selective investment in fixed-line assets makes excellent sense and strengthens Mobily's overall competitiveness without allowing its attention to be diverted from its core mobile business.

Valuation: Using long-run discounted economic profit valuation, we estimate fair value per share for Mobily at SAR64.7; we have set this as our target price. Our valuation assumes a 30 year period of competitive advantage and a WACC of 8.7%. Despite strong share price performance over 2009, Mobily is not yet expensive for a fast-growing telecoms operator on a 2010 EV/sales ratio of 2.6x, an EV/EBITDA ratio of 6.8x and a PE of 9.3x. The 2009 dividend yield is 2.7%, which is low compared to 6-7% for STC but far from negligible.

Stock rating and conclusion: Driven by mobile data, we think that the Saudi mobile market still has strong growth potential despite high penetration. We think Mobily will be the key beneficiary of strong demand for mobile broadband service. However, Mobily has also selectively acquired fixed-line assets, meaning that it is well-placed to enhanced its service range over the medium term. We expect revenue and profits growth to moderate after surging in recent quarters, but to remain impressive. Mobily's valuation ratios are not excessive for an expanding mobile operator in an emerging market. We launch coverage with an Overweight rating and a price target of SAR64.9, implying 39% upside potential.



Corporate summary

Etiihad Etisalat (Mobily) is the second-placed telecoms operator in Saudi Arabia, with a market value of US\$9bn. Mobily has a market share of mobile accounts of about 40%, although its revenue share is lower at 31%. Mobily has at least 50% of mobile broadband subscriptions; this is the fastest-growing segment of the Saudi telecoms market. Mobily's presence in fixed-line service is very limited, but should expand due to selective acquisitions. Mobily is an affiliate of Emirates Telcoms Corp., which owns 27% of its shares.

Share information

Market cap (SAR/US\$) 32.70 bn / 8.70 bn
52-week range 31.40 - 48.00
Daily avg volume (US\$) 13.4 mn
Shares outstanding 700.0mn
Free float (est) 56.9%

Performance:	1M	3M	12M
Absolute	5.9%	3.3%	51.1%
Relative to index	3.2%	5.7%	10.7%

Major Shareholder:
Emirates Telecoms Corp. 27.4%
Gen. Organisation for Social Insc. 11.2%

Source: Bloomberg, Al Rajhi Capital

Valuation

Period End	12/09A	12/10E	12/11E	12/12E
Revenue (SARmn)	13,058	14,895	16,735	18,171
EBITDA (SARmn)	4,837	5,640	6,309	6,905
Net Profit (SARmn)	3,014	3,527	3,959	4,285
EPS (SAR)	4.93	5.04	5.66	6.12
DPS (SAR)	1.25	1.38	1.58	1.90
EPS Growth	23.2%	2.2%	12.2%	8.3%
EV/EBITDA (x)	7.3	6.8	5.7	5.0
P/E (x)	9.5	9.3	8.3	7.6
P/B (x)	2.7	2.2	1.9	1.6
Dividend Yield	2.7%	2.9%	3.4%	4.1%

Source: Company data, Al Rajhi Capital

We expect mobile broadband to help push Saudi penetration substantially higher

All three operators seem to be gathering pace in mobile data, but Mobily remains the clear leader

A key reason for our optimism about mobile broadband is the fact that fixed-line DSL is still underdeveloped

We have favourable long-run forecasts for Mobily

Mobile broadband

Despite penetration of 154%, in our view the Saudi mobile market still offers solid growth potential. The biggest driver of further growth is 3.5G HSPA mobile data service. Mobile data has surged over the past couple of quarters. Based on our estimates, combined fixed and mobile broadband accounts reached 2.06mn at the end of Q2 2009 and 2.69mn at the end of Q3, including 0.85mn and 1.40mn mobile broadband accounts respectively. While DSL has been growing at a steady pace, mobile broadband seems to have taken off.

We believe that the acceleration in Q3 2009 continued in Q4. Mobily announced at the year end that it had reached 1.0mn mobile broadband accounts. We do not have good indications for STC, but estimate that it had reached the 0.6mn mark. Zain KSA's strong accounts growth in Q4 was driven largely by a new international package. However, we think Zain's mobile broadband subscriptions also grew strongly, and believe its launch of pay per day broadband service in December further boosted demand. We thus estimate that total mobile broadband accounts surged to 2.00mn by the end of Q4 2009. While the other players are gathering pace, Mobily is still the clear leader in the mobile data market with at least 50% market share.

How fast can mobile broadband service grow from now? In Saudi Arabia, we think it can grow much further, mainly because fixed-line DSL is relatively underdeveloped. We believe there were 1.41mn DSL lines at the end of Q4 2009, or 5% of the population. The importance of DSL relative to broadband mobile can be understated, since one DSL line can serve a household rather than an individual, and households in Saudi Arabia are large standards, with 5-6 members on average. Comparing our estimate of 1.41mn DSL lines to our estimate of 5.1mn households in the Kingdom suggests DSL penetration of 28%. While this is a far higher figure than 5%, it still means that a large segment of the population is unserved by fixed-line broadband. Given greater convenience and greater competition to boost quality, we think strong latent demand for broadband service will be met primarily by 3.5G mobile.

Mobily: long-run assumptions

We assume in our long-run model for the Saudi mobile telecoms market that STC gradually loses share to Mobily and Zain, so that by 2020 STC's share of total mobile accounts falls from the present 46% to 39%, whereas Mobily's market share stays fairly constant at 39-40%. (We expect Zain to see more impressive growth in accounts market share than Mobily, but to gain share largely at the expense of STC.) We forecast that Mobily's share of mobile market revenues will increase over the same period, from around 30% now to 33% by 2020.

Comparing Mobily's performance in 2009 with our estimates for 2020, we assume that sales growth will slow from 21% to 5%, that the EBITDA margin will expand from 37% to a mature level of 41%, and that the capex/sales ratio will drop from 24% to 16%. This is closer to what we regard as a maintenance level in a developing market with an expanding population. We also typically assume high long-run capex/sales ratios to reflect investment in future generations of technology; we think that it would be over-optimistic to assume a long-run capex/sales ratio of 10% or below. Combining these forecasts with our assumption of a period of competitive advantage of 30 years, we estimate fair value per share for Mobily at SAR64.9.



2009 saw sales growth of 21% and expansion in the EBITDA margin from 35% to 37%

Income Statement (SARmn)	12/08A	12/09A	12/10E	12/11E	12/12E
Revenue	10,795	13,058	14,895	16,735	18,171
Cost of Goods Sold	(4,766)	(5,512)	(6,224)	(7,079)	(7,632)
Gross Profit	6,028	7,547	8,671	9,656	10,539
Government Charges					
S.G. & A. Costs	(2,234)	(2,710)	(3,031)	(3,347)	(3,634)
Operating EBIT	2,496	3,208	3,799	4,256	4,532
Cash Operating Costs	(7,000)	(8,221)	(9,255)	(10,426)	(11,266)
EBITDA	3,794	4,837	5,640	6,309	6,905
Depreciation and Amortisation	(1,298)	(1,629)	(1,841)	(2,054)	(2,373)
Operating Profit	2,496	3,208	3,799	4,256	4,532
Net financing income/(costs)	(438)	(204)	(181)	(195)	(137)
Forex and Related Gains	-	-	-	-	-
Provisions	-	-	-	-	-
Other Income	41	41	-	-	-
Other Expenses	-	-	-	-	-
Minority Interests	-	-	-	-	-
Net Profit Before Taxes	2,099	3,045	3,617	4,060	4,395
Taxes	(7)	(31)	(90)	(102)	(110)
Net Profit	2,092	3,014	3,527	3,959	4,285
Dividends	-	(875)	(963)	(1,107)	(1,328)
Transfer to Capital Reserve	-	-	-	-	-

Rising earnings give scope to boost dividend

	12/08A	12/09A	12/10E	12/11E	12/12E
Adjusted Shares Out (mn)	523.0	700.0	700.0	700.0	700.0
CFPS (SAR)	6.48	7.59	7.67	8.59	9.51
EPS (SAR)	4.00	4.93	5.04	5.66	6.12
DPS (SAR)	0.000	1.250	1.375	1.581	1.898

Growth rates set to moderate in 2010, but to remain high

Growth	12/08A	12/09A	12/10E	12/11E	12/12E
Revenue Growth	27.9%	21.0%	14.1%	12.4%	8.6%
Gross Profit Growth	29.7%	25.2%	14.9%	11.4%	9.1%
EBITDA Growth	17.2%	27.5%	16.6%	11.9%	9.4%
Operating Profit Growth	13.1%	28.5%	18.4%	12.0%	6.5%
Net Profit Growth	51.6%	44.1%	17.0%	12.2%	8.3%
EPS Growth	51.6%	23.2%	2.2%	12.2%	8.3%

Strong growth and rising margins drive returns

Margins	12/08A	12/09A	12/10E	12/11E	12/12E
Gross profit margin	55.8%	57.8%	58.2%	57.7%	58.0%
EBITDA margin	35.1%	37.0%	37.9%	37.7%	38.0%
Operating Margin	23.1%	24.6%	25.5%	25.4%	24.9%
Pretax profit margin	19.4%	23.3%	24.3%	24.3%	24.2%
Net profit margin	19.4%	23.1%	23.7%	23.7%	23.6%

Mobily offers solid value, especially on EV/sales and PE

Other Ratios	12/08A	12/09A	12/10E	12/11E	12/12E
ROCE	15.2%	17.2%	17.9%	17.7%	16.8%
ROIC	16.8%	16.2%	16.9%	17.0%	16.2%
ROE	26.7%	27.4%	26.1%	24.4%	22.4%
Effective Tax Rate	0.3%	1.0%	2.5%	2.5%	2.5%
Capex/Sales	27.4%	25.2%	21.5%	21.0%	20.5%
Dividend Payout Ratio	0.0%	29.0%	27.3%	28.0%	31.0%

Valuation Measures	12/08A	12/09A	12/10E	12/11E	12/12E
P/E (x)	11.7	9.5	9.3	8.3	7.6
P/CF (x)	7.2	6.2	6.1	5.4	4.9
P/B (x)	2.5	2.7	2.2	1.9	1.6
EV/Sales (x)	3.0	2.7	2.6	2.2	1.9
EV/EBITDA (x)	8.4	7.3	6.8	5.7	5.0
EV/EBIT (x)	12.8	11.0	10.2	8.5	7.6
EV/IC (x)	1.6	1.8	1.6	1.3	1.1
Dividend Yield	0.0%	2.7%	2.9%	3.4%	4.1%

Source: Company data, Al Rajhi Capital



We expect Mobily to have net cash by 2013

Balance Sheet (SARmn)	12/08A	12/09A	12/10E	12/11E	12/12E
Cash and Cash Equivalents	2,314	2,000	3,778	6,106	7,920
Current Receivables	3,389	5,029	5,647	6,025	6,541
Inventories	108	132	242	251	273
Other current assets	4,200	1,416	1,416	1,416	1,416
Total Current Assets	6,621	8,577	11,083	13,798	16,150
Fixed Assets	8,117	10,370	12,256	14,238	16,112
Investments	-	-	-	-	-
Goodwill	1,530	1,530	1,530	1,530	1,530
Other Intangible Assets	10,923	10,450	9,928	9,407	8,885
Total Other Assets	-	-	-	-	-
Total Non-current Assets	20,570	22,349	23,714	25,175	26,527
Total Assets	27,192	30,926	34,797	38,972	42,677
Short Term Debt	3,148	3,235	3,235	3,235	3,235
Trade Payables	7,523	7,978	9,197	10,376	10,902
Dividends Payable	-	875	963	1,107	1,328
Other Current Liabilities	78	100	100	100	100
Total Current Liabilities	10,749	12,189	13,495	14,818	15,566
Long-Term Debt	6,642	6,425	6,425	6,425	6,425
Other LT Payables	-	-	-	-	-
Provisions	46	70	70	70	70
Total Non-current Liabilities	6,688	6,495	6,495	6,495	6,495
Minority interests	-	-	-	-	-
Paid-up share capital	7,000	7,000	7,000	7,000	7,000
Total Reserves	2,754	5,243	7,808	10,659	13,617
Total Shareholders' Equity	9,754	12,243	14,808	17,659	20,617
Total Equity	9,754	12,243	14,808	17,659	20,617
Total Liabilities & Shareholders' Equity	27,192	30,926	34,797	38,972	42,677

Annualised Q409 net debt/ EBITDA was 1.3 at end 2009; this is a healthy gearing level

Ratios	12/08A	12/09A	12/10E	12/11E	12/12E
Net Debt (SARmn)	7,476	7,660	5,882	3,554	1,740
Net Debt/EBITDA (x)	1.97	1.58	1.04	0.56	0.25
Net Debt to Equity	76.6%	62.6%	39.7%	20.1%	8.4%
EBITDA Interest Cover (x)	8.7	23.7	31.1	32.3	50.3
BVPS (SAR)	18.65	17.49	21.15	25.23	29.45

We expect capex to remain relatively high due to capacity requirements for data

Cashflow Statement (SARmn)	12/08A	12/09A	12/10E	12/11E	12/12E
Net Income before Tax & Minority Interest	2,099	3,045	3,617	4,060	4,395
Depreciation & Amortisation	1,298	1,629	1,841	2,054	2,373
Decrease in Working Capital	(40)	(974)	491	793	(12)
Other Operating Cashflow	189	547	(90)	(102)	(110)
Cashflow from Operations	3,546	4,246	5,858	6,805	6,646
Capital Expenditure	(2,952)	(3,292)	(3,205)	(3,514)	(3,725)
New Investments	(1,050)	448	-	-	-
Others	(1,580)	(44)	-	-	-
Cashflow from investing activities	(5,583)	(2,889)	(3,205)	(3,514)	(3,725)
Net Operating Cashflow	(2,037)	1,357	2,653	3,290	2,921
Dividends paid to ordinary shareholders	(250)	(525)	(875)	(963)	(1,107)
Proceeds from issue of shares	2,000	-	-	-	-
Increase in Loans	836	(1,162)	-	-	-
Effects of Exchange Rates on Cash	-	-	-	-	-
Other Financing Cashflow	12	-	-	-	-
Cashflow from financing activities	2,598	(1,687)	(875)	(963)	(1,107)
Total cash generated	561	(331)	1,778	2,328	1,814
Cash at beginning of period	703	2,314	2,000	3,778	6,106
Implied cash at end of year	1,264	1,983	3,778	6,106	7,920

Ratios	12/08A	12/09A	12/10E	12/11E	12/12E
Capex/Sales	27.4%	25.2%	21.5%	21.0%	20.5%

Source: Company data, Al Rajhi Capital



US\$3.800bn Market cap
51.7% Free float
US\$11.30mn Avg. daily volume

Target price **7.98** -21.7% over current
 Consensus price **11.20** 9.8% over current
 Current price **10.20** as at 20/1/2010

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Underweight Neutral **Overweight**

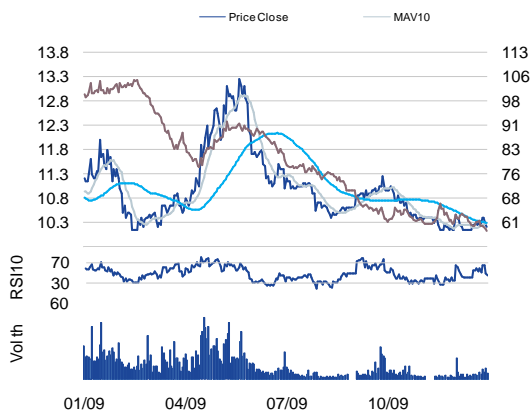
Key themes

We expect mobile to continue to outperform fixed-line telecoms in Saudi Arabia over the next few years, driven by mobile data. We think that STC has slightly lost its way in the domestic mobile market, to the benefit of its competitors.

Implications

Zain KSA is performing well on many measures and we expect it to achieve strong market share gains over the next decade, even though is less strong in mobile data than Mobily. Unfortunately, Zain is hobbled by a high debt burden, which reduces the share of enterprise value attributable to equity shareholders.

Performance



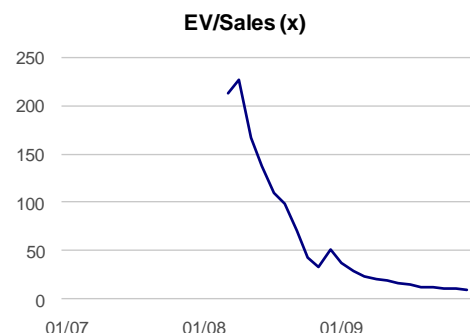
Source: Bloomberg

Earnings

Period End (SAR)	12/09A	12/10E	12/11E	12/12E
Revenue (SARmn)	3,004	5,444	7,629	9,264
Revenue Growth	494.6%	81.2%	40.1%	21.4%
EBITDA (SARmn)	(1,072)	394	1,450	2,501
EBITDA Growth	-15.3%		268.0%	72.6%
EPS	(2.21)	(1.35)	(0.68)	(0.08)
EPS Growth	36.0%	-39.0%	-49.4%	-88.7%

Source: Company data, Al Rajhi Capital

Valuation



Source: Company data, Al Rajhi Capital

Zain KSA

Maybe no jam at all

Zain KSA is performing well for a no.3 operator and should achieve strong growth over the next decade. However, it is highly indebted, with net debt likely to reach 2.4x 2010 revenues by our estimate. The high debt reduces the share of enterprise value attributable to equity shareholders. We estimate fair value per share at SAR8.0 and launch coverage with an Underweight rating.

Market: Saudi Arabia is an attractive telecoms market, benefiting from a young and growing population and from high GDP/capita. Mobile communications accounts for around 74% of the total market. STC still accounts for 61% of the Saudi mobile market by revenues. However, Zain KSA has grown rapidly for an operator which only launched service in Q3 2008. We estimate that Zain now accounts for 13% of mobile market accounts, although for only 8% of revenues.

Mobile and data growth: Headline mobile penetration in Saudi Arabia is 154%. However, mobile data has taken off in recent quarters and will, we think, help drive penetration towards 220% by 2014. Zain has shown strong growth so far, and we expect this to continue: we predict that Zain's share of mobile accounts will rise to 21% by 2020. Zain is performing well in the mobile voice market, achieving higher ARPU than the no.2 operator, Mobily. However, Mobily has built a clear lead in mobile data, and we think it will be hard for Zain to catch up. We are also worried that Zain's recent successes (e.g. its international package) have been concentrated at the low end of the market. This raises questions about the quality of Zain's subscribers and the sustainability of its ARPU.

New opportunities: Zain is a young operator owned by an international mobile group with ambitious expansion targets. As such, Zain's pursuit of a pure mobile strategy is no surprise; we think any investment in fixed-line assets will be very small. In our view, Zain has the sharpest focus of the three Saudi telecoms operators, with imaginative tariff packages and high media exposure. All the same, we do not believe that Zain has yet differentiated itself sufficiently from Mobily. Lack of fixed-line assets could also prove to be a long-run weakness.

Valuation: Using long-run discounted EVA valuation, we estimate fair value per share for Zain at SAR8.0 per share. Our fair value is 22% below the current price. A key reason for this is Zain's high fixed asset base: we forecast invested capital turnover at only 0.3x for 2010. This reflects the high price of US\$6.1bn that Zain paid for the third mobile licence in Saudi Arabia (capitalised as an asset on its balance sheet). We expect Zain to achieve EBITDA break-even on a full-year basis in 2010, but not to report a net profit till 2013, with annual depreciation and amortisation charges of around SAR1.9bn and high financial costs weighing on net income. As a loss-making company, EV/sales is a good measure by which to compare Zain with its peers. Zain's 2010 EV/sales ratio of 5.0x reflects its high net debt of SAR11.9bn. By comparison, STC trades on an EV/sales ratio of 2.1x and Mobily of 2.6x.

Stock rating and conclusion: While Zain is performing well operationally, it is highly indebted, with net debt set to reach 2.4x 2010 revenues by our estimate. This high debt burden reduces value for equity shareholders. Our target price for Zain is SAR8.0 (equal to fair value), and we rate it Underweight. In the event that our analysis is too harsh, investors should have a better chance to purchase Zain around two years from now, as net profit break-even draws closer.



Corporate summary

Zain KSA is the third-placed telecoms operator in Saudi Arabia, with a market value of nearly US\$4bn; it launched service in Q3 2008. By our estimate Zain has a market share of mobile accounts of 13%, although its revenue share is lower at 8-9%. Zain has no presence in the fixed-line market. Zain KSA is an affiliate of the Zain group of Kuwait; this is an emerging telecoms player operating in 24 markets in the Middle East and Africa, and serving over 69.5mn customers.

Share information

Market cap (SAR/US\$)	14.30 bn / 3.800 bn		
52-week range	10.15 - 13.25		
Daily avg volume (US\$)	13.6 mn		
Shares outstanding	1,400mn		
Free float (est)	45.0%		

Performance:	1M	3M	12M
Absolute	0%	-7.3%	-5.1%
Relative to index	-2.7%	-4.9%	-45.5%

Major Shareholders:

Mobile Telecommunications Co. (Kuwait)	25%
Faden Trading and Contracting	6.8%
Saudi Plastics	6.8%

Source: Bloomberg, Al Rajhi Capital

Valuation

Period End	12/09A	12/10E	12/11E	12/12E
Revenue (SARmn)	3,004	5,444	7,629	9,264
EBITDA (SARmn)	(1,072)	394	1,450	2,501
Net Profit (SARmn)	(3,098)	(1,890)	(956)	(108)
EPS (SAR)	(2.21)	(1.35)	(0.68)	(0.08)
DPS (SAR)	-	-	-	-
EPS Growth	36.0%	-39.0%	-49.4%	-88.7%
EV/EBITDA (x)	NA	69.3	19.3	11.0
P/E (x)	NA	NA	NA	NA
P/B (x)	1.7	2.1	2.5	2.5
Dividend Yield	0.0%	0.0%	0.0%	0.0%

Source: Company data, Al Rajhi Capital

Like its parent company, Zain KSA has ambitious targets

Strategy of Zain KSA

While Zain KSA is the smallest of the three Saudi operators, it is part of the much larger Zain group of Kuwait, which has a vision of becoming one of the top ten mobile operators globally by executing its “3x3x3” expansion plan by 2011. Like its parent, Zain KSA has ambitious goals. Zain is targeting mobile market share in Saudi Arabia of 30% by 2020, and aims to achieve this by capitalising on the following perceived strengths:

- Recognition of the Zain brand (already well-known even before service launch),
- Innovative pricing plans and commercial offers,
- A highly efficient, lean distribution platform,
- The experience of the Zain group in launching greenfield mobile operations

We would add another pillar to Zain KSA’s strategy: maximum outsourcing of operations, which is intended to improve efficiency and to allow a clear focus on customer management.

Zain has launched innovative and successful tariff plans

Zain’s pricing plans have enjoyed much success. A good example is its prepaid international plan, which permits users to connect to a favourite international number in any of six Asian countries at a favourable rate. Launched late last year, this service has proved very popular with – we assume – foreign migrant workers. This is the key reason why Zain increased mobile accounts from 4.3mn at the end of Q3 2009 to over 6.0mn by the end of December.

Still, in terms of strategy and customer perception, we see few substantive differences between Zain and Mobily

The main body of our report provides details of Zain’s other plans, e.g. its “One network” offer and “pay per day” broadband. We believe Zain has the most imaginative pricing plans in the Saudi mobile market. Nevertheless, in terms of strategy and customer perception, we see few substantive differences between Zain and the larger Mobily. Mobily offers several plans that are essentially parallel to Zain’s; we also regard Mobily’s offering to postpaid users as stronger. On balance, we consider Mobily’s market position and market image to be superior. Notably, Mobily is far stronger than Zain in the mobile data market where growth is surging.

Positive: very strong growth.
Negative: net debt represents nearly 50% of Zain’s EV

Implications of debt for fair value

We expect Zain KSA to achieve the strongest growth in market share, revenues and profits of the three Saudi operators over the coming decade. Nevertheless, we think Zain is overvalued even in our most optimistic scenario of a 50 year period of competitive advantage. The key reason for this is the company’s high debt load: net debt stood at SAR11.9bn at the end of 2009, and we think it will rise further in the near term. The debt burden lowers the portion of Zain’s enterprise value (EV) attributable to equity investors. At present, we calculate that debt represents 47% of EV for Zain, compared to 21% for STC and 19% for Mobily. We expect net debt to peak as a proportion of EV at 48-49% in 2010-11, and to decline steadily thereafter, turning negative in 2019, which is the year in which we assume Zain will first show net cash on its balance sheet. By contrast, we expect Mobily to have net cash by 2013.



Zain should achieve very strong growth over the next few years, albeit from a lower base than its rivals

We expect Zain to pay a dividend for 2013

The EBITDA margin should swing upwards rapidly from now on

Zain is not cheap on EV/sales, which is the simplest valuation measure for a loss-making company

Income Statement (SARmn)	12/08A	12/09A	12/10E	12/11E	12/12E
Revenue	505	3,004	5,444	7,629	9,264
Cost of Goods Sold	(489)	(2,127)	(3,196)	(3,891)	(4,447)
Gross Profit	16	877	2,248	3,738	4,817
Government Charges	-	-	-	-	-
S.G. & A. Costs	(1,281)	(1,949)	(1,854)	(2,289)	(2,316)
Operating EBIT	(1,700)	(2,466)	(1,567)	(596)	295
Cash Operating Costs	(1,770)	(4,076)	(5,050)	(6,180)	(6,763)
EBITDA	(1,265)	(1,072)	394	1,450	2,501
Depreciation and Amortisation	(435)	(1,394)	(1,961)	(2,045)	(2,206)
Operating Profit	(1,700)	(2,466)	(1,567)	(596)	295
Net financing income/(costs)	(226)	(634)	(372)	(385)	(406)
Forex and Related Gains	-	-	-	-	-
Provisions	-	-	-	-	-
Other Income	65	1	-	-	-
Other Expenses	(418)	(0)	-	-	-
Minority Interests	-	-	-	-	-
Net Profit Before Taxes	(2,278)	(3,098)	(1,938)	(981)	(111)
Taxes	-	-	48	25	3
Net Profit	(2,278)	(3,098)	(1,890)	(956)	(108)
Dividends	-	-	-	-	-
Transfer to Capital Reserve	-	-	-	-	-

	12/08A	12/09A	12/10E	12/11E	12/12E
Adjusted Shares Out (mn)	1,400	1,400	1,400	1,400	1,400
CFPS (SAR)	(1.317)	(1.217)	0.050	0.778	1.498
EPS (SAR)	(1.627)	(2.213)	(1.350)	(0.683)	(0.077)
DPS (SAR)	0	0	0	0	0

Growth	12/08A	12/09A	12/10E	12/11E	12/12E
Revenue Growth		494.6%	81.2%	40.1%	21.4%
Gross Profit Growth		5228.6%	156.3%	66.3%	28.9%
EBITDA Growth		-15.3%		268.0%	72.6%
Operating Profit Growth		45.1%	-36.5%	-62.0%	
Net Profit Growth		36.0%	-39.0%	-49.4%	-88.7%
EPS Growth		36.0%	-39.0%	-49.4%	-88.7%

Margins	12/08A	12/09A	12/10E	12/11E	12/12E
Gross profit margin	3.3%	29.2%	41.3%	49.0%	52.0%
EBITDA margin	-250.4%	-35.7%	7.2%	19.0%	27.0%
Operating Margin	-336.4%	-82.1%	-28.8%	-7.8%	3.2%
Pretax profit margin	-450.9%	-103.1%	-35.6%	-12.9%	-1.2%
Net profit margin	-450.9%	-103.1%	-34.7%	-12.5%	-1.2%

Other Ratios	12/08A	12/09A	12/10E	12/11E	12/12E
ROCE	-12.5%	-11.7%	-7.8%	-3.0%	1.5%
ROIC		-10.7%	-7.3%	-2.9%	1.5%
ROE	-38.9%	-30.5%	-24.6%	-15.3%	-1.9%
Effective Tax Rate	0.0%	0.0%	2.5%	2.5%	2.5%
Capex/Sales	5130.5%	63.0%	22.9%	21.0%	19.0%
Dividend Payout Ratio	0.0%	0.0%	0.0%	0.0%	0.0%

Valuation Measures	12/08A	12/09A	12/10E	12/11E	12/12E
P/E (x)	NA	NA	NA	NA	NA
P/CF (x)	NA	NA	202.5	13.1	6.8
P/B (x)	1.2	1.7	2.1	2.5	2.5
EV/Sales (x)	49.5	8.7	5.0	3.7	3.0
EV/EBITDA (x)	NA	NA	69.3	19.3	11.0
EV/EBIT (x)	NA	NA	NA	NA	93.0
EV/IC (x)	1.1	1.2	1.4	1.4	1.4
Dividend Yield	0.0%	0.0%	0.0%	0.0%	0.0%

Source: Company data, Al Rajhi Capital



With equity representing 31% of the balance sheet, Zain is undercapitalised compared to its peers

Balance Sheet (SARmn)	12/08A	12/09A	12/10E	12/11E	12/12E
Cash and Cash Equivalents	583	506	250	250	781
Current Receivables	317	1,007	2,060	2,689	3,179
Inventories	60	39	89	114	139
Other current assets	369	697	697	697	697
Total Current Assets	1,182	1,850	2,696	3,351	4,397
Fixed Assets	2,409	3,847	4,563	5,550	6,533
Investments	-	-	-	-	-
Goodwill	-	-	-	-	-
Other Intangible Assets	23,075	22,133	20,704	19,275	17,846
Total Other Assets	-	-	-	-	-
Total Non-current Assets	25,484	25,980	25,268	24,825	24,379
Total Assets	26,665	27,830	27,964	28,175	28,775
Short Term Debt	9,479	-	-	-	-
Trade Payables	3,055	6,247	7,425	7,880	8,589
Dividends Payable	-	-	-	-	-
Other Current Liabilities	556	543	543	543	543
Total Current Liabilities	13,090	6,789	7,967	8,423	9,131
Long-Term Debt	1,849	12,408	13,254	13,966	13,966
Other LT Payables	-	-	-	-	-
Provisions	4	10	10	10	10
Total Non-current Liabilities	1,854	12,418	13,264	13,976	13,976
Minority interests	-	-	-	-	-
Paid-up share capital	14,000	14,000	14,000	14,000	14,000
Total Reserves	(2,278)	(5,378)	(7,268)	(8,224)	(8,332)
Total Shareholders' Equity	11,722	8,622	6,732	5,776	5,668
Total Equity	11,722	8,622	6,732	5,776	5,668
Total Liabilities & Shareholders' Equity	26,665	27,830	27,964	28,175	28,775

We forecast that net debt will reach 2.4x revenues for 2010

Ratios	12/08A	12/09A	12/10E	12/11E	12/12E
Net Debt (SARmn)	10,745	11,902	13,004	13,716	13,185
Net Debt/EBITDA (x)	(8.49)	(11.11)	33.02	9.46	5.27
Net Debt to Equity	91.7%	138.0%	193.2%	237.5%	232.6%
EBITDA Interest Cover (x)	(5.6)	(1.7)	1.1	3.8	6.2
BVPS (SAR)	8.37	6.16	4.81	4.13	4.05

A large positive movement on working capital supported cash flow in 2009. This may not be sustainable

Cashflow Statement (SARmn)	12/08A	12/09A	12/10E	12/11E	12/12E
Net Income before Tax & Minority Interest	(2,278)	(3,098)	(1,938)	(981)	(111)
Depreciation & Amortisation	435	1,394	1,961	2,045	2,206
Decrease in Working Capital	796	2,065	76	(199)	194
Other Operating Cashflow	-	634	48	25	3
Cashflow from Operations	(1,048)	995	146	890	2,291
Capital Expenditure	(25,919)	(1,892)	(1,248)	(1,602)	(1,760)
New Investments	1	-	-	-	-
Others	65	3	-	-	-
Cashflow from investing activities	(25,853)	(1,889)	(1,248)	(1,602)	(1,760)
Net Operating Cashflow	(26,901)	(894)	(1,102)	(712)	531
Dividends paid to ordinary shareholders	-	-	-	-	-
Proceeds from issue of shares	14,000	-	-	-	-
Increase in Loans	13,710	1,080	846	712	-
Effects of Exchange Rates on Cash	-	-	-	-	-
Other Financing Cashflow	(226)	(262)	-	-	-
Cashflow from financing activities	27,484	818	846	712	-
Total cash generated	583	(77)	(256)	-	531
Cash at beginning of period	-	583	506	250	250
Implied cash at end of year	583	507	250	250	781

We expect the capex/sales ratio to decline steadily

Ratios	12/08A	12/09A	12/10E	12/11E	12/12E
Capex/Sales	5130.5%	63.0%	22.9%	21.0%	19.0%

Source: Company data, Al Rajhi Capital



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Additional disclosures

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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