المجموعة المالية - هيرميس
EFG HERMES

SAUDI TELECOM SECTOR NOTE

Will Growth Continue to Surprise?

16 JUNE 2008

SAUDI ARABIA | TELECOM

CONTENTS

I. Mobile Market 02

II. Fixed Line and Data Markets 09

Companies

Saudi Telecom Co. (STC) 12

Etihad Etisalat (Mobily) 38

Zain Saudi Arabia 47

• **Stronger-than-Expected Mobile Market Growth:** The Saudi mobile market racked up impressive subscriber growth in 2007 as the two incumbents Saudi Telecom Company (STC) and Etihad Etisalat (Mobily) ramped up growth ahead of the entry of the third operator. Subscriber came in at 27.0 million at the end of 2007, 10% higher than our forecast, implying a penetration rate of 109%.

• **Market Shares Broadly in Line:** STC's market share was 64% in 2007, down from 69% at the end of 2006, while that of Mobily was 36%, up from 31%. We expect Zain Saudi, which will start operations in July 2008, to have 1.3 million subscribers at the end of 2008e, implying a market share of 4.0%. In the longer term, or in 2015e, we expect STC to still have the highest market share, at 50%, followed by Mobily at 35% and Zain Saudi at 15%.

• **Upgrading Mobile Subscribers Forecasts:** We revise upwards our subscriber forecasts to reflect higher-than-expected growth in 2007. We now expect total subscribers to reach 33.4 million in 2008e, implying a penetration rate of 131%, up from 113% in our previous forecast. The mobile penetration rate in Saudi Arabia, at 109% at end-2007, was above the MENA average of 84% but still below that of Qatar, Bahrain and the UAE. We believe the entrance of the third operator, Zain Saudi, will stir up competition and push the penetration rate above our estimated addressable market size for its first two years.

• **We Expect Stronger Competition Once Zain Saudi Starts Operations:** We expect that Zain Saudi, to gain a large market share, will opt for an aggressive strategy that may put pressure on prices, but that it will do so in a rational way. We expect even more aggressive competition once Zain Saudi launches its commercial operations in light of: i) the current high penetration rate, ii) evidence of a pro-new-entrant regulatory environment that has helped Mobily gain a 31% market share in less than two years of operation, and iii) the high fee that Zain paid for its mobile license (SAR22.9 billion).

• **Fixed-Line Market Grows Modestly, ADSL to Drive Growth:** Fixed-line subscribers in Saudi Arabia grew to 4.1 million lines at end-2007, implying a penetration rate of 16.6%, slightly lower than our estimate for the year. We maintain our view that fixed-line growth will be driven by growth in the ADSL segment and not by demand for voice services. We therefore believe broadband penetration will increase to 33.2% in 2015e, up from only 2.5% in 2007.

• **We Upgrade LTFV of STC and Mobily and Initiate on Zain Saudi:** We remain buyers of both STC and Mobily and we upgrade our forecast and LT Fair Value for both companies to reflect stronger-than-expected mobile market performance in Saudi Arabia and the integration of STC's the newly acquired operations (Maxis, Oger Telecom and Kuwaiti operator) into our forecasts. We initiate coverage of Zain Saudi with a Sell recommendation. The company is expected to commence operations in the second half of 2008. The stock was listed at par of SAR10.0 but the price has since shot up 175% to SAR27.5 and is currently trading at a 157%-54% premium to our estimated equity value range. We refrain from estimating a fair value for the stock given the high start-up risk to our forecasts.

SECTOR NOTE

Companies Analyzed in this Note

	Current	Rec.				P/E (x)			EV/EBITDA (x)		Div. Yield	
(SAR)	Price	ST	LT	LTFV	07a	08e	09e	07a	08e	09e	07a	08e
STC	62.8	Buy	Buy	101.0	10.4	9.4	9.0	7.8	6.7	6.1	8.0%	8.8%
Mobily	54.3	Buy	Buy	85.6	19.7	14.4	12.0	12.0	9.3	7.9	0.9%	1.7%
Zain Saudi	27.5	Sell	Sell	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	0.0%

Prices ast at 15 June 2008

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I. MOBILE MARKET

MOBILE MARKET PERFORMANCE

Subscriber growth above expectations in 2007

In our initiation note on the Saudi telecom market "A Blue Ocean Market in the GCC – 9 July 2007", we forecasted that in 2007 subscriber growth in the Saudi market would be strong. In fact, the mobile market exceeded our expectations, adding some 7.4 million subscribers in 2007 versus the 4.9 million we had expected.

This was the Saudi mobile market's largest yearly subscriber addition ever. The total subscriber base increased to 27.0 million from 19.6 million as of end-2006, a 38% Y-o-Y increase and a substantial 10% above our forecast of 24.5 million. Saudi Telecom Company (STC) added 3.77 million subscribers, 91% more than our estimate, while Etihad Etisalat (Mobily) added 3.63 million, which was 23% more.

This implies a penetration rate of around 109% by the end of 2007 versus the 100% that we had been expecting, taking into account an adjustment in the 2007 actual population figure to 24.69 million, higher than our forecast 24.55 million.

Where did it come from?

We attribute the better-than-expected subscriber mobile growth to the following factors:

1. **A ramp up of additions prior to entry of the third operator:** Both STC and Mobily have sped up efforts to snap up subscribers by introducing new packages and promotions ahead of Zain's entrance at the end of June 2008. We believe an important factor driving subscriber additions has been a decline in prepaid tariffs, which dropped by a minimum 15% and helped spur further growth in the mobile market (we will tackle this point in more details later on).

2. **A larger-than-expected addressable market:** In our previous report, we estimated that the Saudi mobile addressable market would be around 30.4 million, or 121% of the population, at the end of 2008. The substantial growth witnessed last year, however, suggests we might have underestimated the addressable market size. Our new forecasts suggest that the addressable market could well be around 41.2 million, or 141% of the population in 2012e, versus our previous forecast of 126%.

RISK TO THE SUBSCRIBER FIGURES

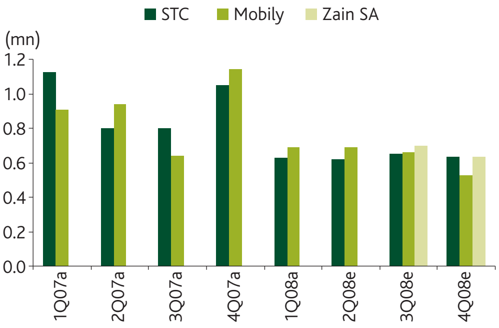
The CITC definition of active subscribers will be mandatory starting 1Q2008

The Communications and Information Technology Commission (CITC), Saudi Arabia's telecom regulatory authority, recently issued a directive requiring all operators to report their active subscribers based on the following definition: "Any subscriber making at least one chargeable event in a 90-day period". This decision will be effective starting 1Q2008. We believe the absence of a clear definition that operators must adhere to may imply a downside risk to these subscriber numbers, should any of these operators be using a definition less stringent than that newly issued by the CITC.

According to the CITC annual report for 2007, STC's subscribers reached 17.3 million at the end of 2007, while Mobily's subscribers reached 11.1 million. We however use 9.7 million active subscribers for Mobily, which we estimate to be the active number of subscribers and the same 17.3 million for STC, as indicated by the company's management as the active number.

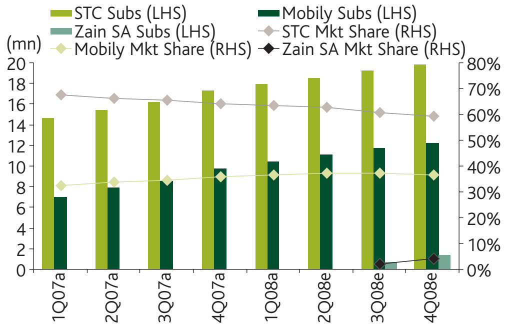
During 2007, STC's and Mobily's quarterly net additions were roughly equal. According to our estimates, the highest additions were in the fourth quarter, partly due to the annual pilgrimage (Hajj), when around 2-3 million pilgrims visited Saudi Arabia (see Figure 1.1).

Fig 1.1: STC, Mobily and Zain SA Quarterly Subscriber Additions (1Q2007-4Q2008)



Source: EFG-Hermes estimates

Fig 1.2: STC, Mobily and Zain SA Quarterly Subscribers and Market Share (1Q2007-4Q2008)



Source: EFG-Hermes estimates

MOBILE MARKET OUTLOOK

Table 1.3: Saudi Arabia Mobile Market Indicators

	2007a	2008e	2009e	2010e	2011e	2012e	2013e	2014e	2015e
Population (mn)	24.7	25.6	26.4	27.4	28.3	29.3	30.3	31.4	32.5
Addressable Mkt. (mn)	29.3	33.5	35.4	37.3	39.3	41.2	43.2	45.3	47.5
% of Population	*119%*	*131%*	*134%*	*136%*	*139%*	*141%*	*142%*	*144%*	*146%*
New Additions (mn)	7.4	6.4	5.3	2.8	1.5	1.0	0.9	0.9	1.0
Total Subscribers (mn)	**27.0**	**33.4**	**38.8**	**41.6**	**43.1**	**44.0**	**44.9**	**45.9**	**46.9**
Penetration to Addressable	92%	100%	110%	112%	110%	107%	104%	101%	99%
Penetration Rate	**109%**	**131%**	**147%**	**152%**	**152%**	**150%**	**148%**	**146%**	**144%**
STC									
STC Subscribers (mn)	17.3	19.8	21.4	22.2	22.5	22.8	23.0	23.2	23.5
STC Share of Additions	51%	39%	30%	25%	25%	25%	25%	25%	25%
STC Market Share	64%	59%	55%	53%	52%	52%	51%	51%	50%
Mobily									
Mobily Subscribers (mn)	9.7	12.3	13.9	14.7	15.2	15.5	15.7	16.0	16.3
Mobily Share of Additions	49%	40%	30%	30%	30%	30%	30%	30%	30%
Mobily Market Share	36%	37%	36%	35%	35%	35%	35%	35%	35%
Zain SA									
Zain Subscribers (mn)		1.3	3.5	4.7	5.4	5.8	6.2	6.6	7.1
Zain Share of Additions		21%	40%	45%	45%	45%	45%	45%	45%
Zain Market Share		4%	9%	11%	12%	13%	14%	14%	15%

Source: STC, Mobily, and EFG-Hermes estimates

REVISITING THE ADDRESSABLE MARKET ASSUMPTIONS

We increase our addressable market to 131% of the population in 2008

We upgrade our addressable market forecast for 2008e to 33.5 million, or 131% of the population, from our previous forecast of 30.4 million, or 121% of the population. For 2015e, we now forecast an addressable market of 47.5 million, or 146% of the population, versus our previous 37.8 million, or 126% of the population. The upgrade in forecasts comes on the back of:

i) Higher Population: Based on statistics provided by STC, the kingdom's population grew 3.2% to 24.69 million in 2007, versus our expectation of 24.55 million. We now forecast annual population growth of 3.5% instead of the 2.5% we had previously forecast. We attribute the strong growth mainly to an increasing number of expatriates moving to Saudi Arabia and to the GCC in general.

ii) More SIMs per person: In our segmentation of the addressable market (see our initiation of coverage on the Saudi Telecom Sector), we assigned 2.0 SIMs per employed national. We now increase this number to 2.3 SIMs to reflect a stronger-than expected uptake of subscribers, which may suggest that our earlier estimate was conservative. We nonetheless remain cautious about 2Q2008 subscriber numbers, which may show significant retreat in net additions, after the two operators begin reporting subscribers as per the CITC definition.

SUBSCRIBER FORECASTS

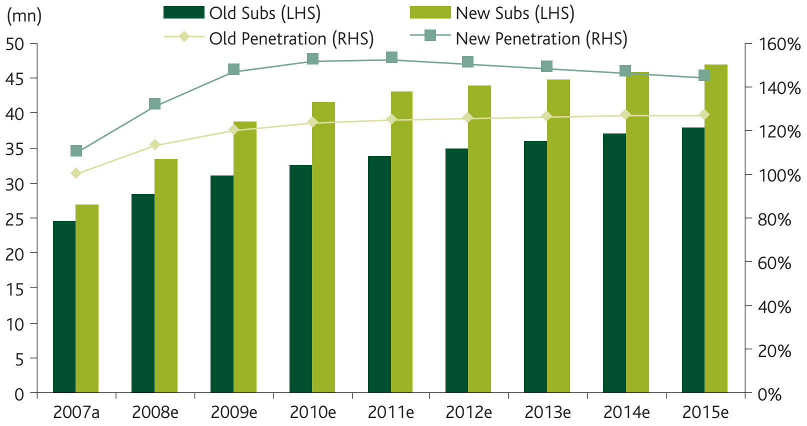
Penetration should go up to 131% by end of 2008, 144% in 2015

We expect mobile additions of 6.4 million in 2008e, lower than the 7.4 million added in 2007a. We expect additions to slow in 2009e to 5.3 million as the penetration to the addressable market hits the 100% mark. This should bring the total number of mobile subscribers in Saudi Arabia to 33.4 million in 2008e and 38.8 million in 2009e. As with other MENA markets, we expect the contribution of prepaid subscribers to the total to continue increasing, rising to 82% in 2008e from 76% in 2006. Neither company reports its prepaid/postpaid subscriber breakdown on a regular basis.

Our new subscriber forecasts suggest a penetration rate of 131% in 2008e, up from 113% in our old forecasts. The entrance of the third operator, Zain Saudi, is expected to stir up competition that may result in the penetration rate exceeding our estimated addressable market size for its first two years, a trend we have seen in the UAE since the entrance of the second mobile operator du in February 2007. Penetration in the UAE as of the end of March 2008 jumped to 161% from 126% a year earlier - higher than our addressable market estimate of 139%.

Going forward, we forecast net additions to fall to around 2.8 million in 2010e and eventually to stabilize at around 1 million annually. We forecast total subscribers to climb to 44.0 million by 2012e, which represents a five-year CAGR of 10%. The penetration rate is expected to reach a peak of 152% by 2011e and to stabilize going forward at the 144% level. As figure 1.4 below shows, this is more aggressive than our previous penetration forecast, which assumed a penetration rate of 127% by 2015e.

Figure 1.4: New versus Old Forecasts for Mobile Subscribers and Penetration Rate in Saudi Arabia

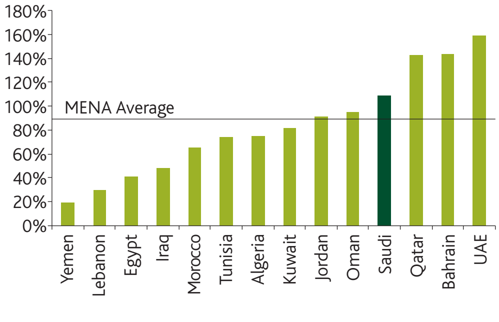


Source: Companies, EFG-Hermes estimates

Mobile penetration above MENA average but below other comparable countries

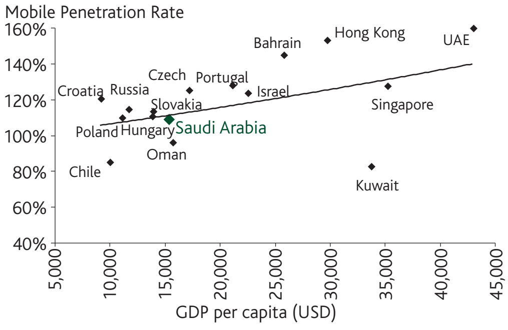
The mobile penetration rate in Saudi Arabia, at 109%, is above the MENA average of 84% but still below those of Qatar, Bahrain and the UAE, which exceeded 140% in 2007. Since our last report, the mobile penetration rate in Saudi Arabia increased to 109% in 2007 from around 82% in 2006.

Fig 1.5: Mobile Penetration Rate Across MENA Region (2007)



Source: Regulators, ITU

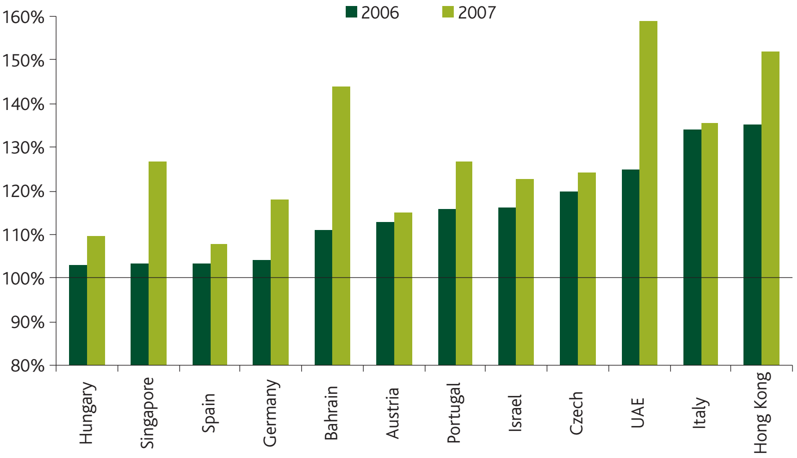
Fig 1.6: Mobile Penetration Rate versus GDP per Capita for Comparable Countries (2007)



Source: Regulators, ITU, and IMF

Figure 1.7 below shows that countries which exceeded the 100% penetration rate in 2006 continued to add subscribers in 2007. This shows that it is not enough to look at penetration rates, and that one should look at the potential market size or the addressable market to know whether the market is saturated or still has room for growth.

Figure 1.7: Mobile Penetration Rate for Selected Countries in 2006-2007



Source: Regulators, ITU

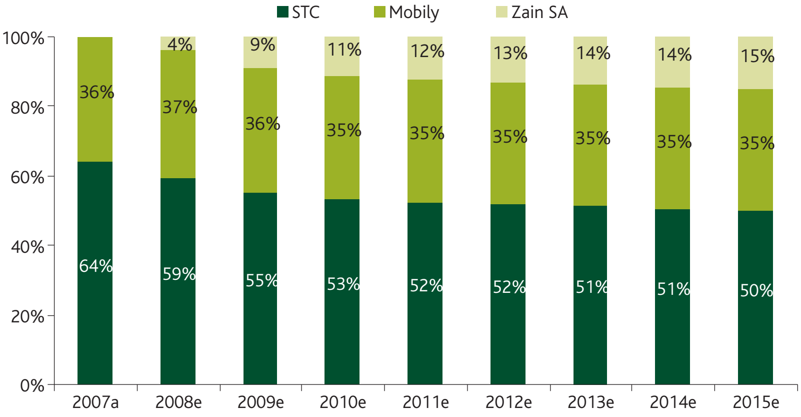
MARKET SHARES

According to our estimates and based on management indication, STC ended 2007 with a 64% market share, down from 69% in 2006, while Mobily ended the year at 36%, up from 31%. This was in line with our expected 63%/37% market share split for 2007.

Zain to gain 4.0% market share in 2008

For 2008, we forecast that Zain Saudi, with 1.3 million subscribers, will be able to capture a 4.0% market share in its first year of operation. We expect that most of the incumbents' market share loss will come from STC, whose market share we forecast will fall to 59%. Mobily's market share, on the other hand, will remain at the 37% level. Going forward, we forecast that Mobily will be able to preserve a market share in the range of 34-35%, while STC as the incumbent with the highest number of subscribers will stabilize its market share at around 50%. STC plans to stabilize its market share at around 55%, according to management, however we prefer to remain conservative for the time being and be positively surprised.

Figure 1.8: Subscriber Market Share by Operator



Source: Companies, EFG-Hermes estimates

We forecast more aggressive competition once Zain Saudi launches commercial operations

Since its liberalization, Saudi Arabia's mobile market has never taken the form of a lazy duopoly. Competition between STC and Mobily has since been strong, with both operators intensifying their offers and promotions and launching aggressive advertising campaigns. We expect even more aggressive competition once Zain Saudi launches its commercial operations in light of: i) the current high penetration rate, ii) evidence of a pro-new-entrant regulatory environment that has helped Mobily gain a 31% market share in less than two years of operation, and iii) the high fee that Zain paid for its mobile license (SAR22.9 billion). Despite the different market dynamics, the Egyptian mobile market after the entrance of third mobile operator, Etisalat Misr, is a case in point: Less than one year after the entrance of the third operator, competition prompted substantial tariff decreases in the range of 33-57%.

STC and Mobily filling the gaps

In our initiation of coverage, we suggested that the third operator faces two main factors that could help it gain a competitive advantage: i) tariff levels prevailing in the Saudi market are relatively high, and ii) the market is under-segmented in terms of the number of packages offered.

In the past six months, however, both STC and Mobily have intensified efforts to fill these gaps and boost their market shares to get as many new subscribers as possible before the entrance of Zain Saudi.

1- TARIFFS

STC and Mobily slashed prepaid tariffs

Prepaid tariffs, which constitute the majority of subscribers in Saudi Arabia, decreased in the second half of 2007 by a minimum of 15% and are now around SAR0.55 (USD0.15), as highlighted in Table 1.9. We believe that the lower prepaid tariffs played a significant role in accelerating subscriber growth, especially in the last quarter of 2007. Postpaid tariffs, on the other hand, remained stable from last year at an average SAR0.41 (USD0.11) per minute for STC and SAR0.38 (USD0.10) for Mobily.

In addition to lower prepaid tariffs, Mobily offered its subscribers a promotion that removes the monthly fee for the first year of their subscription. The promotion applied to all new subscribers and all subscribers who migrate their numbers using MNP. STC also removes monthly fees for subscribers who migrate to it through MNP.

Table 1.9: Some of STC and Mobily Tariffs for Selected Products

	STC		
	Old Tariffs	New Tariffs	Comment
Postpaid Packages			
JAWAL 25	0.45 - 0.50	0.45 - 0.50	No change
JAWAL 35	0.40 - 0.45	0.40 - 0.45	No change
JAWAL 45	0.30 - 0.45	0.30 - 0.45	No change
Prepaid Packages			
SAWA	0.65 - 0.85	0.55	A decline of 15% to 35%

The first rate is for on-net calls, second is for off-net calls

	Mobily		
	Old Tariffs	New Tariffs	Comment
Postpaid Packages			
Khatty	0.45	0.45	No change
Khatty Plus	0.30	0.30	No change
Prepaid Packages			
7ala		**0.55**	New offer since August 2007, per second billing We believe the aim of this offer is to replace Anees and Wafeer
Anees	0.83 - 0.73	0.83 - 0.73	Not used anymore. Only existing subscribers can continue using it
Wafeer	0.79 - 0.69	0.79 - 0.69	Not used anymore. Only existing subscribers can continue using it
Fallah	0.65 - 0.35	0.65 - 0.35	This offer targets the youth

The first rate is a peak, second is off-peak; except for Wafeer where the first rate is for the first and second minute and the second rate applies from the third minute

Source: Companies, EFG-Hermes estimates

2- MARKET SEGMENTATION

Well into the first half of 2007, the Saudi market did not enjoy adequate market segmentation. Mobile operators offered the population only a limited number of packages regardless of its different segments. However, a careful follow-up of the Saudi mobile market over the past few months suggests that STC and to a larger extent Mobily have been quite successful in addressing this issue. Mobily, for example, has launched a product, "Najma" that specifically targets women, another, "Blue Wave", that targets supporters of Al Hilal soccer team and a third, "Fallah", designed to appeal to youth. STC also introduced "Lana", a product targeting the youth segment in addition to its mass market prepaid product "Sawa".

Again, What Can a Third Operator Do?

We expect that Zain Saudi will opt for an aggressive pricing strategy to gain a large market share, but will do so in a rational way to minimize the payback period for the license. Furthermore, the presence of STC in Kuwait, Zain's domicile market, will in our view limit the eruption of price wars in Saudi Arabia that could potentially backfire on Zain in Kuwait.

"One Network"

This nevertheless raises the question of what options Zain Saudi does have. Zain Group has been quite vocal about the new "One Network" service it now offers its Middle Eastern subscribers. "One Network" allows subscribers to make calls and send SMSs at local rates and receive calls free of charge when traveling in member countries. The service is automatically activated when Zain subscribers cross borders, with no need for pre-registration, extra fees or roaming deposits. The service was originally launched by Zain Group in Africa through its fully-owned subsidiary Celtel. Zain Saudi Arabia is expected to join "One Network" once it begins commercial services.

While we believe the service is quite innovative and should encourage subscribers who regularly travel between these countries to subscribe to Zain's services, we believe it will not have a significant effect on Zain's additions. After all, STC has presence in India and Indonesia, while Etisalat (Mobily's parent company) is present in Egypt and Pakistan. This could allow them to adopt similar call discounts for the countries of origin of the majority of Saudi Arabia's expatriates.

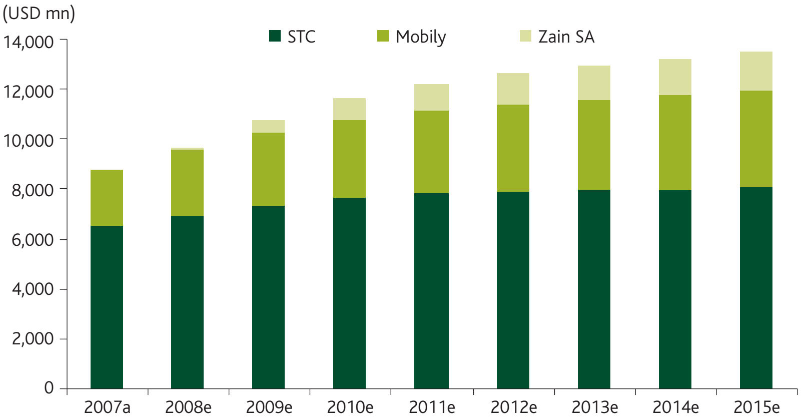
MOBILE USAGE

Spending on mobile services increased 10% in 2007

Saudi spending on mobile services in 2007 increased 10% Y-o-Y to an estimated USD8.0 billion, in line with our forecast. STC, at 74.8%, maintained the largest contribution to the total, down from 80.7% in 2006. We forecast that despite an increase in competition that will put pressure on ARPUs, spending on mobile services in the Saudi market over the next three years will continue its pattern of strong growth due to subscriber growth and an increased focus on value-added services and 3G applications.

We expect that starting in 2011, growth in total spending will slow to around 3% annually. We estimate that total spending on mobile services will grow at an eight-year CAGR of 5.6% to SAR13,516 million by 2015e.

Figure 1.10: Annual Spending on Mobile Services in Saudi Market

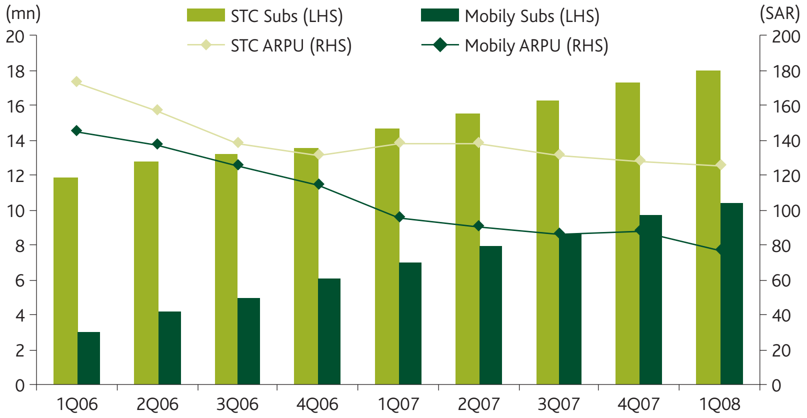


Source: STC, Mobily, and EFG-Hermes estimates

Faster-than-expected ARPU dilution...

We calculate that STC blended monthly ARPU (excluding connection fees and including roaming) dropped 16% in 2007 to SAR131 (USD35), down from SAR155 (USD41) in 2006. Mobily's blended monthly ARPU fell by even more, sliding 23% to SAR89 (USD24). This is explained by both a decline in prepaid tariffs and higher-than-expected growth in subscriber additions, which inevitably leads to faster ARPU dilution. STC's ARPU came in 5.8% lower and Mobily's 8.2% lower than our estimates. Both operators nevertheless surprised on the upside in terms of subscriber additions, which compensated for the lower-than-expected ARPU, resulting in revenue for both operator coming in line with our estimates.

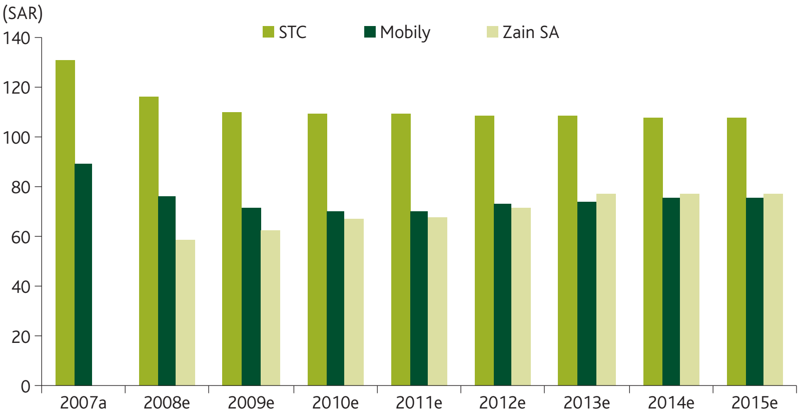
Figure 1.11: STC and Mobily Quarterly ARPUs (1Q2006-1Q2008)



Source: EFG-Hermes estimates

Going forward, we forecast that ARPUs will drop by a lower rate as subscriber growth slows. We expect STC's ARPU to drop at a five-year compounded rate of 3.6% to SAR109 (USD29) by 2012e and Mobily's at a five-year compounded rate of 4.3% to SAR72 (USD19). We expect Zain Saudi to have a blended monthly ARPU of SAR59 (USD16) in its first year of operation.

Figure 1.12: ARPU Forecasts for the Three Operators



Source: EFG-Hermes estimates

II. FIXED-LINE AND DATA MARKETS

FIXED-LINE MARKET

Table 2.1: Saudi Arabia Fixed-line Market Indicators

	2007a	2008e	2009e	2010e	2011e	2012e	2013e	2014e	2015e
Population (mn)	24.7	25.6	26.4	27.4	28.3	29.3	30.3	31.4	32.5
Addressable Mkt. (mn)	4.6	5.1	5.4	5.6	6.1	6.4	6.6	6.9	7.2
% of Population	*18.6%*	*20.0%*	*20.3%*	*20.6%*	*21.6%*	*21.7%*	*21.8%*	*21.9%*	*22.0%*
New Additions (mn)	0.11	0.15	0.36	0.49	0.41	0.39	0.37	0.35	0.34
Total Subscribers (mn)	**4.10**	**4.25**	**4.61**	**5.10**	**5.51**	**5.90**	**6.28**	**6.63**	**6.97**
Penetration to Addressable	89%	83%	86%	90%	90%	93%	95%	96%	97%
Penetration Rate	**17%**	**17%**	**17%**	**19%**	**19%**	**20%**	**21%**	**21%**	**21%**
STC									
STC Subscribers (mn)	4.10	4.21	4.40	4.65	4.83	4.99	5.14	5.25	5.35
STC Share of Additions	100%	70%	55%	50%	45%	40%	40%	30%	30%
STC Market Share	100.0%	98.9%	95.5%	91.2%	87.7%	84.5%	81.9%	79.1%	76.7%
Other Operators									
Others Subs (mn)		0.05	0.21	0.45	0.68	0.91	1.14	1.38	1.62
Others Share of Additions		30%	45%	50%	55%	60%	60%	70%	70%
Others Market Share		1.1%	4.5%	8.8%	12.3%	15.5%	18.1%	20.9%	23.3%

Source: STC, EFG-Hermes estimates

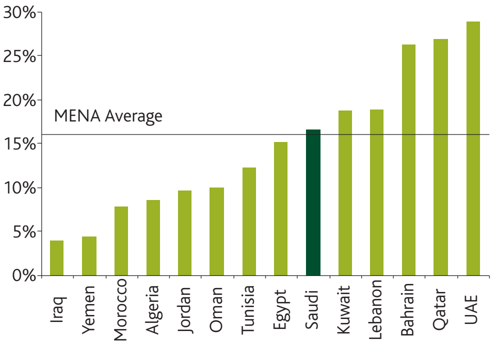
Fixed-line subscribers grow modestly to 4.1 million lines

As we had forecast, Saudi fixed-line subscribers grew by a modest 2.8% to 4.10 million lines in 2007 from 3.99 million a year before, implying a penetration rate of 16.6%, unchanged from 2006. This implies that the Saudi fixed-line market, in line with other markets in the region, is undergoing fairly strong fixed-to-mobile substitution.

It is apparent that while Saudi Arabia's fixed-line penetration rate is relatively high compared that to the MENA region as a whole, it is still well below those of neighboring GCC markets, which implies there is still some room for growth. When plotted against countries with similar GDP per capita, we find that Saudi Arabia comes below average.

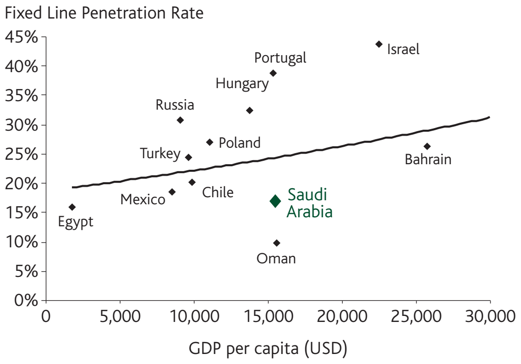
We continue to believe that additions of new subscribers will not be driven mainly by demand for voice services, but by the growth in the ADSL segment.

Fig 2.2: Fixed-Line Penetration Rate Across the MENA Region (2007)



Source: Regulators, ITU, and EFG-Hermes

Fig 2.3: Fixed-Line Penetration Rate vs. GDP per Capita for Comparable Countries (2007)



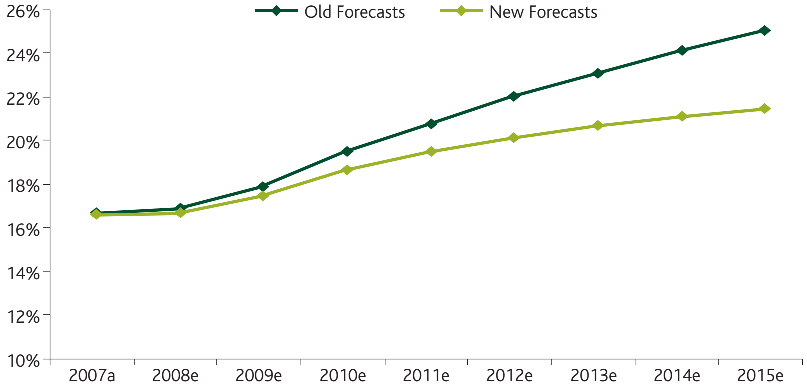
Source: Regulators, ITU, and EFG-Hermes

Downward revision of fixed-line subscribers

We have revised our subscriber forecasts slightly downward even though fixed-line additions were in line with our expectations. This is due to: i) the announcement that new fixed-line operators would enter the market later than we had forecast, and ii) higher-than-expected mobile subscriber growth, which suggests faster fixed-to-mobile substitution.

Our new fixed-line penetration forecasts, as illustrated in chart 2.4 below, appear slightly lower than our old forecasts due to both the lower subscriber forecasts and the higher population estimates. We believe that fixed-line subscribers should grow at an eight-year CAGR of 6.8% to 6.97 million lines in 2015, or a penetration rate of around 21%, as new entrants and more innovative products stimulate further market growth.

Figure 2.4: Old versus New Fixed-Line Penetration Rate Forecasts



Source: STC, EFG-Hermes estimates

Delay in entry of competition

Until now, STC continues to maintain a monopoly over the fixed-line segment, as the three new entrants that received fixed-line licenses in April 2007 from the CITC have yet to launch their services. We had been expecting their entry in mid-2008, but Etihad Atheeb, the consortium led by Bahrain's Batelco, now expects to launch services in late 2008, while the two other consortiums led by Hong-Kong's PCCW and US's Verizon will launch in 2009.

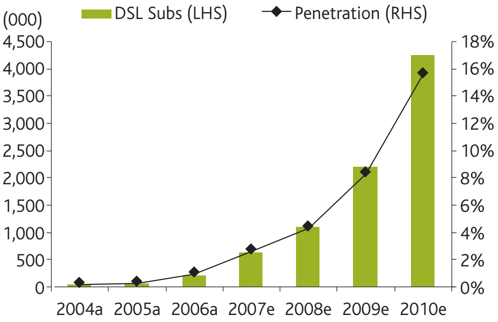
We expect STC to maintain its lead in market share, as we forecast that the cumulative market share of the three new entrants will reach 23% in 2015 and their share of new additions will increase to around 45% in 2009 and around 70% in 2015. Over the past few months, STC has tried to stimulate subscriber additions through several fixed-line products and offers. These include "Jood", a new fixed-line product that allows subscribers to make unlimited local and national calls for a flat monthly subscription of SAR99. Subscribers can also choose two mobile numbers that they can call at a 25% discount.

INTERNET AND DATA MARKET

Broadband to offer huge value in the longer term

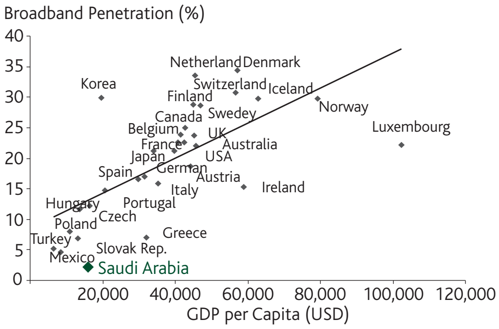
In our initiation of coverage in July 2007, we held the view that the broadband and high-bandwidth segment (both fixed-line and mobile) would lead the second wave of telecom growth after voice usage growth began to slow down. This was based on extremely low ADSL penetration levels (less than 1% for DSL) and favorable demographics. The surprisingly aggressive move on the part of the CITC to license three new fixed-line operators proved that the Saudi regulator understood clearly that the broadband market was under-penetrated and that it was willing to take sufficient measures to increase its growth.

Fig 2.5: Evolution of DSL Subscribers and Penetration Rates in Saudi Arabia (2004 – 2010)



Source: STC, EFG-Hermes estimates

Fig 2.6: Broadband Penetration Rate versus GDP per Capita for Selected Countries (June 2007)



Source: OECD, IMF, and EFG-Hermes estimates

Broadband penetration rate as of end-2007 estimated at around 2.5%

We estimate that Saudi DSL subscribers grew 186% Y-o-Y to 623,000 subscribers as of end-2007, up from 218,000 as of end-2006. This implies a penetration rate of around 2.5% in 2007, up from 0.9% in 2006. STC had 602,704 DSL subscribers at the end of 2007, with an estimated market share of 97%. If we estimate one broadband line for each 2.5 users, this implies a user penetration rate of around 6.5%, still very low compared with the OECD average of 18.8%. Figure 2.6 above shows that Saudi Arabia lies significantly below average, even when compared with countries with similar GDP per capita.

We believe the number of broadband subscribers should exceed 1 million in 2008 and 2 million in 2009, when all three new fixed-line licensees will have become operational. STC intensified its efforts over the past few months to assert its presence in the market prior to the arrival of the competition through a number of offers and promotions, including decreasing monthly DSL subscription rates by 17%-26%, increasing the speeds available in preparation for more advanced services and eliminating connection fees when installing new landlines.

Mobily, on the other hand, is focusing increasingly on wireless broadband services to ensure a place in the burgeoning segment; its acquisition of data-service provider Bayanat al-Oula after it failed to obtain a fixed-line license is a case in point.

المجموعة المالية - هيرميس
EFG HERMES

SAUDI TELECOM COMPANY

Expansions to Pay Off

16 JUNE 2008

SAUDI ARABIA | TELECOM

ST Rec.: Buy	Current Price*: SAR 62.8
LT Rec.: Buy	LT Fair Value : SAR 101.0

CONTENTS

I. Valuation 13

II. 1Q2008 Results Review 16

III. Saudi Operation 18

IV. Maxis 20

V. Kuwait Operation 25

VI. Oger Telecom 27

VII. New Forecasts 33

- **1Q2008 Strong Margins and Earnings Growth:** STC's 1Q2008 results came in strong with better-than-expected margins and net profit. Consolidated revenue grew 21% Y-o-Y, driven by 24% mobile revenue growth. We understand that consolidated revenue for 1Q2008 includes revenue from Maxis operations (Malaysia and India), 25% owned by STC and proportionally consolidated. We estimate that revenue from Saudi operations made up around 93% of total revenue for 1Q2008. EBITDA surprised positively, growing 23% Y-o-Y, 12% higher than our estimate due to a better-than-expected EBITDA margin of 49.4% and better cost control. Net profit grew 11% Y-o-Y, 8.5% higher than our estimates.

- **Finally a Multi-Country Player:** In 2007, STC bought a 25% stake in Maxis and a 62% stake in NTS (Maxis's Indonesian operation). The same year, STC won a 26% stake in Kuwait's newly established third mobile operator and in early 2008 bought a 35% stake in Oger Telecom. After a busy year of M&A activities, STC has finally evolved from a single-country player to a multi-country player, with operations in Saudi Arabia, Malaysia, India, Indonesia, Turkey, South Africa and Kuwait.

- **We Upgrade Our Forecasts and Integrate the New Operations:** We upgrade our Saudi operations revenue forecasts to reflect the growth in mobile subscribers. We also integrate into our forecasts the newly acquired operations, including Maxis, Oger Telecom and the Kuwaiti operation. We expect non-Saudi operations to contribute 25% of STC's consolidated revenue in 2008 and 33% in 2015. We expect consolidated revenue to grow at a five-year CAGR of 10.7%, EBITDA at 9.4% and net profit at 6.6%.

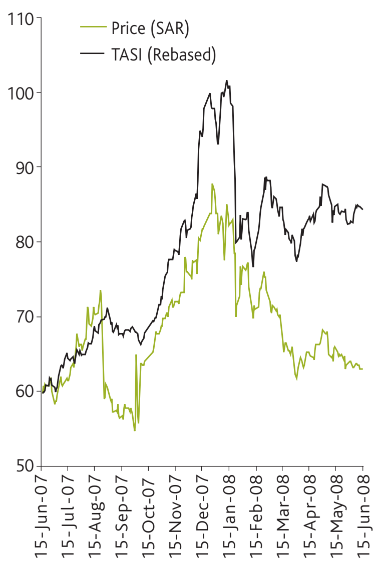
- **We Raise our LTFV to SAR101.0:** Our new estimated equity value for STC, at SAR202 billion, is 14.3% higher than our previous estimate. The Saudi operations contribute 90% of our total estimated equity value, followed by Maxis at 5.3% and Oger Telecom at 5.2%. We value the Kuwaiti operation at SAR208 million.

- **STC is One of Our Top Picks in the Region, and We Remain Buyers:** STC currently trades at attractive multiples compared to regional average multiples. The stock trades at 2009 P/E of 9.0x versus the regional average of 12.6x and an EV/EBITDA of 6.1x versus the average of 7.5x. STC also generates very strong cash flows, offering one of the region's highest FCF yields: 11.8% for 2009 versus an average of 8.2%. We reiterate our Buy recommendation on the stock, which currently offers 61% upside potential over and above the market price.

December year end	*2007a*	*2008e*	*2009e*	*2010e*
Operating Income (mn)	*12,807*	*16,056*	*17,304*	*18,107*
Net Income (Attr.) (mn)	*12,022*	*13,420*	*13,966*	*14,945*
ROE	*33.5%*	*35.0%*	*34.7%*	*35.4%*
EPS	*6.01*	*6.71*	*6.98*	*7.47*
Earnings Growth	*-6.1%*	*11.6%*	*4.1%*	*7.0%*
P/E (Attrib.)	*10.4*	*9.4*	*9.0*	*8.4*
DPS	*5.00*	*5.50*	*6.00*	*6.50*
Dividend Yield	*8.0%*	*8.8%*	*9.6%*	*10.4%*
BVPS	*17.94*	*19.15*	*20.13*	*21.10*
P/BV	*3.5*	*3.3*	*3.1*	*3.0*
CFPS (Operating CF)	*7.73*	*9.62*	*11.20*	*11.59*
P/CF	*8.1*	*6.5*	*5.6*	*5.4*
EBITDA	*16,906*	*22,125*	*24,264*	*25,323*
EBITDA Margin	*49.1%*	*46.7%*	*45.8%*	*46.0%*
*EV/EBITDA***	*7.8*	*6.7*	*6.1*	*5.7*
*EV/Sub***	*4,165*	*3,912*	*3,308*	*2,896*
Net Debt (Cash) (mn)	*5,962*	*23,615*	*22,019*	*19,391*
Net Debt (Cash)/ BV	*16.6%*	*61.7%*	*54.7%*	*45.9%*
Net Debt (Cash)/ Mkt cap	*4.8%*	*18.8%*	*17.5%*	*15.5%*

Fig in SAR unless otherwise stated

** Proportionate*



Estimate Changes

	2007a	*2008e*		*2009e*	
(SAR mn)		*Old*	*New*	*Old*	*New*
Revenue	*34,458*	*35,103*	*47,360*	*35,517*	*52,991*
EBITDA	*16,906*	*16,288*	*22,125*	*16,370*	*24,264*
EBITDA Margin	*49.1%*	*46.4%*	*46.7%*	*46.1%*	*45.8%*
Net Attrib. Income	*12,022*	*12,378*	*13,420*	*12,586*	*13,966*

Stock Data

Last Ex-Div Date	*SAR1.0 on 03 May 2008*
Mkt. Val. (mn)	*SAR125,500*
Shares (mn)	*2,000*
Av. Mthly Liqd. (mn)	*SAR2,481*
52-Week High / Low	*SAR87.8 / 54.0*
Bloomberg / Reuters	*STC AB / 7010.SE*
Est. Free Float	*20.0%*

**prices as of 15 June 2008*

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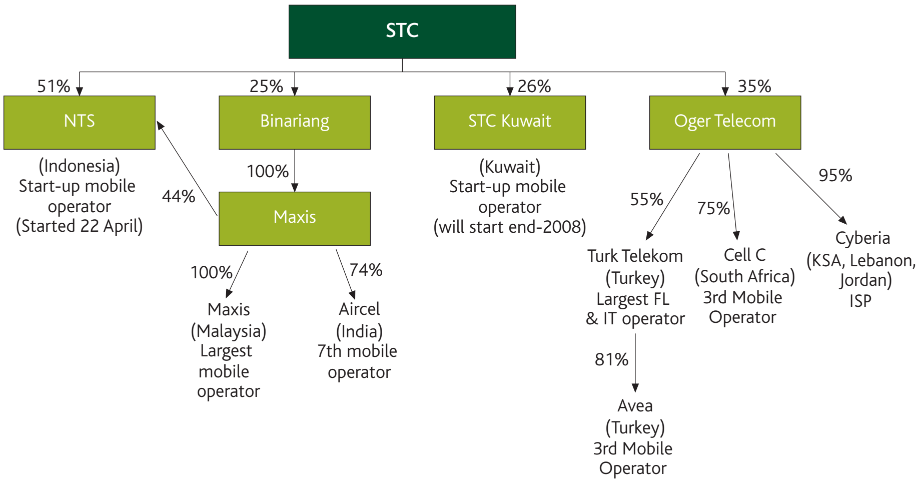
I. VALUATION

Finally a multi-country player

Saudi Telecom Company (STC) has evolved from a single-country to a multi-country player in the past year, with operations in Saudi Arabia, Malaysia, India, Indonesia, Turkey, South Africa and Kuwait. It was one of the region's late movers: until recently STC was a local operation with a clean balance sheet and sitting on significant amounts of cash. In June 2007, STC bought a 25% stake in Maxis (Malaysia, India and Indonesia) and a 62% effective stake in NTS (Maxis's Indonesian operation). It won a 26% stake in Kuwait's newly established third mobile operator in November 2007 and agreed to buy a 35% stake in Oger Telecom in January 2008 (Turkey and South Africa).

Figure 1.1: STC's Subsidiaries and Investments


STC
51%
25%
26%
35%
NTS
Binariang
STC Kuwait
Oger Telecom
(Indonesia)
Start-up mobile
operator
(Started 22 April)
44%
100%
Maxis
(Kuwait)
Start-up mobile
operator
(will start end-2008)
55%
75%
95%
Cyberia
(KSA, Lebanon,
Jordan)
ISP
100%
74%
Maxis
(Malaysia)
Largest
mobile
operator
Aircel
(India)
7th mobile
operator
Turk Telekom
(Turkey)
Largest FL
& IT operator
Cell C
(South Africa)
3rd Mobile
Operator
81%
Avea
(Turkey)
3rd Mobile
Operator

Source: EFG-Hermes

Table 1.2: Important Indicators for STC's Main Operations (end of 2007)

(As of 2007)	Population (mn)	GDP Per Capita (USD)	Mob. Penetr. Rate	FL Penetr. Rate	STC Subs* (mn)	STC Mobile Mkt Share	Total Mkt Players
Saudi Arabia***	25	14,800	109%	17%	17.3	64.1%	3**
Malaysia	27	6,948	85%	16%	9.7	41.7%	3
India	1,138	978	21%	3%	9.4	4.0%	11+
Indonesia	229	1,925	45%	8%	-	N/A	11
Turkey***	71	9,629	87%	26%	9.9	16.1%	3
South Africa	48	5,906	93%	10%	4.8	10.8%	3
Kuwait	3	33,634	82%	19%	-	N/A	3

*Mobile subscribers only

**Third operator Zain Saudi Arabia will start operations in July 2008

***STC has fixed-line operations in both Saudi Arabia and Turkey

Source: IMF, ITU, Regulators, and EFG-Hermes

Acquisitions now, consolidation later?

While we are generally positive on STC's recent acquisitions and believe they expose the company to some of the fastest growing markets in the world, especially India, these do not always provide STC with full management control. Both Maxis and Oger Telecom are proportionately consolidated into STC financials, which implies a degree of management control, but this has not been made clear by STC. The company has management control over its 62% owned Indonesian operation, and we expect it to have management control over the Kuwaiti operation.

We believe the lack of full management control presents an opportunity for STC to consolidate its ownership in the underlying subsidiaries and could be a potential value driver if acquisitions were made on value-accretive terms.

We upgrade our LTFV by 14.3% to SAR101.0

We continue to use a DCF-based sum-of-the-parts (SOTP) valuation approach to separately value STC's operations. We reached a total estimated equity value for STC of SAR202.0 billion, 14.3% higher than our previous value. This translates into a Fair Value of SAR101.0 per share. We maintain our ST/LT Buy recommendation on the stock. The reasons for the upgrade in our estimated equity value are:

• The Saudi operation's better-than-expected subscriber growth and margins that led to a 8.3% upgrade in our estimated equity value. The Saudi operation contributes 90% of STC's total value, or SAR181 billion.

• The switch to a DCF-based valuation for Maxis from one based on the acquisition price we previously used for our SOTP valuation. The DCF valuation renders a value 9.3% higher than the USD2.6 billion (SAR9.75 billion) acquisition price. Maxis represents 5.3% of our estimated Fair Value, or SAR10.7 billion.

• The integration of STC's stake in the Kuwaiti third operator and of Oger Telecom into our forecasts and valuation. Oger Telecom contributes 5.2% to our valuation, while Kuwait's contribution is minimal to STC's total value. We value the Kuwaiti operation at SAR208 million. Acquiring a license in Kuwait was more a strategic move than an attractive expansion opportunity, in our view.

Table 1.3: DCF Sum-of-the-Parts Valuation for STC

	Consolidation Method	Equity Value / Hold. Company Debt (SAR mn)	STC's Stake	Prop. Value (SAR mn)	Per Share (SAR)	% of Total Value
STC (Saudi Arabia)	Full	180,911	100%	180,911	90.46	89.5%
Maxis						
Maxis (Malaysia)	Proportionate	44,287	25%	11,072	5.54	5.5%
Aircel (India)	Proportionate	15,159	19%	2,804	1.40	1.4%
NTS (Indonesia)	Proportionate	3,718	62%	2,305	1.15	1.1%
Binariang Holding Debt		(22,080)	25%	(5,520)	(2.76)	-2.7%
Kuwait	Proportionate*	208	26%	54	0.03	0.0%
Oger Telecom						
Turk Telekom (Turkey)	Proportionate	66,375	19%	12,777	6.39	6.3%
Cell C (South Africa)	Proportionate	9,549	26%	2,507	1.25	1.2%
Oger Telecom Holding Debt		(13,875)	35%	(4,856)	(2.43)	-2.4%
Total Equity Value				**202,054**	101.0	

*Based on our assumption. STC has not yet determined the consolidation method for its Kuwait operation

Source: EFG-Hermes

DETAILED ACCOUNT OF THE VARIOUS DEBTS

Table 1.4: STC Total Debt Breakdown

Loan Holder	Loan Value	STC's Prop. Stake (SAR mn)	Purpose	Terms
A. Acquisitions / Holding Company Loans				
STC	**SAR6,000 mn Murabaha**	**6,000**	To finance 50% of the acqusition price of Binariang (Maxis' Holding Company)	Maturity: 60 months, Commission: SIBOR + 0.25%
Binariang (Maxis' Holding Company)	**SAR22,080 mn Sukuks**	**5,520**	Acquisition of the remaining stake in Maxis to raise Binariang's holding to 100%	N / A
B. Operational Loans				
Saudi Operation	**SAR1,983 mn Murabaha and Tawarroq**	**1,983**	To finance internal operations	Varying maturities till 2009, variable commissions, not yet utilized
Maxis	**SAR6,825 mn**	**2,060**	To finance internal operations	N / A

Borrowings are as of 31 December 2007

Source: STC, EFG-Hermes estimates

In companies with a structure similar to STC's, it is important to differentiate between two types of debt for accounting and valuation purposes:

i) Holding Company Debts: These are held at the holding company level and are generally used to finance the acquisition of subsidiaries. Binariang, the holding company which owns Maxis, has debt of SAR22.1 billion. This was taken to finance the acquisition of the 40% stake in Maxis that Binariang did not own. STC's stake in Binariang's debt is SAR5.5 billion. In turn, STC, which in this case would be treated as a holding company, took a SAR6.0 billion murabaha, a form of Islamic financing, to finance part of its acquisition of 25% of Binariang. Another subsidiary, Oger Telecom, has a debt of SAR13.9 billion used to finance its purchase of Turk Telekom. STC's chairman announced to the media in February 2008 that the company was in the final stages of borrowing SAR9.6 billion to finance its acquisition of 35% of Oger Telecom. We estimate the SAR9.6 billion will appear on STC's books in 2008, so it does not appear in Table 1.4, which shows total debts as of December 2007.

ii) Operational Debts: This is the debt taken at the operating subsidiaries level and used to finance operations. The sum of these debts is SAR8.8 billion, with STC's attributable debt at SAR4.0 billion.

II. 1Q2008 RESULTS REVIEW

1Q2008 revenue increases 21% Y-o-Y, in line with estimates

STC's consolidated revenue for 1Q2008 increased 21% Y-o-Y but slid 1% Q-o-Q to SAR9,575 million, in line with our estimate of SAR9,771 million. STC restated its 1Q2007 revenue figure for comparative reasons. The company indicated that this was due to a change in recognition of pre-paid sales proceeds from gross to net after dealer's commission. Administrative and marketing expenses were also revised. All of 2007 will be restated in the remaining quarterly results that the company will issue for 2008. We note that our quarterly revenue estimate is based on gross revenue, while the reported figure is based on net revenue.

Mobile revenue drives growth, fixed-line revenue still picking up

Mobile revenue for 1Q2008 grew 24% Y-o-Y but declined 2% Q-o-Q to SAR7,045 million, only 4% below our estimate. Mobile revenue made up 73.6% of total revenue. Fixed-line revenue, which has been growing on a quarterly basis since 2Q2007 after having been in decline since 2Q2006, grew 12% Y-o-Y and 2% Q-o-Q, 4% above our estimate. We understand that consolidated revenue for 1Q2008 includes revenue from the operations of Maxis (Malaysia and India), which is 25% owned by STC and proportionally consolidated. The company did not provide a revenue breakdown by country of operations, but we estimate that revenue from the Saudi operation made up around 93% of total revenue for 1Q2008.

EBITDA surprises on the upside, driven mainly by lower-than-expected access charges

EBITDA surprised positively at SAR4,733 million (+23% Y-o-Y, +12% Q-o-Q), 11.6% higher than our estimate. The 1Q2008 EBITDA margin of 49.4% (1Q2007a: 48.4%, 4Q2007a:44.0%) was better than our estimate of 43.4%. The better-than-expected margin was partially due to our estimate being based on gross revenue, but mainly due to better-than-expected cost control.

RESTATEMENT OF COSTS

All cost items surprised on the upside, but the main positive surprise was that access or interconnection charges were 27% below our estimate on both an absolute basis and as percentage of revenue (11.9% of revenue, down from 14.4% in 4Q2007). Interconnection charges were below our estimates partly due to STC restating the figure in 1Q2008. Restated interconnection charges for 1Q2007 were 12% lower than the original figure. Administrative and marketing expenses were also restated, and the impact was more significant than on interconnection charges. Restated administrative and marketing expenses for 1Q2007 were 40% lower than original figures.

Net profit was SAR3,029 million (+11% Y-o-Y, -1% Q-o-Q), 8.5% higher than our estimate of SAR2,792 million.

Dividends for the quarter may indicate a slight shift in dividend policy

The company's board of directors recommended an interim dividend distribution of SAR2,000 million, or SAR1 per share, for the first quarter of 2008. This implies a DPO of 66% based on 1Q2008 net profit and represents 18% of the total dividend distribution we estimate for 2008. We expect a total dividend distribution of SAR11.0 billion in 2008, representing a payout ratio of 82%.

The company distributed a total dividend of SAR11,500 million in FY2006, implying a 90% dividend payout ratio (DPS: SAR5.75). This fell to SAR10,000 million in FY2007, or a 83% dividend payout ratio (DPS: SAR5.00). The expected decline in the dividend payout ratio is largely due to the company's aggressive expansions over the past year.

Table 2.1: STC Historical Versus Forecast Quarterly Income Statement

Income Statement (SAR mn)	1Q07a*	4Q07a	1Q08a	*Q-o-Q*	*Y-o-Y*	1Q08e**	*Dif.*
Mobile Revenue	5,672	7,162	7,045	*-2%*	*24%*	7,330	*-4%*
FL Revenue	2,266	2,473	2,530	*2%*	*12%*	2,441	*4%*
Revenue	**7,938**	**9,635**	**9,575**	*-1%*	*21%*	**9,771**	*-2%*
Government Expenses	(1,180)	(1,326)	(1,218)			(1,253)	
Interconnection Expenses	(956)	(1,386)	(1,144)			(1,563)	
Employee Expenses	(1,103)	(1,192)	(1,147)			(1,235)	
Admin. and Marketing Expenses	(377)	(902)	(890)			(919)	
Repairs and Maintenance Expenses	(479)	(593)	(443)			(561)	
EBITDA	**3,843**	**4,236**	**4,733**	*12%*	*23%*	**4,241**	*12%*
EBITDA Margin	***48.4%***	***44.0%***	***49.4%***			***43.4%***	
Depreciation & Amortization	(923)	(1,245)	(1,335)			(1,112)	
EBIT	**2,920**	**2,991**	**3,398**	*14%*	*16%*	**3,129**	*9%*
EBIT Margin	***36.8%***	***31.0%***	***35.5%***			***32.0%***	
Cost of Manpower Imp. Program	(125)	(2)	(150)			(125)	
Interest Income (Expenses)	110	58	33			(100)	
Earnings from Investments	2	1	28			-	
Others	(46)	76	(107)			5	
PBMI	**2,862**	**3,124**	**3,203**	*3%*	*12%*	**2,909**	*10%*
Minority Interest		-	0.9			0.5	
PBT	**2,862**	**3,124**	**3,204**	*3%*	*12%*	**2,909**	*10%*
Provision for Zakat	(143)	(29)	(96)			(73)	
Provision for Taxes	-	(42)	(78)			(44)	
Net Income	**2,719**	**3,053**	**3,029**	*-1%*	*11%*	**2,792**	*9%*
EPS	1.36	1.53	1.51			1.40	
DPS	1.25	1.25	1.00				

*1Q2007 revenue, access charges, administrative and marketing expenses were restated

**Our estimates for 1Q2008 revenue are based on gross revenue

Source: STC, EFG-Hermes estimates

III. SAUDI OPERATION

SUBSCRIBERS AND ARPUs

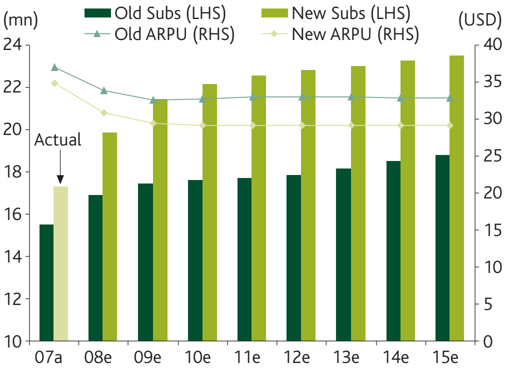
Subscribers higher than expected and ARPU lower

We estimate that STC's ARPU in 2007 fell by 16% Y-o-Y to SAR131 (USD34.9), only 6% lower than our original forecast. Mobile subscribers were 17.3 million, 12% higher than our forecast.

We upgrade our mobile subscriber forecasts for STC and for the Saudi market as a whole. We downgrade our forecasts for STC's ARPUs due to the stronger-than-expected subscriber growth forecast, which resulted in faster ARPU dilution. Our ARPU estimate is based on the company's gross revenue and would be slightly downgraded if we were to use net revenue.

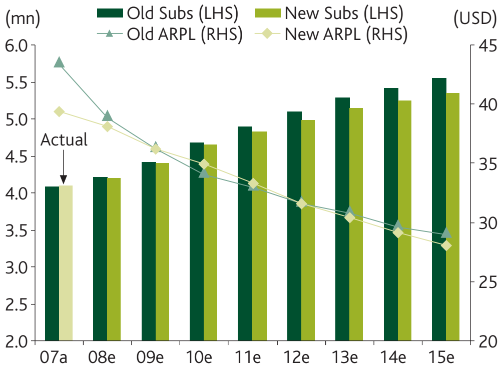
STC had 4.1 million fixed-line subscribers in 2007, in line with what we had expected. ARPL was SAR148 (USD39.4), 9% below our estimate, which we expect was partially due to mobile cannibalization, especially in broadband services. We therefore slightly reduce our long-term ARPL forecasts for STC.

Fig 3.1: New Versus Old Mobile Subscribers and ARPU Forecasts for STC



Source: STC, EFG-Hermes estimates

Fig 3.2: New Versus Old Fixed-Line Subscribers and ARPL and Forecasts for STC



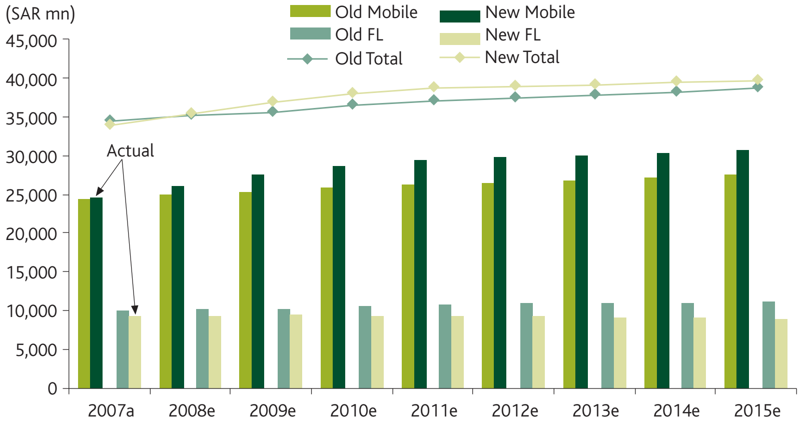
Source: STC, EFG-Hermes estimates

REVENUE

We revise upward total revenue forecast for Saudi Arabia

We estimate that revenue at the Saudi operations grew 4.3% in 2007 to SAR33.8 billion, in line with our original forecast. STC provided consolidated FY2007 figures, which included proportionately consolidated 4Q2007 results for Maxis. We therefore have calculated revenue for the Saudi operations alone based on our estimates for Maxis numbers. Mobile revenue, the main driver of total revenue growth, was exactly as we had expected and constituted 73% of FY2007 total revenue for Saudi Arabia. Fixed-line revenue was 8% below our estimate. As a result of changing our forecasts for both the mobile and fixed-line business, our forecasts for mobile revenue increased but decreased slightly for fixed-line revenue. The net effect was a minimal increase in total revenue for the Saudi operations over our forecast period.

Figure 3.3: New Versus Old Mobile and Fixed-Line Revenue Forecast for STC's Saudi Operation



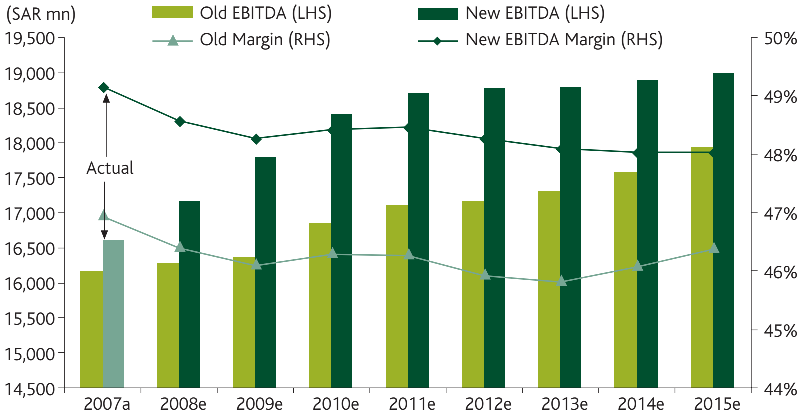
Source: STC, EFG-Hermes estimates

EBITDA

Strong 2007 margin, better than expected

Our calculated EBITDA for Saudi operations in FY2007 was SAR16.6 billion, ahead of our estimate. The EBITDA margin, at 49.2% in FY2007, came in better than expected but was slightly lower than the 50.9% of FY2006. We raised our forecast for the EBITDA margin and now expect it to stabilize at 48% at the end of our forecast period, up from our previous forecast of 46%.

Figure 3.4: New Versus Old EBITDA and EBITDA Margin Forecast for STC's Saudi Operation



Source: STC, EFG-Hermes estimates

VALUATION

Higher value for local operations due to higher margins and top-line growth

We arrived at an estimated equity value of SAR181 billion for STC's local operations, 8.3% higher than our previous estimate, which was mostly driven by upgrading our EBITDA forecasts. We used our previous cost of equity of 10.5% (risk free rate: 5.0%, equity risk premium: 5.5%). Our 10.0% WACC was 33 basis points lower than our previous figure due to higher debts.

Table 3.5: KPIs and DCF Valuation for STC's Saudi Operation

(SAR mn)		**2007a**	**2008e**	**2009e**	**2010e**	**2011e**	**2012e**	**2013e**	**2014e**	**2015e**
Total Subscribers		21.4	24.0	25.9	26.8	27.4	27.8	28.1	28.5	28.8
ARPU (SAR)		130.8	115.9	110.4	109.4	109.5	109.2	109.2	109.1	109.1
ARPL (SAR)		147.7	143.1	135.9	130.9	124.8	118.6	114.1	109.3	105.4
Total Revenue		33,788	35,337	36,867	38,008	38,618	38,905	39,080	39,339	39,546
EBITDA		16,611	17,167	17,795	18,407	18,714	18,784	18,794	18,896	18,997
EBITDA Margin		***49.2%***	***48.6%***	***48.3%***	***48.4%***	***48.5%***	***48.3%***	***48.1%***	***48.0%***	***48.0%***
CAPEX & Change in WC		(3,899)	(4,936)	(4,579)	(4,499)	(3,475)	(3,356)	(3,367)	(3,604)	(3,376)
Zakat		(385)	(327)	(337)	(350)	(368)	(369)	(367)	(369)	(369)
FCF		**12,327**	**11,904**	**12,879**	**13,558**	**14,870**	**15,058**	**15,060**	**14,923**	**15,252**
Cost of Equity	10.5%									
Cost of Debt	5.2%									
Weight of Debt	9.9%									
Weight of Equity	90.1%									
WACC	10.0%									
Terminal Growth	2.5%									
EV	**177,632**									
Net Debt (Cash)*	(3,280)									
Equity Value	**180,911**									
LTFV (SAR)	**90.5**									

*Represents debts used to acquire Maxis (SAR6.0 billion) and Oger Telecom (SAR9.6 billion), in addition to SAR2.0 billion operational debt. Net debt includes 2008 estimated dividends

Source: EFG-Hermes estimates

IV. MAXIS

MALAYSIA - MAXIS

Table 4.1: Malaysia Mobile Market Indicators

(mn)	2007a	2008e	2009e	2010e	2011e	2012e	2013e	2014e	2015e
Population	27.4	28.0	28.6	29.1	29.7	30.3	30.9	31.5	32.2
Mobile Market Indicators									
Mobile Addressable Mkt.	24.2	25.8	27.4	29.4	31.5	32.7	34.0	35.3	36.7
Additions	3.9	2.9	2.5	1.9	1.3	0.9	0.7	0.7	0.6
Subscribers	**23.3**	**26.3**	**28.7**	**30.6**	**31.9**	**32.8**	**33.6**	**34.2**	**34.8**
Penetration to Addressable	97%	102%	105%	104%	101%	100%	99%	97%	95%
Penetration Rate	85%	94%	101%	105%	107%	108%	109%	109%	108%
Maxis									
Maxis Subscribers	9.7	10.9	11.8	12.4	12.8	13.1	13.3	13.5	13.7
Maxis Market Share	42%	41%	41%	40%	40%	40%	40%	39%	39%
Telekom Malaysia (Celcom)									
Celcom Subscribers	7.2	8.0	8.7	9.2	9.5	9.7	9.9	10.1	10.2
Celcom Market Share	31%	31%	30%	30%	30%	30%	30%	29%	29%
DiGi									
DiGi Subscribers	6.4	7.3	8.0	8.6	9.1	9.4	9.6	9.8	10.0
DiGi Market Share	27%	28%	28%	28%	28%	29%	29%	29%	29%
Others									
Others Subscribers		0.1	0.2	0.2	0.1	0.1	0.1	0.1	0.1
Others Market Share		0%	1%	1%	2%	2%	2%	3%	3%

Source: Operators, EFG-Hermes estimates

Relatively mature market with penetration exceeding 85%

Malaysia had a population of 27.4 million and a GDP per capita of USD6,948 at the end of 2007. The Malaysian mobile sector is dominated by three mobile operators: Maxis, Celcom (Telekom Malaysia) and DiGi. More than one operator is expected to enter the market in 2008, including a new 3G and mobile virtual network operator (MVNO) licensee, U-Mobile, which launched 3G MVNO services in early 2008. The mobile market is relatively mature, with 23.3 million subscribers. The mobile penetration rate increased to around 85% at the end of 2007 from 72% at the end of 2006. In our view, it would be hard to sustain more than four operators on the long term in this market.

Competitive landscape about to get more aggressive

We expect the competitive landscape to become more aggressive as new operators enter the market and when mobile number portability (MNP) is introduced. This service has been delayed several times, but is now expected to start in 2008.

Maxis's market share to stabilize in the low forties in the long run

Maxis is the leading mobile operator in terms of market share, which was 42% at the end of 2007, followed by Celcom at 31% and DiGi at 27%. Maxis's subscribers grew 21% in 2007 to 9.7 million. We forecast that Maxis Malaysia's subscribers will grow at a five-year subscriber CAGR of 6.1% to 13.1 million by the end of 2012, implying a market share of 40%. Because of Maxis's strong position in the Malaysian market, we do not expect its market share to fall below this level going forward despite the entry of new players and the introduction of MNP. Maxis also offers fixed-line and broadband services, which contribute only 2% to total revenue.

We calculate that the company's ARPU was around USD18.6 in 2007, and we expect it to decline at a five-year compounded rate of 4.0% to USD15.2 in 2012. We estimate that the EBITDA margin fell to 52% in 2007 from 54% in 2006 and will stabilize in the low fifties going forward. We forecast a five-year earnings CAGR of 7.6% from 2007 to 2012. Our forecasts do not take into account revenue generated from leasing infrastructure to MVNOs.

VALUATION

We estimate Maxis Malaysia will contribute 5.5% of STC's value

We use a DCF model to reach a valuation for Maxis's Malaysian operation. We calculate Malaysia's equity value at USD11,810 million, which implies a proportionate equity stake for STC of USD2,952 million. This will add SAR5.54 to our estimated Fair Value for STC. Our assumptions are based on a WACC of 8.9% based on a 9.2% cost of equity (risk free rate: 4.2%, equity premium: 5.0%), and a 7.0% cost of debt.

Table 4.2: KPIs and DCF Valuation for Maxis Malaysia

(USD mn)	**2007a**	**2008e**	**2009e**	**2010e**	**2011e**	**2012e**	**2013e**	**2014e**	**2015e**
Total Subscribers (mn)	8.1	9.7	10.9	11.8	12.4	12.8	13.1	13.3	13.5
ARPU (USD)	18.6	18.2	16.9	16.0	15.5	15.2	14.9	14.7	14.5
Revenue	2,343	2,430	2,492	2,531	2,562	2,591	2,608	2,632	2,653
EBITDA	1,218	1,239	1,246	1,265	1,281	1,296	1,304	1,316	1,327
EBITDA Margin	*52.0%*	*51.0%*	*50.0%*	*50.0%*	*50.0%*	*50.0%*	*50.0%*	*50.0%*	*50.0%*
CAPEX & Change in WC	(582)	(308)	(301)	(314)	(305)	(306)	(308)	(306)	(307)
Taxes	(134)	(166)	(174)	(189)	(193)	(194)	(197)	(198)	(199)
FCF	**502**	**765**	**771**	**763**	**783**	**796**	**799**	**812**	**820**

WACC	8.9%
Terminal Growth	3.0%
EV	**12,612**
Net Debt (Cash)	802
Equity Value	**11,810**
STC Stake (25%)	**2,952**
Value per STC share (SAR)	**5.54**

Source: EFG-Hermes estimates

INDIA - AIRCEL

Table 4.3: India Mobile Market Indicators

(mn)	**2007a**	**2008e**	**2009e**	**2010e**	**2011e**	**2012e**	**2013e**	**2014e**	**2015e**
Population	1,138	1,156	1,174	1,192	1,211	1,229	1,249	1,268	1,288
Mobile Market Indicators									
Mobile Addressable Mkt.	597.7	618.5	639.8	661.7	684.0	706.9	730.4	754.4	779.0
Additions	84.0	108.4	106.2	106.2	81.8	54.8	35.6	23.1	15.0
Subscribers	**233.6**	**342.0**	**448.2**	**554.4**	**636.1**	**690.9**	**726.5**	**749.7**	**764.7**
Penetration to Addressable	39%	55%	70%	84%	93%	98%	99%	99%	98%
Penetration Rate	21%	30%	38%	46%	53%	56%	58%	59%	59%
Aircel									
Aircel Subscribers	9.4	16.7	25.0	34.3	43.0	49.9	54.8	57.9	59.9
Aircel Market Share	4%	5%	6%	6%	7%	7%	8%	8%	8%
Bharti									
Bharti Subscribers	55.2	84.4	112.0	138.6	159.0	172.7	181.6	187.4	191.2
Bharti Market Share	24%	25%	25%	25%	25%	25%	25%	25%	25%
Reliance									
Reliance Subscribers	41.0	56.1	71.5	86.9	99.1	107.3	112.6	116.0	118.3
Reliance Market Share	18%	16%	16%	16%	16%	16%	15%	15%	15%
Hutch Essar (Vodafone)									
Essar Subscribers	39.9	61.0	81.7	102.3	118.1	128.7	135.1	139.3	142.0
Essar Market Share	17%	18%	18%	18%	19%	19%	19%	19%	19%
Others									
Others Subscribers	88.2	123.8	158.0	192.3	216.9	232.3	242.4	249.0	253.3
Others Market Share	38%	36%	35%	35%	34%	34%	33%	33%	33%

Source: Regulator, Operators, and EFG-Hermes estimates

Indian telecom market offers impressive growth

The Indian telecom market has grown with impressive speed over the last few years, with the penetration rate exceeding 20% at the end of 2007, up from 4% at the end of 2004. This shows the market's strong growth potential. Total subscribers using both GSM and CDMA technologies grew 56% Y-o-Y to 234 million in 2007. There is substantial room for growth given India's population of over 1 billion and its relatively low mobile penetration rate. The Indian telecom regulator identifies 23 geographic "circles" with separate licenses. Calls made to numbers within each circle are treated as local and calls to other circles as long distance. Of the more than 11 mobile operators in India, only five are licensed to operate within all 23 circles. Bharti Airtel leads with a 24% market share, followed by Reliance with 17% and Vodafone Essar with 17%.

Aircel is a small player in India's telecom landscape

Aircel, 74% owned by Maxis, is one of the smaller Indian operators, with a 4% market share and only 9.43 million subscribers at the end of 2007. Aircel increased the number of licenses it had to include all 23 circles, up from only nine. We forecast that Aircel will be able to increase its market share to 7.2% in 2012 and 7.8% by 2015, when it will have around 60.0 million subscribers. We estimate that Aircel's ARPU was USD5.8 in 2007 and expect it to fall at a four-year compounded rate of 7.3% to USD4.3 by 2011. We estimate Aircel's 2007 EBITDA margin was 33% and that margins will stabilize in the low 30s going forward.

VALUATION

Aircel Contributes 1.4% of STC's Fair Value

We estimate an equity value of USD4,042 million for Aircel based on a DCF model. Our cost of equity is based on a 7.5% risk free rate and an equity premium of 5.5%. We use a WACC of 12.4% and a terminal growth rate of 5.0%. STC's effective stake in Aircel is 18.5%. This implies STC's proportionate equity value is USD748 million (SAR 2,804 million), or SAR1.4 per STC share.

Table 4.4: KPIs and DCF Valuation for Aircel

(USD mn)	2007a	2008e	2009e	2010e	2011e	2012e	2013e	2014e	2015e
Total Subscribers (mn)	9.4	16.7	25.0	34.3	43.0	49.9	54.8	57.9	59.9
ARPU (USD)	5.8	5.4	5.0	4.6	4.3	4.1	4.0	4.0	3.9
Revenue	515	877	1,291	1,682	2,026	2,339	2,560	2,702	2,793
EBITDA	170	281	400	521	638	748	845	905	950
EBITDA Margin	*33.0%*	*32.0%*	*31.0%*	*31.0%*	*31.5%*	*32.0%*	*33.0%*	*33.5%*	*34.0%*
CAPEX & Change in WC	(666)	(470)	(532)	(514)	(440)	(408)	(433)	(342)	(337)
Taxes	(3)	(20)	(32)	(43)	(56)	(70)	(84)	(92)	(94)
FCF	**(499)**	**(209)**	**(164)**	**(36)**	**142**	**270**	**327**	**471**	**519**

WACC	12.4%
Terminal Growth	5.0%
EV	**3,800**
Net Debt (Cash)	(243)
Equity Value	**4,042**
STC Stake (18.5%)	**748**
Value per STC share (SAR)	**1.40**

Source: EFG-Hermes estimates

INDONESIA - NTS "AXIS"

Table 4.5: Indonesia Mobile Market Indicators

(mn)	2007a	2008e	2009e	2010e	2011e	2012e	2013e	2014e	2015e
Population	229	232	235	238	241	244	247	250	253
Mobile Market Indicators									
Mobile Addressable Mkt.	164	168	172	176	180	184	189	193	197
Additions	34.8	31.3	23.5	15.3	9.9	6.9	5.9	5.3	5.0
Subscribers	**103.9**	**135.2**	**158.6**	**173.9**	**183.8**	**190.8**	**196.7**	**202.0**	**207.0**
Penetration to Addressable	63%	81%	92%	99%	102%	104%	104%	105%	105%
Penetration Rate	45%	58%	68%	73%	76%	78%	80%	81%	82%
NTS - Axis									
NTS Subscribers		2.5	6.0	8.8	11.0	12.5	13.7	14.9	16.1
NTS Market Share		2%	4%	5%	6%	7%	7%	7%	8%
Telkomsel (Singtel)									
Telkomsel Subscribers	47.9	58.5	66.3	71.2	74.2	76.4	78.2	79.9	81.4
Telkomsel Market Share	46%	43%	42%	41%	40%	40%	40%	40%	39%
Indosat									
Indosat Subscribers	24.5	31.1	35.8	38.7	40.6	41.9	43.0	44.0	45.0
Indosat Market Share	24%	23%	23%	22%	22%	22%	22%	22%	22%
Excelcommindo (XL)									
XL Subscribers	15.5	21.1	25.2	27.8	29.4	30.5	31.4	32.3	33.1
XL Market Share	15%	16%	16%	16%	16%	16%	16%	16%	16%
Others									
Others Subscribers	16.0	21.9	25.4	27.4	28.6	29.5	30.2	30.8	31.4
Others Market Share	15%	16%	16%	16%	16%	15%	15%	15%	15%

Source: Operators, EFG-Hermes estimates

Attractive Market: Large population, penetration still at 45%

Indonesia is very attractive for mobile operators: It had a population of 229 million at the end of 2007 and around a 104 million subscribers, implying a mobile penetration rate of 45%. The telecoms landscape is very competitive, with five mobile operators and six CDMA-based fixed-wireless operators. Three GSM-based operators dominate the market: Telkomsel (Singtel) with an end-2007 market share of 46%, Indosat with 24% and Excelcommindo (Telekom Malaysia) with 15%. The market in 2007 added 34.8 million subscribers, up almost 85% Y-o-Y. We believe competition will intensify in the next few years due to the large number of players, of which a significant number are small new entrants looking to increase their market share. A 20% to 40% reduction in the interconnection tariffs that took effect in April should also reduce tariffs and increase competition.

Wave of consolidation?

We believe it is highly possible that a wave of consolidation will hit the Indonesian market over the long term due to the large number of operators. We believe this may provide STC with a good opportunity.

Natrindo Telepon Seluler (NTS), with both GSM and 3G licenses, is the newest player in the market. It re-launched its operations on 22 April 2008 under the brand name "Axis" and plans to achieve national coverage by 2009. NTS had been present in the Indonesian market for a few years, but faced hurdles in launching its operations. News reports quoted its CEO Eric Aas as saying that NTS's strategy is to offer simpler, more transparent and competitive pricing than that of its competitors. NTS is looking to acquire more than 1 million subscribers in its first year of operation and a 10% market share in three years.

We forecast that NTS in 2008 will be able to capture 2.5 million subscribers, or a 1.8% market share. We expect that by 2015 it will expand its market share to 7.8%, with 16.1 million subscribers, a seven-year CAGR of 31%. We expect that NTS's market share will only be 6% after three years, lower than the company's estimate, which we believe is too bullish.

We forecast EBITDA breakeven in 2010 and earnings breakeven in 2011

We forecast an entry ARPU of USD5 for the first year, which will eventually drop to USD3.8 by 2015. We expect the company to break even on an EBITDA level in 2010 after two years of operations and on a net profit level in 2011 after three years.

VALUATION

1.1% contribution to STC's total value

We reached an estimated equity value of USD991 million for NTS based on a WACC of 11.6% and a terminal growth rate of 5.0%. We use a relatively high cost of equity of 14.25% (risk free rate: 7.75%, equity risk premium: 6.5%) to account for the start-up nature of the operation. STC's 62% effective stake is estimated at USD615 million, or SAR1.2 per share. NTS's contribution to the total equity value estimate of STC is only 1.1%.

Table 4.6: KPIs and DCF Valuation for NTS

(USD mn)		**2008e**	**2009e**	**2010e**	**2011e**	**2012e**	**2013e**	**2014e**	**2015e**
Total Subscribers (mn)		2.5	6.0	8.8	11.0	12.5	13.7	14.9	16.1
ARPU (USD)		5.0	4.8	4.6	4.4	4.2	4.1	4.0	3.8
Revenue		75	243	408	521	597	644	680	709
EBITDA		(31)	(17)	86	156	233	258	272	284
EBITDA Margin		*-42.2%*	*-7.0%*	*21.0%*	*30.0%*	*39.0%*	*40.0%*	*40.0%*	*40.0%*
CAPEX & Change in WC		(31)	(37)	78	145	218	252	269	282
Taxes		(500)	(400)	(150)	(75)	(50)	(50)	(45)	(45)
FCF		**(562)**	**(454)**	**13**	**226**	**401**	**459**	**496**	**520**
WACC	11.6%								
Terminal Growth	5.0%								
EV	**939**								
Net Debt (Cash)	(53)								
Equity Value	**991**								
STC Stake (62%)	**615**								
Value per STC share (SAR)	**1.15**								

Source: EFG-Hermes estimates

V. KUWAIT

STC wins 26% stake in Kuwait's third mobile company

In November 2007, STC won the 26% stake in Kuwait's third mobile company that the Kuwaiti government offered for sale in an auction. STC's KWD248.7 million (USD908 million) bid was the highest of nine, followed by a KWD195 million (USD715 million) bid from a consortium led by Kuwait Finance House. Although the only asset that this licensee had at the time of the tender was the license itself, the Kuwaiti Investment Authority (KIA) referred to it as a company. This is the second foray for STC outside its home market, after its USD3.05 billion acquisition of a 25% stake in Maxis in June 2007.

STC will own a 26% stake in the new operator, government institutions will retain a 24% stake and the remaining 50% will be sold in an initial public offering, which was originally planned for Kuwaiti citizens in February 2008 but has since been delayed. It is not yet clear when the IPO will take place. The company will have a share capital of KWD50 million distributed over 500 million shares.

Was the bid overpriced?

STC paid KWD248.7 million for a 26% stake of the company, a 28% premium over the second highest bid. The bid price values the whole company at KWD956.5 million, implying a value of KWD1.91 per share. The implied price per population for this license is USD1,041, which is extremely high given that the next highest price per population paid for a license in the region was USD255 for Saudi Arabia's third mobile license. The presence of two mature operators and a relatively small population make it even harder to justify the high bid.

STC believes high levels of synergy between Kuwait and Saudi Arabia justify the price paid

According to STC's CEO, Saudi Arabia receives 75% of the international outgoing traffic of Kuwait, which is an estimated USD200 million market. We believe this is a conservative figure. We had expected to see more international traffic going to countries like India, Pakistan, Bangladesh, the Philippines and other Arab countries because a high percentage of the Kuwaiti population are Asian expatriates. The CEO also indicated that around 1 million Kuwaiti visitors on average roam in Saudi Arabia per year. Despite these encouraging statistics, we find the price paid for the license economically hard to justify.

THE KUWAIT TELECOM MARKET

Kuwait lags in terms of the regulatory environment

As of 2007, Kuwait had a small population of 3.4 million and a high GDP per capita income of USD33,634, which nonetheless was lower than that of neighboring UAE and around half that of Qatar. Kuwait lags behind other GCC and MENA countries in terms of telecom regulatory environment because it has neither a telecom regulator nor a fixed-line operator. The Ministry of Communications still performs both functions.

Figure 5.1: Kuwait Mobile Market Indicators

(mn)	2007a	2008e	2009e	2010e	2011e	2012e	2013e	2014e	2015e
Population	3.4	3.6	3.8	4.0	4.2	4.4	4.7	4.9	5.1
Mobile Market Indicators									
Mobile Addressable Mkt.	3.4	3.6	3.9	4.1	4.4	5.4	5.9	6.2	6.5
Additions	0.2	0.3	0.4	0.6	0.5	0.5	0.5	0.5	0.5
Subscribers	**2.8**	**3.1**	**3.5**	**4.0**	**4.6**	**5.1**	**5.6**	**6.1**	**6.5**
Penetration to Addressable	81%	85%	90%	99%	104%	94%	95%	98%	100%
Penetration Rate	82%	85%	91%	100%	108%	115%	120%	124%	127%
Zain									
Zain Subscribers	1.6	1.7	1.9	2.0	2.2	2.4	2.6	2.7	2.9
Zain Market Share	57%	55%	53%	51%	49%	47%	46%	45%	44%
Wataniya									
Wataniya Subscribers	1.2	1.3	1.5	1.6	1.8	2.0	2.2	2.3	2.5
Wataniya Market Share	43%	43%	42%	41%	40%	39%	39%	38%	38%
STC									
STC Subscribers		0.1	0.2	0.4	0.5	0.7	0.9	1.0	1.2
STC Market Share		2%	5%	9%	12%	14%	16%	17%	18%

Source: Operators, EFG-Hermes estimates

Mobile penetration, at 82%, is lower than that of GCC peers

Kuwait's end-2007 mobile penetration rate, at 82%, was the lowest of the GCC countries, which together had an average of 121%. We believe that this could be due to the relatively low percentage of expatriates resident in Kuwait, where they make up 40% of the population compared to 80% in the UAE and Qatar. We estimate that penetration levels will exceed 100% in 2010 and the addressable market will increase gradually to around 127% of the total population by 2015.

The Kuwaiti market operates as a lazy-duopoly, with Zain taking the lead in terms of market share

The mobile market could currently be described as a lazy duopoly, with Zain holding a 57% market share, and Wataniya a 43% share at the end of 2007. We believe the entrance of STC in late 2008 or early 2009 will stimulate market growth.

We do not forecast cut-throat competition in the Kuwaiti market

We do not expect cut-throat competition the Kuwaiti market given the expected cooperation between STC and Zain. STC hinted that it is in talks with Zain to allow Zain to use STC's infrastructure and networks in Saudi Arabia. Similar cooperation is expected in the Kuwaiti mobile market.

18% market share by 2015

We forecast that STC by the end of 2008 will capture a market share of only 1.8%, which will grow to 18%, or 1.18 million subscribers, in 2015. This implies a seven-year subscriber CAGR of 55%. We assume an ARPU of USD40, 43% lower than Zain and 30% lower than Wataniya. This should stabilize in the low 30s.

We expect revenue to increase at a seven-year CAGR of 102% to SAR446 million by the end of 2015 and an EBITDA breakeven in the fourth year of operations. We believe EBITDA margin will stabilize in the low thirties. We forecast breakeven on net profit by the fifth year of operation.

VALUATION

We use a DCF model to value the company and reach an equity value for the operations of USD55 million (SAR208 million).

Table 5.2: KPIs and DCF Valuation for STC Kuwait

(USD mn)		2008e	2009e	2010e	2011e	2012e	2013e	2014e	2015e
Total Subscribers (mn)		0.1	0.2	0.4	0.5	0.7	0.9	1.0	1.2
ARPU (USD)		40.0	38.4	36.4	35.0	34.0	33.8	33.7	33.6
Total Revenue		3	52	114	185	252	320	385	446
EBITDA		(8)	(14)	(14)	4	43	80	112	138
EBITDA Margin		*-250.0%*	*-27.0%*	*-12.0%*	*2.0%*	*17.0%*	*25.0%*	*29.0%*	*31.0%*
CAPEX & Change in WC		(150)	(84)	(95)	(83)	(75)	(69)	(66)	(58)
Taxes						(0)	(2)	(3)	(4)
FCF		**(158)**	**(98)**	**(109)**	**(80)**	**(32)**	**9**	**43**	**76**
WACC	12.8%								
Terminal Growth	3.0%								
EV	**55**								
Equity Value	**55**								
STC Stake (26%)	**14**								
Value per STC share (SAR)	**0.03**								

Source: EFG-Hermes estimates

VI. OGER TELECOM

STC Acquires 35% of Oger Telecom

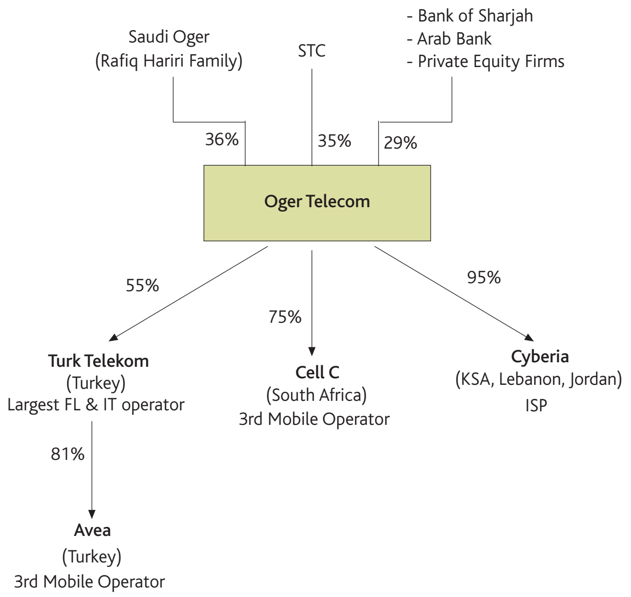
STC announced on 21 January 2008 that it had signed an agreement with the principal shareholders of Oger Telecom to acquire 35% of the company for SAR9.6 billion (USD2.6 billion), implying a valuation for the whole company of around SAR27.86 billion (USD7.43 billion). The agreement was finalized on 28 April, and STC decided to fund it through a murabaha funding agreement with three local banks. This is the third acquisition for the Saudi operator outside its local market in less than a year.

OVERVIEW OF OGER TELECOM

Dubai-based Oger Telecom is a holding company with telecom interests is several emerging markets. Before the STC purchase, Oger Telecom was 71% owned by Saudi Oger, which in turn was wholly owned by the family of former Lebanese Prime Minister Rafiq Hariri. The remaining 29% was owned by investors, including the Arab Bank, Bank of Sharjah and several private equity firms. Oger Telecom was supposed to float its shares on the Dubai Financial Market (DFM) stock exchange in late 2006 but, citing regional market volatility, canceled the IPO.

Oger Telecom's main value driver is its 54.5% stake in Turk Telekom, Turkey's leading fixed-line and broadband internet provider. Turk Telekom also owns an 81% stake in Avea, Turkey's third mobile operator by subscribers. Oger Telecom also has a 75% stake in Cell C, the third mobile operator in South Africa, and a 95% stake in internet service provider (ISP) Cyberia, which operates in Jordan, Lebanon and Saudi Arabia.

Figure 6.1: Oger Telecom Subsidiaries and Shareholder Structure


Saudi Oger
(Rafiq Hariri Family)
STC
- Bank of Sharjah
- Arab Bank
- Private Equity Firms
36%
35%
29%
Oger Telecom
55%
75%
95%
Turk Telekom
(Turkey)
Largest FL & IT operator
Cell C
(South Africa)
3rd Mobile Operator
Cyberia
(KSA, Lebanon, Jordan)
ISP
81%
Avea
(Turkey)
3rd Mobile Operator

Source: Oger Telecom, EFG-Hermes

TURKEY - TURK TELEKOM

FIXED-LINE

Table 6.2: Turkey Fixed-Line Market Indicators

(mn)	2007a	2008e	2009e	2010e	2011e	2012e	2013e	2014e	2015e
Population	70.6	71.4	72.2	73.0	73.8	74.5	75.3	76.0	76.8
Fixed-Line Market Indicators									
Fixed Line Addressable Mkt.	20.9	21.5	21.7	22.0	22.2	22.4	22.7	22.9	23.1
Fixed-Line Additions	(0.5)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Turk Tel. Fixed-Lines	**18.2**	**18.2**	**18.2**	**18.3**	**18.3**	**18.3**	**18.3**	**18.4**	**18.4**
FL Penetration to Addressable	86.9%	84.9%	83.9%	83.1%	82.3%	81.6%	80.9%	80.2%	79.5%
FL Penetration Rate	25.8%	25.6%	25.3%	25.1%	24.8%	24.8%	24.3%	24.1%	23.9%
Total ADSL subscribers	**4.7**	**6.8**	**9.2**	**11.5**	**13.6**	**15.4**	**16.9**	**18.2**	**19.3**
ADSL Penetration to FL	24.8%	37.4%	50.1%	62.6%	73.9%	83.3%	91.3%	98.0%	103.6%
ADSL Penetration Rate	6.7%	9.6%	12.7%	15.8%	18.4%	20.7%	22.5%	23.9%	25.2%
Turk Tel. ADSL subscribers	4.5	6.3	8.0	8.9	10.2	10.8	11.3	11.8	12.5
Turk Tel. ADSL Market Share	95%	93%	87%	77%	75%	70%	67%	65%	65%

Source: Turk Telekom, EFG-Hermes estimates

Leading fixed-line provider in Turkey

We estimate that fixed-line penetration rate in Turkey was 26% at the end of 2007. The number of ADSL subscribers grew significantly over the past two years, increasing to an estimated 4.7 million at the end of 2007 from 1.6 million in 2005. With a market share of around 95%, Turk Telekom is Turkey's leading fixed-line and ADSL operator.

We expect fixed lines to start growing as broadband use spreads

The number of fixed lines in Turkey has been declining on an annual basis since 2005, sliding to 18.2 million in 2007 from 19.0 million in 2005. Turk Telekom has been losing some of its fixed-line market share to alternative telecommunications operators offering long distance national and international voice services. Turk Telekom's market share in long distance voice traffic is around 70% and in the international voice traffic around 75%. We expect fixed lines, including ADSL lines, to start increasing slowly in 2008 due to high growth in the broadband market, which is still relatively under-penetrated.

Revenue growth driven by ADSL and wholesale services

As with most fixed-line providers, Turk Telekom's revenue from fixed-line voice services has declined for the past two years due to fixed-to-mobile substitution. Wholesale and ADSL/data revenue on the other hand has grown rapidly during the same period. Turk Telekom went through a tariff rebalance in early-2007 whereby long distance and international tariffs were reduced and monthly fees for local calls increased. Following the rebalance, Turk Telekom's national call traffic from March to December 2007 increased by 19%, its international call traffic by 43% and its fixed-to-mobile traffic by 6%.

We forecast that Turk Telekom's total fixed-line revenue will remain almost stable or grow slightly over the next five years, driven mostly by ADSL and wholesale services. The EBITDA margin declined to 49.5% in 2007 from 52.1% a year earlier. We forecast that the margin will stabilize or decrease slightly while remaining in the high 40s over our forecast period.

MOBILE-AVEA

Table 6.3: Turkey Mobile Market Indicators

(mn)	2007a	2008e	2009e	2010e	2011e	2012e	2013e	2014e	2015e
Population	70.6	71.4	72.2	73.0	73.8	74.5	75.3	76.0	76.8
Mobile Market Indicators									
Mobile Addressable Mkt.	80.9	82.1	83.3	84.4	85.4	86.4	87.4	88.3	89.4
Additions	9.4	7.7	5.0	3.7	2.6	2.1	1.7	1.3	1.1
Subscribers	**61.4**	**69.1**	**74.1**	**77.8**	**80.5**	**82.6**	**84.2**	**85.6**	**86.6**
Penetration to Addressable	76%	84%	89%	92%	94%	96%	96%	97%	97%
Penetration Rate	87%	97%	103%	107%	109%	111%	112%	113%	113%
Avea (Turk Telekom)									
Avea Subscribers	9.9	11.9	13.1	14.1	14.7	15.3	15.7	16.0	16.3
Avea Market Share	16%	17%	18%	18%	18%	18%	19%	19%	19%
Turkcell									
Turkcell Subscribers	35.4	38.0	39.8	41.1	42.1	42.9	43.5	44.0	44.4
Turkcell Market Share	58%	55%	54%	53%	52%	52%	52%	51%	51%
Telsim (Vodafone)									
Telsim Subscribers	16.1	19.2	21.2	22.6	23.6	24.4	25.1	25.6	26.0
Telsim Market Share	26%	28%	29%	29%	29%	30%	30%	30%	30%

Source: Operators, EFG-Hermes estimates

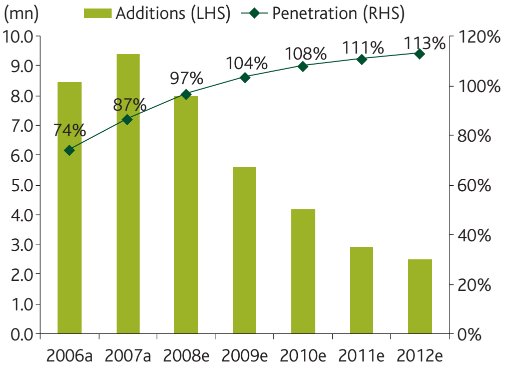
Avea, 81% owned by Turk Telekom, is Turkey's third mobile operator by subscriber market share in a three-player market (Turkcell, Vodafone-Telsim and Avea). Avea was able to increase its market share to 16.1% at the end of 2007 from 14.4% a year earlier.

Mobile penetration rate to reach 97% in 2008

The Turkish mobile market grew at a relatively quick pace over the past two years as competition became fierce, especially after Vodafone Group bought Telsim and Turk Telekom bought a majority stake in Avea. The mobile penetration rate in Turkey jumped to 87% at the end of 2007 from 74% in 2006, with a record 9.4 million subscribers added in 2007. We believe that 2008 will also be strong in terms of subscriber additions but that the rate will be slower than in 2007. Competition among the three existing players will become more aggressive after MNP services, expected in October, are introduced.

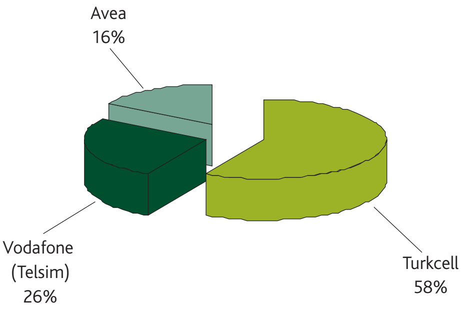
We expect the mobile penetration rate to climb to 97% with 69.1 million mobile subscribers in 2008 and to 111% with 82.6 million mobile subscribers in 2012.

Fig 6.4: Mobile Additions and Mobile Penetration Rate in Turkey



Source: Operators, EFG-Hermes estimates

Fig 6.5: Mobile Market Share Breakdown on Operators (2007)



Source: Operators

Competition is getting more aggressive

We expect Turkcell to start losing some of its 58% market share to both Telsim and Avea. Turkcell's total subscribers declined to 35.1 million at the end of March 2008 from 35.4 million in December 2007, its first decline ever in subscribers. At the same time, the churn rate for 1Q2008 rose to 7.2% from 5.9% in 4Q2007. Avea had the highest growth in mobile additions in 2007, with 26% of total market additions, up from 17% a year earlier.

37% of Avea's subscribers are postpaid, generating 60% of its revenue

Some 37% of Avea's subscribers are postpaid, the highest ratio of postpaid subscribers among the three operators. This is one of the most important drivers boosting Avea's profitability.

Avea broke even on an EBITDA level in 2006 (with an EBITDA margin of 13.7%) after two years of operations. The company was able to increase its ARPU in 2007 to USD12.2 from USD10.4 in 2006. We expect Avea's ARPUs to decline to USD10.1 in 2012 as competition gets more aggressive. We forecast that revenue will grow by a five-year CAGR of 6.7% and that the EBITDA margin will reach 38.5% by 2012.

VALUATION

LTFV for Turk Telekom: TRY6.17 per share

We arrived at an estimated equity value of USD17.70 billion for Turk Telekom's fixed-line and mobile operations. The company listed 15% of its shares on the Turkish stock exchange in May 2008, with trade starting on 15 May (TTKOM.IS). The offering was 4.7 times oversubscribed locally and 4.3 times internationally. Turk Telkom's listing price was TRY4.6 per share, resulting in a total equity value of USD12.9 billion for the company. Our estimated equity value for Turk Telkom is 34% higher than the IPO price. This implies a Fair Value of TRY6.17 per Turk Telekom share. There is a risk to our Fair Value estimate related to the TRY, which remains overvalued. Our forecasts are USD-based and our assumptions are foreign exchange neutral (i.e. they assume a fixed exchange rate), which makes our fair value TRY sensitive to USD:TRY fluctuations. Our valuation implies a P/E of 7.5x for 2008 and an EV/EBITDA of 4.0x for 2008, based on today's closing price.

Table 6.6: KPIs and DCF Valuation for Turk Telekom

(USD mn)	**2007a**	**2008e**	**2009e**	**2010e**	**2011e**	**2012e**	**2013e**	**2014e**	**2015e**
Total Subscribers	28.1	30.1	31.4	32.3	33.0	33.6	34.0	34.4	34.6
ARPU (USD)	12.2	12.0	11.3	10.7	10.4	10.1	10.0	9.9	9.9
ARPL (USD)	22.1	21.5	20.1	18.9	17.9	17.0	16.2	15.5	14.9
Total Revenue	7,096	7,544	7,661	7,578	7,501	7,415	7,345	7,269	7,218
EBITDA	3,202	3,397	3,548	3,533	3,541	3,503	3,455	3,425	3,433
EBITDA Margin	*45.1%*	*45.0%*	*46.3%*	*46.6%*	*47.2%*	*47.2%*	*47.0%*	*47.1%*	*47.6%*
CAPEX & Change in WC	(435)	(1,256)	(1,241)	(1,085)	(985)	(903)	(864)	(857)	(855)
Taxes	(298)	(424)	(440)	(433)	(439)	(442)	(450)	(457)	(474)
FCF	**2,468**	**1,717**	**1,867**	**2,015**	**2,117**	**2,159**	**2,141**	**2,112**	**2,105**

Cost of Equity	15.0%
Cost of Debt	7.5%
Weight of Debt	9.9%
Weight of Equity	90.1%
WACC	14.9%
Terminal Growth	2.0%
EV	**18,366**
Net Debt (Cash)	666
Equity Value	**17,700**
STC Stake (35%)	**3,407**
Value per STC share (SAR)	**6.39**

Source: EFG-Hermes estimates

SOUTH AFRICA - CELL C

Table 6.7: South Africa Mobile Market Indicators

(mn)	2007a	2008e	2009e	2010e	2011e	2012e	2013e	2014e	2015e
Population	47.9	48.9	49.9	50.9	51.9	52.9	53.9	54.9	55.9
Mobile Market Indicators									
Mobile Addressable Mkt.	53.2	54.6	55.7	56.8	58.0	59.1	60.2	61.4	62.5
Additions	8.2	6.6	4.3	2.6	1.9	1.6	1.4	1.3	1.2
Subscribers	**44.3**	**50.9**	**55.2**	**57.7**	**59.6**	**61.2**	**62.7**	**63.9**	**65.1**
Penetration to Addressable	83%	93%	99%	102%	103%	104%	104%	104%	104%
Penetration Rate	93%	104%	111%	113%	115%	116%	116%	116%	116%
Cell C									
Cell C Subscribers	4.8	5.7	6.4	7.0	7.6	8.1	8.6	9.0	9.4
Cell C Market Share	11%	11%	12%	12%	13%	13%	14%	14%	14%
Vodacom									
Vodacom Subscribers	25.0	28.6	30.8	31.8	32.5	33.0	33.5	34.0	34.4
Vodacom Market Share	56%	56%	56%	55%	54%	54%	54%	53%	53%
MTN									
MTN Subscribers	14.5	16.5	18.0	18.9	19.5	20.1	20.5	21.0	21.4
MTN Market Share	33%	33%	33%	33%	33%	33%	33%	33%	33%

Source: Operators, EFG-Hermes estimates

Covers 95% of the population

Cell C in 2007 had 4.8 million subscribers, representing a market share of around 11%, making it the third largest mobile operator in the country. South Africa is a relatively mature market with three mobile operators and a mobile penetration of around 93%. Vodacom, which is owned by Vodafone and Telkom SA, dominates the market with a market share of around 56%, followed by MTN at 33%.

Cell C began offering mobile services at the end of 2001 and since then it has been able to cover approximately 95% of the population. We estimate that Cell C's ARPU was around USD20 at the end of 2007, and we expect it to decline gradually to USD16.1 in 2012.

Virgin Mobile South Africa

Virgin Mobile South Africa, a 50-50 joint venture between Cell C and Virgin Group, began operations in mid-2006. It is targeting high-spending mobile users in South Africa.

We expect Cell C revenue to continue its high growth, reaching USD1,823 million in 2012, a five-year CAGR of 9.6%. The company broke even on an EBITDA level in 2005, and we forecast a long-term EBITDA margin of only 31%. This relatively low EBITDA margin assumption is comparable with other mobile providers in South Africa.

Equity value of USD2,546 million

We arrive at an estimated equity value for Cell C of USD2,546 million based on a DCF valuation. We use a risk free rate of 6.2% and an equity premium of 5.5%. Our WACC is 9.3% based on 35% weight of debt. STC's proportionate stake is USD668 million, or 1.2% of STC's total value. STC effectively owns 26.25% of Cell C through its 35% stake in Oger Telecom, which owns 75% of Cell C.

Table 6.8: KPIs and DCF Valuation for Cell C

(USD mn)	2007a	2008e	2009e	2010e	2011e	2012e	2013e	2014e	2015e
Total Subscribers	4.8	5.7	6.4	7.0	7.6	8.1	8.6	9.0	9.4
ARPU (USD)	19.9	17.7	16.7	16.2	16.1	16.1	16.2	16.2	16.3
Revenue	1,151	1,340	1,451	1,563	1,693	1,823	1,944	2,056	2,159
EBITDA	160	274	329	402	464	528	584	618	660
EBITDA Margin	*13.9%*	*20.5%*	*22.7%*	*25.7%*	*27.4%*	*29.0%*	*30.0%*	*30.1%*	*30.6%*
CAPEX & Change in WC	(145)	(171)	(148)	(161)	(171)	(179)	(184)	(190)	(195)
Taxes	-	(12)	(25)	(46)	(58)	(77)	(93)	(101)	(119)
FCF	**15**	**91**	**155**	**194**	**234**	**272**	**307**	**327**	**345**

WACC	9.3%
Terminal Growth	2.5%
EV	**4,075**
Net Debt (Cash)	1,528
Equity Value	**2,546**
STC Stake (26.25%)	**668**
Value per STC share (SAR)	**1.25**

Source: EFG-Hermes estimates

CYBERIA

We value Cyberia at acquisition price

Cyberia, Oger Telecom's ISP arm, is the company's smallest operations. Cyberia offers dial-up, ADSL, virtual private network (VPN) and leased-line services in Saudi Arabia, Lebanon and Jordan.

We did not include Cyberia in STC's consolidated numbers because data for the ISP's main performance indicators were not available. We value Oger's 95% stake in Cyberia at its acquisition value of USD52.3 million. Cyberia makes up 0.4% of Oger Telecom's total value.

VALUATION

Table 6.9: DCF Valuation of Oger Telecom

Operator	Valuation Method	Total Equity Value (USD mn)	Oger Stake	Prop. Equity Value (USD mn)	*% of Total*
Turk Telekom	DCF	17,700	55%	9,735	*83.2%*
Cell C	DCF	2,546	75%	1,910	*16.3%*
Cyberia	Acquisition Price	55	95%	52	*0.4%*
Total				11,697	
Holding Debt				3,700	
Total Equity Value				**7,997**	

Source: EFG-Hermes estimates

Our estimated equity value for Oger Telecom is 7.7% higher than the price paid by STC

We reached a total estimated equity value of USD11,697 million for Oger Telecom using a SOTP valuation. Oger Telecom has USD3.70 billion in debt at the holding company level that is related to the acquisition of Turk Telekom. We deduct the debt from the total equity value to get USD7,997 million. Our estimated total equity value for Oger Telecom is 7.7% higher than the USD2.6 billion that STC paid for its 35% stake in the company.

VII. NEW FORECASTS

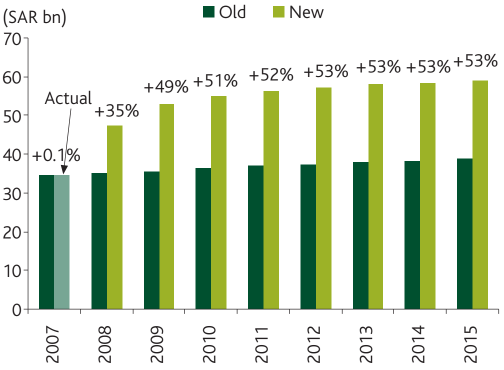
REVENUE

STC started to proportionally consolidate its 25% stake in Maxis in 4Q2007, and we estimate the company will start proportionally consolidating its 35% stake in Oger Telecom starting in 2Q2008. We upgrade our consolidated revenue forecast for STC driven by: i) an upgrade in our forecasts for the Saudi operations revenue, and ii) the integration of the proportionate revenue from Maxis, Oger Telecom and the Kuwaiti operation.

Non-Saudi operation to constitute 33% of total revenue in 2015

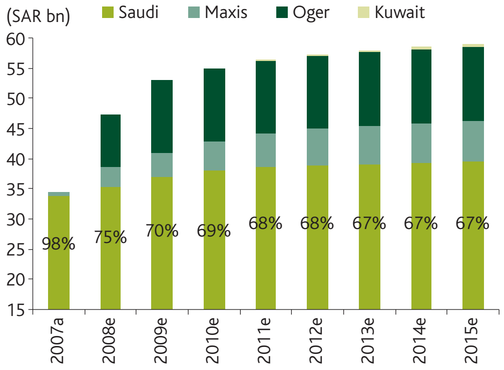
Our new consolidated revenue forecast implies a five-year (2007-12) CAGR of 10.7%. We forecast that 2008 revenue will grow 37.4% Y-o-Y to SAR47.4 billion, of which 25% is generated from non-Saudi operations. We expect the contribution of non-Saudi operations to total revenue will continue increasing until it reaches 33% in 2015.

Fig 7.1: Old Versus New Consolidated Revenue Forecast



Source: STC, EFG-Hermes estimates

Fig 7.2: Breakdown of Historical and Forecast Revenue By Country

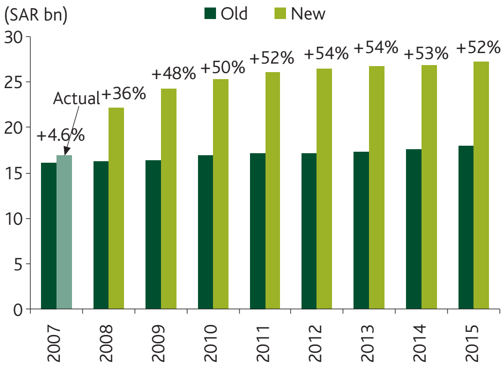


Source: STC, EFG-Hermes estimates

EBITDA

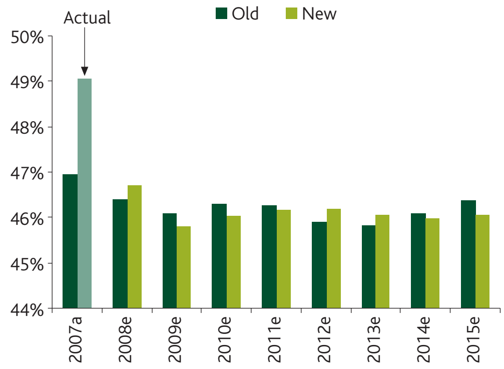
We also upgrade our EBITDA, driven by the upgrade in revenue and the better-than-expected EBITDA margin for the Saudi operation in 2007. Our new forecast implies a five-year CAGR of 9.4%, up from our previous CAGR forecast of 1.2%. The consolidation of Maxis and Oger Telecom into our forecasts put some downward pressure on the EBITDA margin for the first two years of consolidation. This is because they include operations that are not yet mature and report very low or negative margins, such as NTS in Indonesia, Cell C in South Africa and, to some extent, Avea in Turkey.

Fig 7.3: Old Versus New Consolidated EBITDA Forecast



Source: STC, EFG-Hermes estimates

Fig 7.4: Old Versus New Consolidated EBITDA Margin Forecast

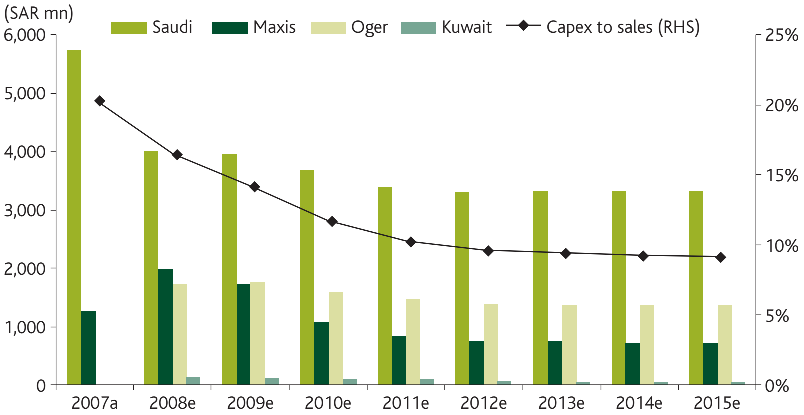


Source: STC, EFG-Hermes estimates

CAPEX

STC's total capital spending in 2007 was SAR7.0 billon, up from SAR3.4 billion a year earlier. We estimate Maxis contributed SAR1,254 million to STC's total capex in 2007, representing 18% of 2007's total capex. We forecast that total capex will increase to SAR7.8 billion in 2008, with 49% generated from non-Saudi operations.

Figure 7.5: STC Capex Breakdown and Capex to Sales



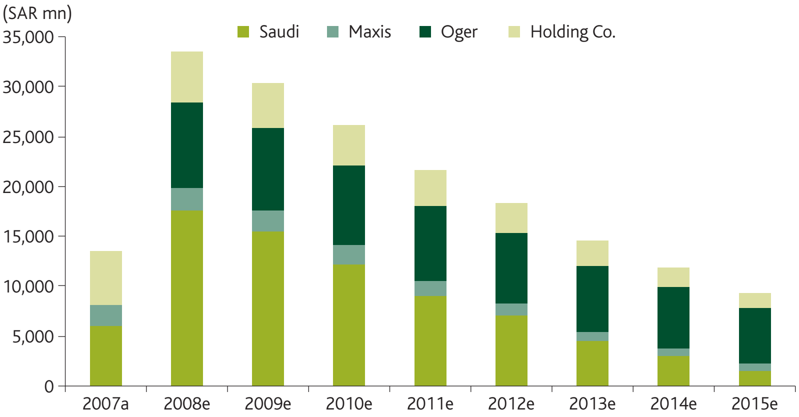
Source: STC, EFG-Hermes estimates

LEVERAGE

2007's SAR13.6 billion debt versus 2006's zero debt

STC's proportionate debt position rose to SAR13.6 billion at the end of 2007 from zero in 2006. STC obtained a SAR6.0 billion murabaha from local banks in 3Q2007 to finance the Maxis acquisition. Of STC's share in the Binariang loan, SAR5.52 billion was in the form of sukuks, the Islamic financing equivalent of bonds, and SAR2.01 billion in the form of banking facilities.

Figure 7.6: STC's Proportionate Debt Breakdown



Source: EFG-Hermes estimates

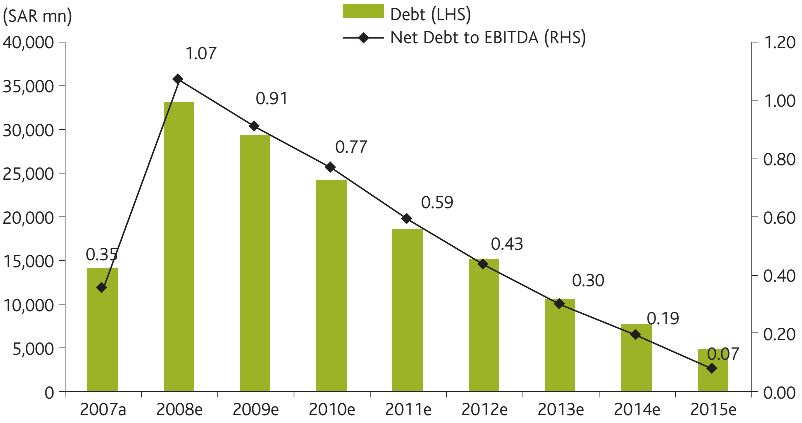
Debt to double in 2008

We forecast that STC's total debts will increase to SAR33.5 billion by the end of 2008 and will include: i) a SAR9.6 billion loan that the company in early 2008 said it was negotiating to raise to finance the purchase of its 35% stake in Oger Telecom, and ii) STC's portion, which we estimate at SAR3.9 billion, of Oger Telecom debt as of the end of 2008.

Net debt to EBITDA only 1.07x in 2008

This implies a net debt-to-EBITDA ratio of only 1.07x in 2008. This is the highest level of debt it will have over our forecast period and is still very low compared to that of other operators. This relatively low leverage allows STC to increase its debts and, by reducing its WACC, to boost its value.

Figure 7.7: STC's Total Debt and Net Debt-to-EBITDA Ratio

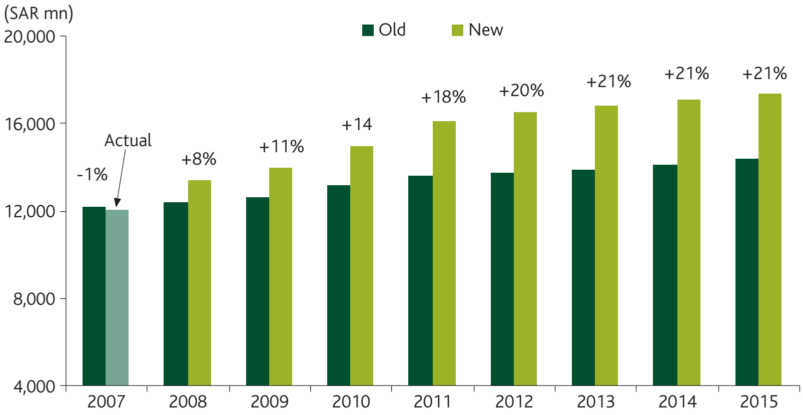


Source: STC, EFG-Hermes estimates

EARNINGS

We forecast that STC's consolidated earnings will grow at a five-year CAGR of 6.6%, higher than our previous CAGR of 2.4% for the same period.

Figure 7.8: STC Old Versus New Earnings Forecasts

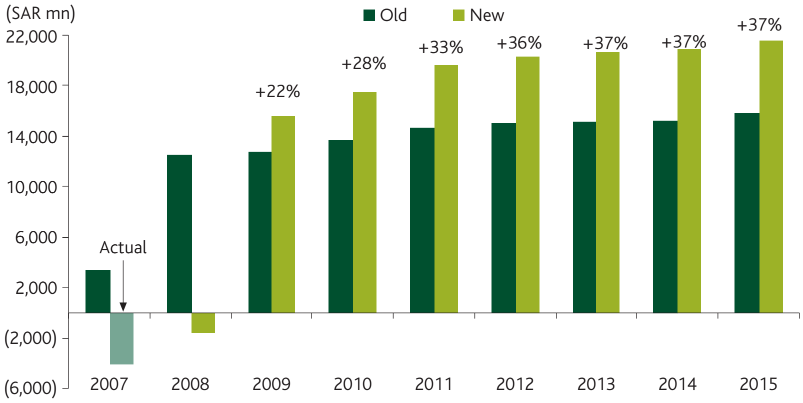


Source: STC, EFG-Hermes estimates

FREE CASH FLOW (FCF)

We calculated STC's FCF in 2007 at negative SAR4.0 billion, down from a positive FCF in 2006 of SAR12.0 billion. The negative FCF is mainly due to the high investment costs of around SAR12 billion that STC has paid for the acquisition of Maxis. Excluding this, FCF rises to SAR8.5 billion, implying a FCF Yield of 6.7%. We forecast that FCF will also be negative in 2008, as it will include the investment it paid for its acquisition of Oger Telecom and its stake in the Kuwaiti company. Excluding both, FCF for 2008 would rise to SAR11.4 billion. Beyond that, we forecast that the company to continue generating high levels of free cash flow until it reaches SAR21.5 billion in 2015.

Figure 7.9: STC Old Versus New FCF Forecasts



Source: STC, EFG-Hermes estimates

Financial Statements (December Year End)

(SAR mn)	1Q2007a	2007a	1Q2008a	2008e	2009e	2010e	2011e	2012e
Balance Sheet								
Cash & Cash Equivalents	8,403	7,618	6,641	9,863	8,264	6,738	6,190	6,938
ST Investments	3,283	-		-	-	-	-	-
Net Accounts Receivable	3,841	4,973	5,094	7,278	7,753	8,097	8,370	8,568
Inventory	167	367	497	441	526	605	673	719
Prepayments and other CA	750	1,019	1,330	1,791	1,910	2,015	2,115	2,221
Total Current Assets	**16,444**	**13,977**	**13,562**	**19,372**	**18,453**	**17,455**	**17,347**	**18,447**
PP&E (Net)	30,446	34,369	35,140	45,198	45,998	45,441	43,908	41,928
Intangible Assets (Net)	722	1,352	1,624	8,510	7,908	7,373	6,846	6,313
Goodwill	-	12,504	12,504	19,326	19,326	19,326	19,326	19,326
Investments (Equity Method)	1,142	2,407	2,435	2,452	2,500	2,551	2,604	2,659
Other Non-current Assets	789	4,202	4,154	1,791	1,836	1,860	1,888	1,916
Total Assets	**49,544**	**68,811**	**69,418**	**96,649**	**96,020**	**94,006**	**91,919**	**90,588**
CPLTD	-	561	1,091	3,094	4,052	3,988	2,821	3,313
Accounts Payable	2,460	3,082	3,228	5,323	5,706	5,924	6,112	6,265
Dividends Payable	3,047	57	2,558	57	57	57	57	57
Other Payables	2,628	6,160	2,928	2,907	2,788	2,659	2,546	2,436
Accrued Expenses	3,727	5,587	6,026	5,754	5,869	5,987	6,107	6,229
Deferred Revenue-Current	1,381	1,773	1,454	1,767	1,843	1,710	1,738	1,751
Other Current Liabilities	-	-	-	300	300	300	300	300
Total Current Liabilities	**13,244**	**17,220**	**17,285**	**19,202**	**20,614**	**20,625**	**19,680**	**20,351**
Long Term Debt	-	13,019	12,900	30,384	26,231	22,141	18,766	15,049
Deferred Revenue	573	437	396	442	461	428	434	438
Emp. End of Service Benefits	1,850	1,932	1,960	2,046	2,172	2,309	2,452	2,605
Deferred Taxes	-	-	-	522	512	502	492	482
Other Long Term Payables	-	311	306	2,097	2,087	2,077	2,067	2,057
Total Liabilities & Provisions	**15,667**	**32,919**	**32,846**	**54,692**	**52,077**	**48,081**	**43,891**	**40,982**
Minority Interest	-	16	13	3,660	3,681	3,718	3,765	3,826
Net Worth	**33,877**	**35,876**	**36,558**	**38,296**	**40,262**	**42,207**	**44,264**	**45,780**
Income Statement								
Revenue								
Saudi Arabia		33,788		35,337	36,867	38,008	38,618	38,905
Maxis*		670		3,274	4,113	4,899	5,514	6,009
Oger Telecom				8,745	11,961	11,997	12,067	12,126
Kuwait				3	51	112	181	245
Total	**7,938**	**34,458**	**9,575**	**47,360**	**52,991**	**55,016**	**56,380**	**57,286**
EBITDA								
Saudi Arabia		16,611		17,167	17,795	18,407	18,714	18,784
Maxis*		295		1,352	1,504	1,875	2,163	2,457
Oger Telecom				3,614	4,979	5,056	5,148	5,183
Kuwait				(8)	(14)	(13)	4	42
Total	**3,843**	**16,906**	**4,733**	**22,125**	**24,264**	**25,323**	**26,028**	**26,466**
EBITDA Margin	*48.4%*	*49.1%*	*49.4%*	*46.7%*	*45.8%*	*46.0%*	*46.2%*	*46.2%*
Depreciation and Amortization	(923)	(4,099)	(1,335)	(6,069)	(6,960)	(7,217)	(7,530)	(7,717)
Net Operating Profit	**2,920**	**12,807**	**3,398**	**16,056**	**17,304**	**18,107**	**18,498**	**18,749**
NOP (EBIT) Margin	*36.8%*	*37.2%*	*35.5%*	*33.9%*	*32.7%*	*32.9%*	*32.8%*	*32.7%*
Cost of Manpower imp. Program	(125)	(548)	(150)	(500)	(500)	(500)	-	-
Net Interest Income (Expense)	110	144	33	(500)	(709)	(486)	(176)	138
Earnings from Investments	2	31	28	45	48	51	54	55
Others	(46)	12	(107)	17	18	18	18	18
Earnings before MI and Taxes	**2,862**	**12,446**	**3,203**	**15,117**	**16,161**	**17,190**	**18,394**	**18,960**
Minority Interest	-	2	1	(767)	(1,054)	(1,049)	(1,064)	(1,082)
Earnings before Taxes	**2,862**	**12,449**	**3,204**	**14,351**	**15,107**	**16,141**	**17,329**	**17,879**
Zakat	(143)	(385)	(96)	(327)	(337)	(350)	(368)	(369)
Taxes	-	(42)	(78)	(603)	(804)	(846)	(904)	(993)
Net Profit after Taxes	**2,719**	**12,022**	**3,029**	**13,420**	**13,966**	**14,945**	**16,057**	**16,516**
Cash Flow Statement								
COPAT	**3,701**	**15,932**	**4,559**	**20,695**	**22,623**	**23,627**	**24,755**	**25,104**
Change Working Investment	726	(468)	(3,724)	(1,458)	(225)	(453)	(218)	(173)
Cashflow Post Change in WI	**4,427**	**15,463**	**834**	**19,237**	**22,398**	**23,174**	**24,537**	**24,931**
Capex	(1,232)	(6,998)	(2,093)	(7,826)	(7,536)	(6,436)	(5,773)	(5,513)
Investments	2,317	(12,504)	(128)	(13,021)	709	744	823	936
Free Cash Flow	**5,511**	**(4,039)**	**(1,386)**	**(1,610)**	**15,571**	**17,481**	**19,587**	**20,353**
Net Financing	-	13,580	411	11,242	(3,195)	(4,153)	(4,543)	(3,224)
Dividends, Interest & Others	(18)	(10,431)	(2)	(7,388)	(13,974)	(14,853)	(15,592)	(16,381)
Change in Cash	**5,494**	**(890)**	**(977)**	**2,244**	**(1,599)**	**(1,525)**	**(548)**	**749**

*Breakdown is based on EFG-Hermes estimates

Source: STC, EFG-Hermes estimates

المجموعة المالية - هيرميس
EFG HERMES

ETIHAD ETISALAT (MOBILY)

Growing on the Right Track

16 JUNE 2008

SAUDI ARABIA | TELECOM

ST Rec.: Buy	Current Price*: SAR 54.3
LT Rec.: Buy	LT Fair Value : SAR 85.6

CONTENTS

I. 1Q2008 Results Review 39

II. New Forecasts 40

III. Valuation 45

• **Weaker-than-Expected 1Q2008 Results; Slowing Growth Not Implied:** Although 1Q2008 revenue, EBITDA and net profit came in lower than expected, we do not believe this implies that growth is slowing. We believe the Saudi mobile market will exhibit strong positive elasticity, especially with the lower tariff levels prevailing in the market.

• **2007 Additions Surprise on the Upside:** Mobily's net additions for the FY2007 came in at 3.6 million subscribers, 23% above our expectations on the back of stronger-than-expected market growth. We therefore upgrade our subscriber forecasts and estimate Mobily will finish 2008 with 12.5 million subscribers.

• **We Lower our ARPU Forecasts:** We assume faster ARPU dilution due to higher-than-expected subscriber growth. We forecast that Mobily's 2008 ARPU will decline to USD21 and eventually stabilize at USD18-19.

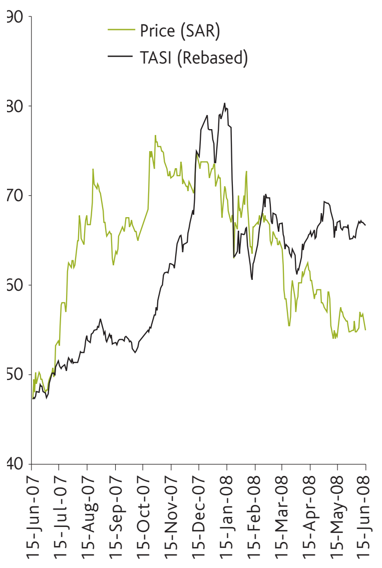
• **We Upgrade our Revenue Forecasts on Lower Margins:** We increase our revenue forecasts for Mobily on the back of higher subscriber growth forecasts. We assume a five-year revenue CAGR of 9% to SAR13,165 million in 2012e. We lower our EBITDA margins to reflect 1Q2008 results and to account for potentially higher costs as inflation surges in the Saudi economy.

• **Tapping Growth Pockets in the Saudi Market:** We believe Mobily's acquisition of data-service provider Bayanat al-Oula will allow it entry into the fast-growing broadband market in Saudi Arabia. Mobily is also about to finalize another acquisition of a local ISP. We are generally positive on this type of acquisition and believe that Mobily's strategy will pay off in the medium term.

• **Substantial Upside Potential; We Remain Buyers of Mobily:** We upgrade our Long-Term Fair Value for Mobily by 7.7% to SAR85.6 per share to reflect higher subscriber and revenue forecasts. This is based on a DCF valuation that employs a WACC of 9.75%. Our new fair value implies an 58% upside potential based on yesterday's share price. We maintain our ST/LT Buy recommendation.

December year end	*2007a*	*2008e*	*2009e*	*2010e*
Operating Income (mn)	*1,916*	*2,465*	*2,820*	*3,161*
Net Attrib. Income (mn)	*1,380*	*1,885*	*2,266*	*2,691*
ROE	*23.3%*	*20.2%*	*21.4%*	*23.4%*
EPS	*2.76*	*3.77*	*4.53*	*5.38*
Earnings Growth	*97.0%*	*36.6%*	*20.2%*	*18.7%*
P/E (Attrib.)	*19.7*	*14.4*	*12.0*	*10.1*
DPS	*0.50*	*0.94*	*2.04*	*3.50*
Dividend Yield	*0.9%*	*1.7%*	*3.8%*	*6.4%*
BVPS	*11.83*	*18.65*	*21.15*	*23.03*
P/BV	*4.6*	*2.9*	*2.6*	*2.4*
CFPS (Operating CF)	*6.64*	*6.64*	*8.41*	*8.88*
P/CF	*8.2*	*8.2*	*6.5*	*6.1*
EBITDA (mn)	*2,947*	*3,685*	*4,211*	*4,711*
EBITDA Margin	*34.9%*	*36.1%*	*37.5%*	*38.9%*
EV/EBITDA	*12.0*	*9.3*	*7.9*	*6.9*
EV/Sub	*3,644*	*2,786*	*2,400*	*2,204*
Net Debt (Cash) (mn)	*8,220*	*7,050*	*6,196*	*5,363*
Net Debt (Cash)/ BV	*139.0%*	*75.6%*	*58.6%*	*46.6%*
Net Debt (Cash)/ Mkt cap	*30.3%*	*26.0%*	*22.8%*	*19.8%*

Fig in SAR unless otherwise stated



Estimate Changes

	2007a	*2008e*		*2009e*	
(SAR mn)		***Old***	***New***	***Old***	***New***
Revenue	*8,440*	*10,083*	*10,196*	*10,502*	*11,237*
EBITDA	*2,947*	*3,884*	*3,685*	*4,197*	*4,211*
EBITDA Margin	*34.9%*	*38.5%*	*36.1%*	*40.0%*	*37.5%*
Net Attrib. Income	*1,380*	*2,116*	*1,885*	*2,361*	*2,266*

Stock Data

Last Ex-Div Date	*SAR0.50 on 31 March 2008*
Mkt. Val. (mn)	*SAR27,125*
Shares (mn)	*500*
Av. Mthly Liqd. (mn)	*SAR966.6*
52-Week High / Low	*SAR76.8 / 47.0*
Bloomberg / Reuters	*EEC AB / 7020.SE*
Est. Free Float	*20.0%*

**prices as of 15 June 2008*

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I. 1Q2008 RESULTS REVIEW

Strong subscriber additions surprises

Subscriber growth in Saudi Arabia was generally ahead of our estimates, driven by stronger-than-expected additions in the second half of 2007. According to the Communications and Information Technology Commission (CITC), Mobily had 11.1 million subscribers at the end of 2007, which we believe is based on the closing number of subscribers after our discussion with management. We estimate a lower subscriber figure of 9.7 million based on the more conservative "active subscriber definition", which defines a subscriber as one who made a chargeable event within 90 days of the reporting date. This was generally stronger than our previous estimate of around 9.0 million at the end of 2007

We estimate Mobily added around 690,000 subscribers in 1Q2008, 39% fewer than in 4Q2007. Mobily's total subscribers increased to 10.4 million at the end of 1Q2008 from an estimated 9.7 million at the end of 2007 (+7.1 Q-o-Q, +48.9% Y-o-Y). We estimate that blended monthly ARPU for the quarter declined 12.8% to SAR77 from SAR88 the previous quarter and SAR95 in 1Q2007. This was expected given the higher-than-forecast growth in subscribers and the lower prepaid tariffs introduced late in 2007. We estimate that around 95% of Mobily's subscribers are prepaid subscribers.

Revenue in line with estimates

Mobily's revenue for 1Q2008 increased 23% Y-o-Y, but declined 4% Q-o-Q to SAR2,308 million, 2.9% below our estimate of SAR2,377 million. The Q-o-Q decline in revenue was expected because of seasonality. The fourth quarter has had the strongest revenue for Saudi mobile operators in recent years because it coincided with the annual pilgrimage (Hajj). Around 2 to 3 million pilgrims spend at least 12 days in Saudi Arabia, leading to a spike in usage, whether by pilgrims roaming on Saudi networks or using temporary visitor lines.

But EBITDA margin came lower-than-expected…

Mobily's EBITDA for the quarter slid 23% Q-o-Q but rose 18% Y-o-Y to SAR726 million. This was 10% lower than our estimate of SAR809 million due to lower revenue. EBITDA margin came lower than expected at 32%, versus our estimate of 34% (4Q2007a: 39%, 1Q2007a: 33%).

… due to, we believe, lower tariffs introduced in 2007

We do not have a detailed breakdown of the different cost items on a quarterly basis, but it appears that higher-than-expected direct costs (COS) pulled down the EBITDA margin, caused, we speculate, by lower-tariff plans that were introduced late in 2007. Margins usually come under pressure when a decrease in tariffs is not met by a similar decrease in interconnection costs. We are confident, however, that this margin drop will be more than compensated for by the rise in on-net traffic as the company grows its customer base, a trend we have seen at other emerging market operators.

Mobily's 1Q2008 net profit dropped 37% Q-o-Q, but increased 30% Y-o-Y to SAR326 million, 12% lower than our estimate of SAR372 million. We do not believe 1Q2008 results should be considered a setback. We believe there are still strong underlying elasticity trends in the Saudi market at these tariff levels. We expect to see stronger revenue growth, possibly surprising on the upside, in upcoming quarters that should compensate for a lower-than-expected first quarter.

Table 1.1: Historical and Forecast Quarterly Income Statement for Mobily

(SAR mn)	1Q07a	4Q07a	1Q08a	Q-o-Q	Y-o-Y	1Q08e	Diff.
Revenue	**1,877**	**2,410**	**2,308**	**-4%**	**23%**	**2,377**	**-2.9%**
Cost of Sales	(891)	(1,037)	(1,084)	5%	22%	(1,069)	1%
COS/Sales	*47.5%*	*43.0%*	*47.0%*			*45.0%*	
Selling and Marketing Costs	(128)	(51)	(112)	118%	-13%	(149)	-25%
General & Admin. Costs	(244)	(383)	(385)	1%	58%	(350)	10%
EBITDA	**613**	**939**	**726**	**-23%**	**18%**	**809**	**-10%**
EBITDA Margin	*32.7%*	*39.0%*	*31.5%*			*34.0%*	
Depreciation & Amortization	(242)	(282)	(292)	4%	21%	(285)	3%
EBIT	**371**	**657**	**434**	**-34%**	**17%**	**524**	**-17%**
EBIT Margin	*19.8%*	*27.3%*	*18.8%*			*22.1%*	
Financing Expense	(129)	(145)	(120)	-17%	-7%	(150)	-20%
Other Income	8	18	14	-21%	66%	7	100%
PBT	**251**	**531**	**328**	**-38%**	**31%**	**381**	**-14%**
Provision for Zakat	-	(16)	(2)			(10)	
Net Income	**251**	**514**	**326**	**-37%**	**30%**	**372**	**-12%**

Source: Mobily, EFG-Hermes estimates

II. NEW FORECASTS

A. RECENT DEVELOPMENTS

ACQUISITION OF BAYANAT AL-OULA

Mobily announced in September 2007 that it had signed a memorandum of understanding to acquire Riyadh-based data services provider Bayanat al-Oula (Bayanat) for Network Services for SAR1,500 million. In March 2008, Mobily received approval from the CITC to finalize the acquisition and signed a SAR1,500 million Islamic loan with three local banks to finance it.

Bayanat, Mobily and Saudi-based Integrated Telecom Company are building a seven-ring, 12,600 kilometer-long fiber optic network project in Saudi Arabia. It has a strategic arrangement with Samsung to build the region's biggest mobile WiMAX network and to launch commercial services in Riyadh, Dammam, Mecca and Jeddah in the first phase of the project.

The fiber optic network's seven rings will connect the main population with business areas in the kingdom. Ring one, two and seven had been completed by the end of 2007 and the rest are expected to be completed in October 2008. Mobily's stake in this project increased to 66% from 33% after it acquired Bayanat.

A positive acquisition for Mobily

We believe this investment is positive for Mobily as:

i) It should boost the EBITDA margin by up to 400 bps to 500 bps, since it will allow Mobily to substitute almost the entire leased line capacity it currently rents from STC.
ii) It should enable Mobily to capture strong growth in Saudi Arabia's booming broadband market.
iii) It should generate revenue over the medium term from the sale of capacity to third parties. News agencies have reported that Mobily signed a contract allowing one of the new fixed-line operators to use the fiber optic network.

We believe this acquisition is more important than the potential cost reduction and additional revenue from selling capacity because it enables Mobily to tap into the high-growth data market. This is especially important after Mobily failed to win one of the fixed-line licenses CITC sold last year. The license would have allowed Mobily to provide a wide range of converged services to consumers. Mobily quickly followed its failure to get a license with its acquisition of Bayanat and a new home-zone billing service called "Mada", which allows subscribers to choose a zone in Saudi Arabia within which they can place calls at much lower rates. Mobily also announced it is interested in pursuing further acquisitions in the Saudi market as part of its strategy of moving from a mobile operator to a fully integrated telecoms operator.

We do not include additional revenue from Bayanat at this stage

We do not include any revenue generated from Bayanat in Mobily's total revenue due to the lack of details regarding the company's revenue and margins. This gives room for potential positive surprises in terms of revenue growth and ARPUs.

MANAGED SERVICES CONTRACT

Mobily announced in March 2008 that it had signed managed services contracts, the Middle East's first, with three companies: Alcatel-Lucent, Ericsson and Huawei. Under the contracts, the three companies will provide Mobily's network with operation, maintenance, network optimization, spare parts management and technical support for three years.

Managed services contract will allow Mobily better management of operating costs

Managed services contracts generally allow operators to improve their operating margins through better cost management. These contracts are becoming increasingly popular with operators, especially in markets with higher penetration levels and declining ARPUs. We believe this deal will allow Mobily to lower operating costs, especially for repairs and maintenance, to around 3% of net assets from 4.5% now. It could also save on capex spending should some form of asset-pooling (another popular strategy among operators to share their network resources among with one another) takes place as managed services contracts become more popular in Saudi.

CHANGES IN SHAREHOLDER STRUCTURE

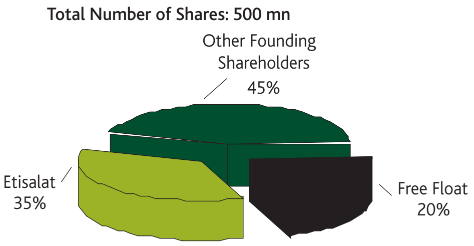
Founding shareholders sold 20% of their stake in Mobily in a private placement

The royal decree issued for Mobily's formation three years ago required Mobily's founding shareholders (UAE-operator Etisalat and other Saudi investors) to sell 20% of their stake, or 100 million shares, three years after its incorporation. The shares were sold in a private placement to Saudi strategic investors at SAR55 per share for a total SAR5,500 million. The sale decreased the founding shareholders' stake to 60% from 80%. Etisalat, whose stake fell to 26.25% from 35%, said later it would investigate increasing its stake in Mobily to up to 50%.

Still one rights issue to come

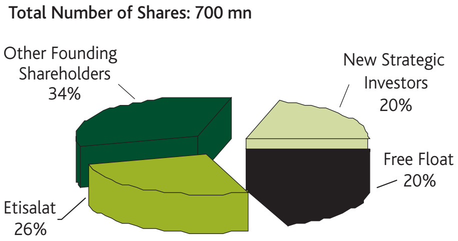
Mobily has filed an application with the Saudi Capital Market Authority for a rights issue to increase its total paid-in capital to SAR7,000 million from SAR5,000 million. The total number of shares would increase to 700 million from the current 500 million. These would be issued at par value of SAR10 with no share premium to existing shareholders on a pro-rata basis. We believe Mobily would use the proceeds to finance further investments in its infrastructure and network and repay some of its outstanding debt. The rights issue would dilute our LT Fair Value per share. If the additional equity were used to pay down part of the company's debts it might also have a slightly negative impact on our estimated equity value for Mobily, as it would bring up the WACC.

Fig 2.1: Mobily's Original Shareholder Structure



Source: Mobily, EFG-Hermes

Fig 2.2: Mobily's New Shareholder Structure Post Private Placement and Rights Issue



Source: Mobily, EFG-Hermes

THE INFOTECH INVESTMENT

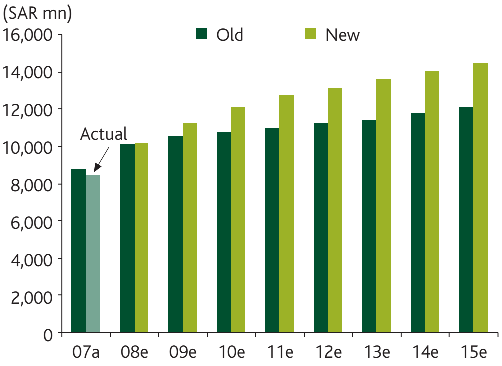
Mobily in 2007 set up a wholly-owned subsidiary in India, "Mobily InfoTech", which develops IT solutions for telecom operators, with an initial investment of INR200 million (SAR18 million). Early in the year, Mobily announced it plans to invest an additional INR700 million (SAR62 million) in the company over the next three years. Mobily InfoTech has not started commercial services yet and is not consolidated into Mobily's financials. We do not include Mobily InfoTech in our forecasts, as its contribution will be insignificant.

B. REVENUE AND ARPUS

Adjusting revenue to reflect higher subscriber forecasts and faster ARPU dilution

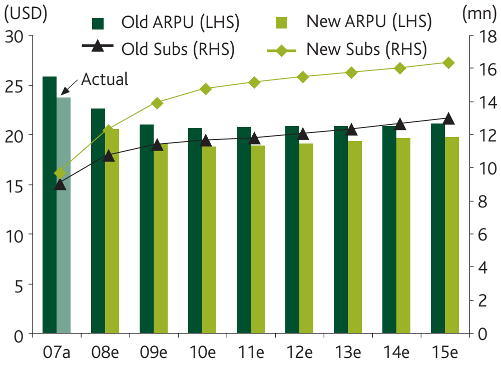
We adjust our revenue and ARPU forecasts for Mobily to reflect the higher-than-expected subscriber additions and faster dilution of ARPU. We estimate 2007 ARPU came in at SAR88.9 (USD23.7), 8.3% lower than our forecast of SAR96.9 (USD25.8). Mobile subscribers surprised on the upside, coming at an estimated 9.7 million, higher than our expected 9.0 million subscribers. We slightly increase our revenue estimate for FY2008e to SAR10,196 million from SAR10,083 million and lower our ARPU to SAR77.2 (USD20.6) to reflect higher subscriber forecasts.

Fig 2.3: Mobily's Old Versus New Revenue Forecasts



Source: Mobily, EFG-Hermes estimates

Fig 2.4: Mobily's Old Vs New ARPU and Subscribers Forecasts



Source: Mobily, EFG-Hermes estimates

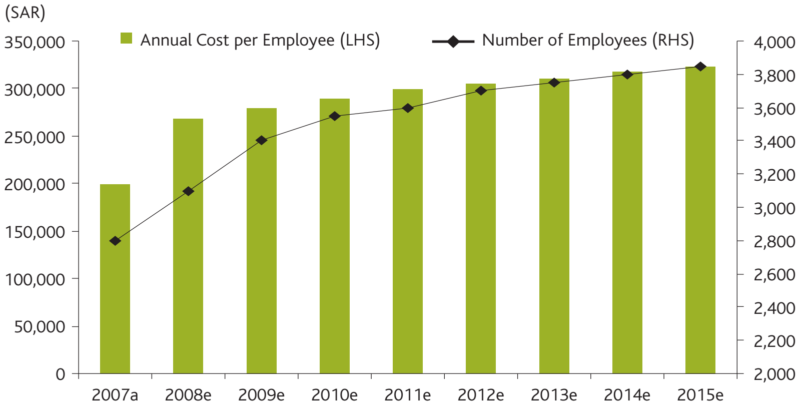
C. EBITDA AND MARGINS

Mobily reported an EBITDA of SAR2,947 million in 2007, up 47% from 2006, exactly in line with our expectations for the year. The EBITDA margin for 2007 was 34.9%, slightly higher than our expectation of 33.6%. We decrease our 2008e margin forecast to 36.1% from 38.5%, mostly as a result of the negative margin surprise in the first quarter, which we speculate was driven by lower tariffs.

We expect higher SG&A expenses and higher salaries

We expect advertising costs to rise as a percentage of revenue to 5.6% due to surging competition. Inflation has soared to record highs in Saudi Arabia and a number of companies have announced salary increases as a result. Mobily was among the first, increasing salaries between 20% and 40%. We expect this to put pressure on margins, especially as new telecom operators gear up and recruit telecom professionals. We forecast that Mobily's employees will increase to 3,100 in 2008e and that the cost per employee will rise 35% on average to around SAR268,000.

Figure 2.5: Mobily's Number of Employees and Cost per Employee Forecasts



Source: Mobily, EFG-Hermes estimates

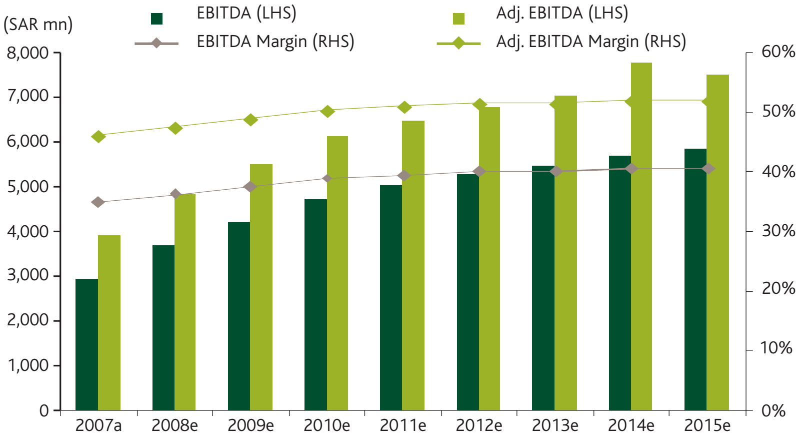
International gateway agreement with STC ended in 2Q2008

We expect the cost of sales in 2008e to decline to 43% of revenue, from 45%, due to: i) lower international gateway costs, as the company's international gateway agreement with STC ended in 2Q2008 and it is no longer forced to direct part of its international traffic to STC, and ii) lower repairs and maintenance costs as a percentage of net assets as its managed services contract kicks in.

EBITDA margins to stabilize in the early 40s

Going forward, we forecast that the EBITDA margin will stabilize at 40-41% because of increased competition and the inflationary environment, which we believe will put upward pressure on Mobily's costs. Saudi telecom operators place government royalties, including license fees, revenue sharing and spectrum fees, above the EBITDA line. This leads to EBITDA levels lower than those of operators elsewhere in the region where these costs are not included above the EBITDA line. If for comparison reasons we calculate the adjusted EBITDA margin for Mobily by removing revenue sharing, as illustrated in Figure 2.6, EBITDA is 10 to 12 percentage points higher than normal EBITDA.

Figure 2.6: Mobily Normal and Adjusted EBITDA and EBITDA Margin Forecasts



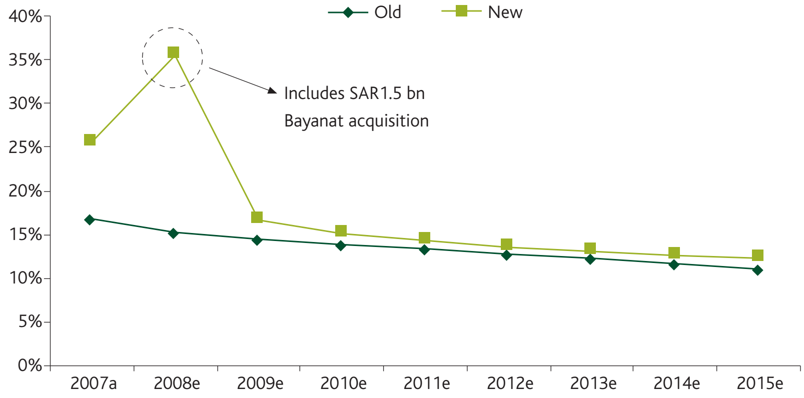
Source: Mobily, EFG-Hermes estimates

D. CAPEX

Mobily spent SAR2.1 billion in capital expenditure in 2007, up 48% Y-o-Y from SAR1.5 billion in 2006 and 45% above our forecast. The capex-to-sales ratio increased slightly to 25.5% from 24.9% the year before. We have increased our 2008e forecast capex to SAR3.6 million, including SAR1.5 billion that was spent to acquire Bayanat al-Oula, in line with management guidance. Excluding capex spent on Bayanat, 2008e capex-to-sales would be 20.8%. We expect Mobily to spend most of its capex on: i) upgrading capacity to accommodate the surge in usage and subscriber growth, ii) building the remaining four rings of the fiber-optic network, and iii) expanding its 3G network coverage.

Going forward, we forecast that capex spending will fall to SAR1.8 billion or lower and that the capex-to-sales ratio will be 16.7% in 2009e and 15.1% in 2010e.

Figure 2.7: Mobily's Old Versus New Capex-to-Sales Forecasts

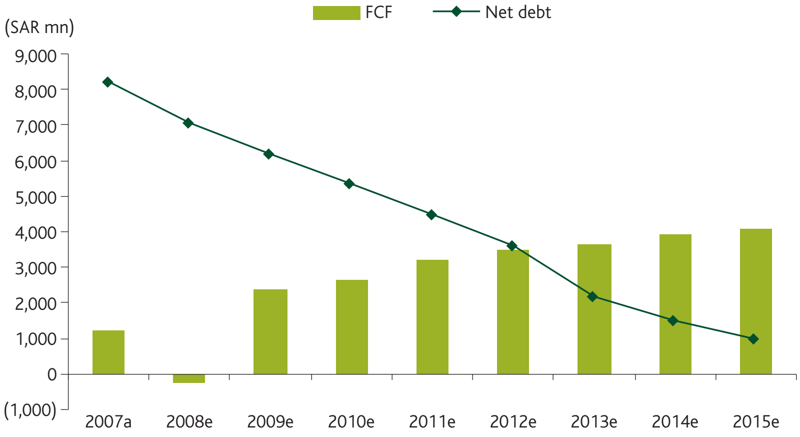


Source: Mobily, EFG-Hermes estimates

E. FREE CASH FLOW (FCF) AND DIVIDENDS

Mobily had begun generating a positive FCF by mid-2006, but we expect that it will turn negative again in 2008 due to its SAR1,500 million investment in Bayanat. Excluding this investment, our 2008 FCF forecasts would be a positive SAR1,240 million, up from SAR1,215 million in 2007. We expect Mobily's FCF will continue to rise faster and climb to as high as 22% of revenue in 2010e.

Figure 2.8: Mobily's Net Debt and FCF Forecasts



Source: Mobily, EFG-Hermes estimates

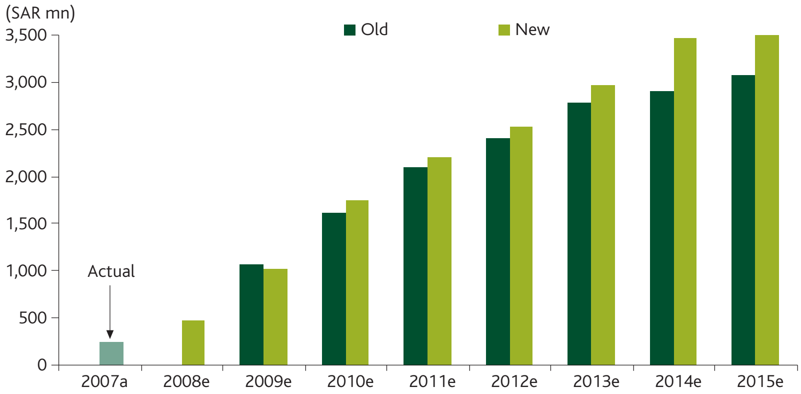
Mobily distributed dividends only two years after earnings breakeven

Mobily's annual general meeting (AGM) approved the distribution of a cash dividend for 2007 of SAR250 million, or SAR0.5 per share, which implies an 18% dividend payout ratio. We had not expected a dividend before 2009, for which we were expecting a 45% payout ratio.

We believe distributing dividends at such an early stage reflects the company's strong cash generation and should boost sentiment for the stock in a retail-driven market that favors dividend-paying stocks.

The dividend will increase Mobily's net debt, creating a more efficient balance sheet. Some investors, however, will see it negatively should it imply a maturing growth story. We changed our dividend forecasts and are now forecasting more aggressive dividends as illustrated in Figure 2.9. We expect that Mobily will distribute SAR471 million in 2008e, a 25% dividend payout ratio that will gradually increase to 100% in 2014e.

Figure 2.9: Mobily's Old Versus New Dividend Forecasts



Source: Mobily, EFG-Hermes estimates

F. LEVERAGE

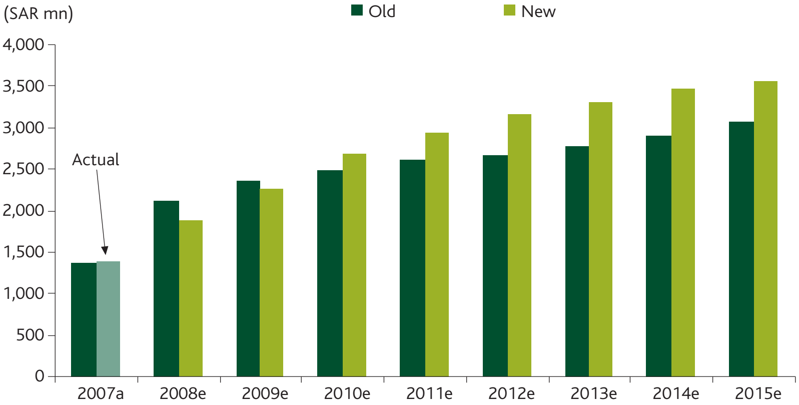
Mobily remains heavily leveraged, with debt of SAR8.9 billion at the end of 2007, down from SAR9.4 billion a year earlier. Net debt for 2007 was SAR8.2 billion. This implies a net-debt-to-EBITDA ratio of 2.8x at the end of 2007. Mobily signed a new SAR1,500 million short-term Islamic financing facility in April 2008 with three local banks to finance the acquisition of Bayanat al-Oula. We therefore expect total debt to increase in absolute terms in 2008e to SAR9.25 billion. We expect the company's net debt to reach SAR7.0 million at the end of the year due to the increase in cash after the rights issue. We expect a net-debt-to-EBITDA ratio of 1.9x at the end of 2008e.

G. EARNINGS

Mobily's earnings to grow at an 18% CAGR for the next five years

Mobily's 2007 net profit was SAR1,380 million, exactly in line with our estimate for the year. We slightly decrease our earnings forecast for 2008e to SAR1,885 million from SAR2,116 million to reflect a lower EBITDA forecast for the year and lower–than-expected 1Q2008 results. We estimate a five-year earnings CAGR of 18% to SAR3,166 million by the end of 2012e. Growth should slow to single digits starting in 2011e then stabilize at between 3% and 5% going forward. Mobily started paying zakat, an Islamic tax, in 2007. For simplicity we assume a zakat rate of 2.5% of pre-zakat income.

Figure 2.10: Mobily's Old Versus New Earnings Forecasts



Source: Mobily, EFG-Hermes estimates

III. VALUATION

We raise our fair value estimate for Mobily by 7.7% to SAR85.6 per share

We use a discounted cash flow (DCF) methodology to value Mobily. Our new equity value is SAR42,800 million, 7.7% above our old equity value, or SAR85.6 per share. The increase is due to:

1. The rolling forward of our DCF model

2. Higher subscriber and revenue growth forecasts. We upgrade Mobily's subscribers growth to reflect our upgrade of mobile subscriber growth in the whole market. We now estimate that Mobily's subscribers will grow at a five-year CAGR of 10% to 15.5 million by 2012e from the current 9.7 million, whereas previously we had forecast a five-year subscriber CAGR of 6%. We in turn increase our revenue forecasts to reflect the greater number of subscribers. Revenue should grow to SAR13,165 million by 2012e from the current SAR8,440 million, a five-year CAGR of 9%.

Our valuation for Mobily is based on a weighted average cost of capital (WACC) of 9.75%. Our LT Fair Value carries upside potential should: i) Mobily maintain higher ARPU levels than those we forecast due to a strong uptake of new value-added services, and ii) the revenue contribution from Bayanat be positive.

Table 3.1: Mobily's DCF Valuation

(SAR mn)		2008e	2009e	2010e	2011e	2012e	2013e	2014e	2015e
EBITDA		**3,685**	**4,211**	**4,711**	**5,019**	**5,272**	**5,461**	**5,691**	**5,851**
Zakat		(48)	(58)	(69)	(76)	(81)	(85)	(89)	(91)
Change in WI and Others		(318)	51	(201)	(65)	52	(5)	55	67
Capex		(3,578)	(1,831)	(1,780)	(1,665)	(1,743)	(1,726)	(1,727)	(1,728)
FCF		**(260)**	**2,374**	**2,661**	**3,214**	**3,500**	**3,646**	**3,930**	**4,099**
Weight of Equity	83%								
Weight of Debt	17%								
WACC	9.75%								
Terminal Growth Rate	3.5%								
EV	**51,020**								
Net Debt (Cash)	8,220								
Total Equity Value	**42,800**								
LTFV (SAR)	**85.6**								

Source: EFG-Hermes estimates

Financial Statements (December year end)

(SAR mn)	1Q2007a	2007a	1Q2008a	2008e	2009e	2010e	2011e	2012e
Balance Sheet								
Cash & Cash Equivalents	721	703	595	2,200	1,678	774	431	635
Accounts Receivables	1,099	1,460	1,823	1,397	1,447	1,493	1,567	1,623
Due from Related Parties	10	71	30	72	74	75	77	78
Inventory	30	69	71	83	91	96	101	104
Other Current Assets	730	810	838	843	826	809	817	826
Total Current Assets	**2,590**	**3,113**	**3,358**	**4,595**	**4,116**	**3,248**	**2,993**	**3,265**
PP&E (net)	4,062	5,479	6,042	6,896	7,894	8,683	9,315	9,821
Intangibles	11,672	11,287	11,158	10,773	10,260	9,747	9,233	8,720
Investments		2	2	1,500	1,500	1,500	1,400	1,400
Total Assets	**18,324**	**19,881**	**20,561**	**23,764**	**23,770**	**23,177**	**22,941**	**23,206**
CPLTD / Short Term Debts	188	1,011	1,011	1,376	2,582	2,969	3,158	1,248
Accounts Payable	2,719	3,076	3,460	2,743	2,859	2,743	2,735	2,813
Dividend Payable	-	-	250	471	510	875	1,106	1,267
Due to Related Parties	240	111	57	123	135	142	149	156
Other CL	1,448	624	1,848	636	649	662	675	689
Deferred Costs		1,207		1,183	1,136	1,068	1,079	1,100
Total Current Liabilities	**4,596**	**6,029**	**6,626**	**6,532**	**7,871**	**8,458**	**8,901**	**7,272**
Emp. End of service provision	15	26	30	30	33	37	40	48
Long-Term Islamic Financing	8,929	7,912	7,916	7,874	5,293	3,167	1,748	3,000
Total Liabilities	**13,540**	**13,968**	**14,572**	**14,437**	**13,197**	**11,662**	**10,689**	**10,321**
Net Worth	**4,784**	**5,913**	**5,989**	**9,327**	**10,573**	**11,515**	**12,252**	**12,886**
Income Statement								
Total Revenue	**1,877**	**8,440**	**2,308**	**10,196**	**11,237**	**12,109**	**12,709**	**13,165**
Cost of Services	(891)	(3,792)	(1,084)	(4,354)	(4,744)	(5,006)	(5,255)	(5,405)
Selling and Marketing	(128)	(467)	(112)	(596)	(588)	(608)	(599)	(594)
G&A	(244)	(943)	(385)	(1,232)	(1,364)	(1,454)	(1,506)	(1,563)
Provisions		(292)		(330)	(330)	(330)	(330)	(330)
EBITDA	**613**	**2,947**	**726**	**3,685**	**4,211**	**4,711**	**5,019**	**5,272**
EBITDA Margin	*32.7%*	*34.9%*	*31.5%*	*36.1%*	*37.5%*	*38.9%*	*39.5%*	*40.1%*
Depreciation and Amortization	(242)	(1,031)	(292)	(1,220)	(1,391)	(1,550)	(1,693)	(1,798)
Net Operating Profit	**371**	**1,916**	**434**	**2,465**	**2,820**	**3,161**	**3,326**	**3,475**
NOP (EBIT) Margin	*20%*	*23%*	*19%*	*24%*	*25%*	*26%*	*26%*	*26%*
Financing Costs	(129)	(555)	(120)	(577)	(541)	(446)	(348)	(274)
Other Income	8	43	14	45	45	46	46	47
Earnings before Taxes	**251**	**1,404**	**328**	**1,934**	**2,324**	**2,760**	**3,024**	**3,248**
Zakat	-	(24)	(2)	(48)	(58)	(69)	(76)	(81)
Net Profit after Taxes	**251**	**1,380**	**326**	**1,885**	**2,266**	**2,691**	**2,949**	**3,166**
Cash Flow Statement								
Cash Operating Profit after Tax	**648**	**2,923**	**771**	**3,637**	**4,153**	**4,642**	**4,943**	**5,191**
Change in Working Investment	(484)	399	(176)	(318)	51	(201)	(65)	52
Cashflow Post Chg in WI	**164**	**3,322**	**595**	**3,318**	**4,205**	**4,441**	**4,878**	**5,243**
Capex	(56)	(2,150)	(703)	(3,623)	(1,876)	(1,826)	(1,711)	(1,790)
Investments and others	-	43	-	45	45	46	46	47
Free Cash Flow	**109**	**1,215**	**(108)**	**(260)**	**2,374**	**2,661**	**3,214**	**3,500**
Change in Equity	-	-	-	2,000	-	-	-	-
Loans	64	(517)	-	327	(1,376)	(1,738)	(1,231)	(658)
Dividends Paid	-	-	-	-	(981)	(1,385)	(1,980)	(2,372)
Interest and other	-	(542)	-	(573)	(538)	(443)	(345)	(266)
Change in Cash	**173**	**156**	**(108)**	**1,494**	**(521)**	**(904)**	**(343)**	**204**

Source: Mobily, EFG-Hermes estimates

المجموعة المالية - هيرميس
EFG HERMES

ZAIN SAUDI ARABIA

Up to the Challenge?

16 JUNE 2008

SAUDI ARABIA | TELECOM

ST Rec.: Sell	Current Price* : SAR 27.5
LT Rec.: Sell	LT Fair Value** : N/A

CONTENTS

I. Company Background and Shareholder Structure 48

II. Strategy and Business Model 49

III. Forecasts 50

IV. Valuation 54

- **Third Mobile Operator in Saudi Arabia:** A consortium of Kuwaiti-based Zain Group and a number of Saudi companies won Saudi Arabia's third mobile license in March 2007 with the high bid of SAR22.9 billion (USD6.1 billion). The company plans to start operations in July 2008, offering 2G and 3G mobile services. Half of its shares were listed on Tadawul through an IPO in 22 March 2008 that was almost three times oversubscribed.

- **Zain Saudi to Leverage on "One Network":** Zain Saudi will differentiate itself from STC and Mobily through its new "One Network" service that the company expects to launch in five countries: Saudi Arabia, Jordan, Bahrain, Iraq and Sudan. The service will allow subscribers in member countries to make calls between those countries at local rates.

- **We Also Believe in Price-Based Competition:** With the mobile penetration rate in Saudi exceeding 100% and competition intense between incumbents STC and Mobily, we expect that Zain Saudi will also have to opt for an aggressive, but rational, pricing strategy to gain significant market share, much as Etisalat Misr is doing in Egypt.

- **Market Share to Reach 15% in 2015e:** We assume Zain Saudi will grow its market share from our expected 4% in 2008e to 15% in 2015e, a bullish assumption that is nonetheless below management's market share target of 33%. We expect an ARPU of SAR59 in 2008e, increasing to SAR78 in 2015e.

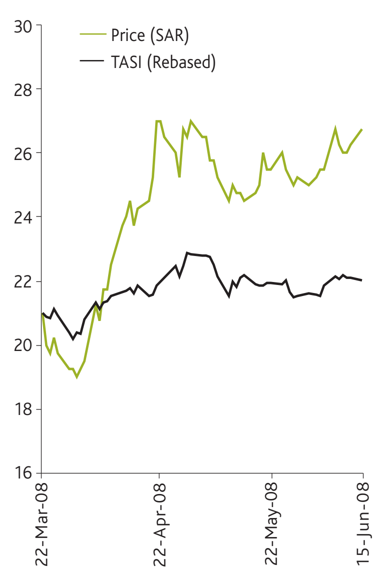
- **EBITDA Breakeven after Three and a Half Years of Operations:** We forecast the company will be able to break even at an EBITDA level in 2011 - after three years and a half of operation, which is longer than it took for Mobily to break even on an EBITDA level. We forecast earnings breakeven in 2016, similar to the period we are forecasting for Etisalat Misr in Egypt, given the high license fees paid by both companies.

- **Rich Valuation, Initiate With a Sell Recommendation:** We use a DCF model to estimate an equity range for Zain Saudi of SAR15.0 billion to SAR25.1 billion based on two scenarios (low-case and high-case). Our estimated equity range for the company is lower than the company's current market capitalization by 61% and 35% respectively. We note that Zain Saudi's current market cap of SAR38.5 billion is higher than Mobily's (at SAR27.1 billion) despite Zain having no subscribers versus an estimated 9.7 million for Mobily. Although we are positive on the performance of the Saudi mobile sector, we initiate coverage of Zain Saudi with a ST/LT Sell recommendation given the significant downside potential to our estimated equity value range.

December year end	*2008e*	*2009e*	*2010e*	*2011e*
Operating Income (mn)	*(911.8)*	*(1,245)*	*(1,120)*	*(324.5)*
Net Attrib. Income (mn)	*(1,251)*	*(1,961)*	*(1,925)*	*(1,210)*
ROE	*-9.8%*	*-18.2%*	*-21.7%*	*-15.8%*
EPS	*(0.89)*	*(1.40)*	*(1.37)*	*(0.86)*
Earnings Growth	*N/R*	*N/M*	*N/M*	*N/M*
P/E (Attrib.)	*N/M*	*N/M*	*N/M*	*N/M*
DPS	*-*	*-*	*-*	*-*
Dividend Yield	*0.0%*	*0.0%*	*0.0%*	*0.0%*
BVPS	*9.11*	*7.71*	*6.33*	*5.47*
P/BV	*3.0*	*3.6*	*4.3*	*5.0*
CFPS (Operating CF)	*1.23*	*0.02*	*0.09*	*0.53*
P/CF	*22.4*	*1,178*	*305.3*	*51.5*
EBITDA (mn)	*(440.7)*	*(198.2)*	*(12.0)*	*830.3*
EBITDA Margin	*-167.5%*	*-10.5%*	*-0.4%*	*19.4%*
EV/EBITDA	*N/M*	*N/M*	*N/M*	*67.1*
EV/Sub	*38,064*	*15,306*	*11,601*	*10,384*
*Net Debt (Cash) (mn)****	*12,374*	*14,329*	*16,167*	*17,241*
Net Debt (Cash)/ BV	*97.1%*	*132.8%*	*182.4%*	*225.3%*
Net Debt (Cash)/ Mkt cap	*32.1%*	*37.2%*	*42.0%*	*44.8%*

Fig in SAR unless otherwise stated

**** Debt includes vendor financing facilities*



Estimate Changes

(SAR mn)	*2007a*	*2008e Old*	*2008e New*	*2009e Old*	*2009e New*
Revenue	*N/A*	*N/A*	*263.1*	*N/A*	*1,891*
EBITDA	*N/A*	*N/A*	*(440.7)*	*N/A*	*(198.2)*
EBITDA Margin	*N/A*	*N/A*	*-167.5%*	*N/A*	*-10.5%*
Net Attrib. Income	*N/A*	*N/A*	*(1,251)*	*N/A*	*(1,961)*

Stock Data

Last Ex-Div Date	*N/A*
Mkt. Val. (mn)	*SAR38,500*
Shares (mn)	*1,400*
Av. Mthly Liqd. (mn)	*SAR26,223*
52-Week High / Low	*SAR27.8 / 18.8*
Bloomberg / Reuters	*ZAINKSA AB / 7030.SE*
Est. Free Float	*45.0%*

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*prices as of 15 June 2008

**Given the startup nature of the company, we refrain from issuing a long-term fair value yet we estimate a valuation range

I. COMPANY BACKGROUND AND SHAREHOLDER STRUCTURE

BACKGROUND

With USD6.1 billion, Zain made the highest bid among seven consortiums

Zain Saudi Arabia is the third mobile operator in Saudi Arabia. It was established after a consortium led by the Kuwait-based Zain Group and number of Saudi companies won Saudi Arabia's third mobile license in March 2007 with a bid of SAR22.9 billion (USD6.1 billion), the highest of the seven consortiums that applied. Samawat Consortium, which included Telecom Italia and Saudi investors, put in the second highest bid, which was 25% less than Zain Group's. The 25-year license allows the company to install, own and operate a mobile network to provide mobile cellular services using 2G and 3G technologies. The company is allowed to provide mobile voice, data, VAS and other supplementary services.

Zain Saudi plans to start operations in July 2008

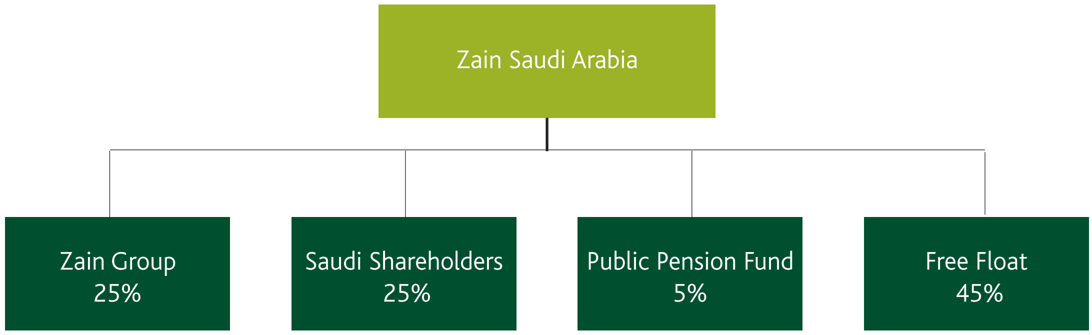
According to media reports, the company plans to launch operations in July 2008, when it will cover 53% of the population through its own infrastructure. The rest will be covered through national roaming agreements with the incumbents. The license stipulates coverage of 93% of the population within five years of the start of service.

CAPITAL AND SHAREHOLDER STRUCTURE

The IPO was almost three times oversubscribed

Zain Saudi's SAR14,000 million capital is distributed over 1,400 million shares at a par value of SAR10 each. The founding shareholders subscribed to 50% of the company's capital (SAR7,000 million or 700 million shares) and the other half was offered in an initial public offering (IPO) on the Saudi stock exchange (Tadawul) in February at SAR10 per share. The IPO was 283% oversubscribed, and the company began trading on the stock exchange on 22 March 2008. The current shareholder structure is illustrated in the chart below.

Figure 1.1: Zain Saudi Shareholder Structure



Zain Saudi Arabia

Zain Group 25%

Saudi Shareholders 25%

Public Pension Fund 5%

Free Float 45%

Source: Zain Saudi, EFG-Hermes

II. STRATEGY AND BUSINESS MODEL

We believe it will be very challenging for Zain Saudi to build market share in Saudi Arabia given that the mobile penetration rate already exceeded 100% in 2007 and because competition is already intense between STC and Mobily. Competitive strategic moves that Zain Saudi might make to build its market share include: i) lower tariffs, ii) its One Network service, and iii) market segmentation.

LOWER TARIFFS

Price-based competition: similar to Etisalat Misr

We believe we can apply some of the lessons learned from Egypt, when a third operator entered the market, to Saudi Arabia. When Etisalat Misr started operations in Egypt as a third operator in May 2007, it undercut the tariffs of Vodafone Egypt and Mobinil by about 15%, signaling very serious, but rational, competition. Vodafone followed suit with tariff reductions in August 2007 and Mobinil in September. Mobinil later slashed its on-net tariffs by 33-56% after introducing mobile number portability (MNP) into the market in April 2008. This prompted Etisalat also to reduce its on-net tariffs, cutting them to EGP0.15 per minute, the lowest tariffs in the Egyptian market. In Saudi Arabia, we believe the current level of tariffs still allows some room for tariff cuts, but we do not expect elasticity will be as strong as in Egypt. We believe that aggressive price-based competition in Saudi Arabia is one of the main risks to our ARPU forecasts.

Zain will first have to create a large subscriber base then focus on usage

The difference between Zain Saudi and Etisalat Misr is the level of penetration and market saturation, since the mobile penetration rate in Egypt was below 38% when Etisalat Misr started operations, while the mobile penetration rate in Saudi Arabia is currently over 109%. We expect Zain Saudi to compete for market share by offering lower prices than those prevailing in the market. We believe the relatively high mobile penetration rate in Saudi Arabia will put pressure on Zain Saudi to be more aggressive and create a significant subscriber base during its first two years of operation. This will initially be at the expense of profitability, but the company will then focus on creating value out of its existing subscribers by enhancing their usage. Zain Saudi's CEO Marwan Al Ahmady indicated in Al Riyadh newspaper that the company plans to introduce roaming and international tariffs that are only slightly higher than tariffs for local calls, as Zain Group has operations in several countries where it can arrange low interconnection and roaming agreements.

ONE NETWORK

Zain Saudi plans on leveraging its "One Network" service to differentiate itself from both STC and Mobily. Under One Network, subscribers pay local rates for calls and SMSs between the countries where Zain Group has a network, rather than international roaming rates. They also receive calls between these countries free of charge. The service is automatically activated when Zain subscribers cross borders, with no need for pre-registration, extra fees or roaming deposits. The service was originally launched by Zain Group in 14 African countries through its fully-owned subsidiary Celtel. Zain Saudi is expected to join the One Network once it starts its commercial services in the Middle East. Jordan, Bahrain, Iraq, Sudan and Saudi Arabia are Middle Eastern countries that would be covered under this service.

While we believe this service is innovative and will encourage subscribers who regularly travel between these countries to subscribe to Zain services, we believe it may not be a significant driver of market share for Zain. STC has presence in India and Indonesia, and Etisalat (Mobily's parent company) is present in Egypt and Pakistan. This could allow them to adopt similar call discounts in the countries where the majority of Saudi Arabia's expatriates originate from.

MARKET SEGMENTATION

We believe Zain will try to target different segments of the mobile market through tailor-made products and promotions. This strategy works well when a second entrant breaks the monopoly of an incumbent in an under-segmented market. However, the Saudi mobile market today has various products and offers and may not present such immediate opportunities for Zain Saudi.

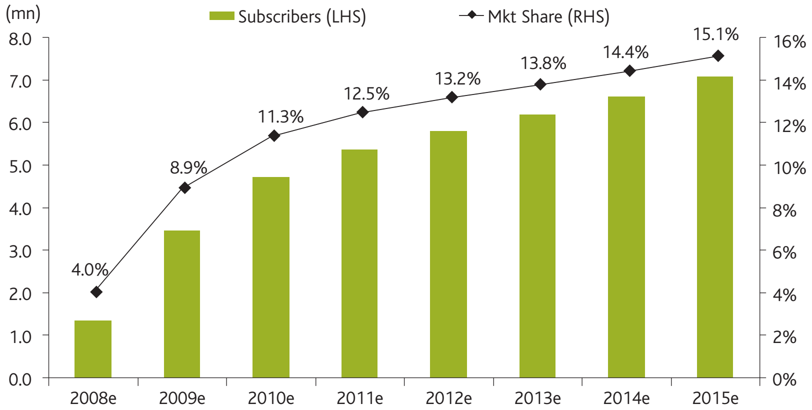
III. FORECASTS

SUBSCRIBERS

We forecast 15% market share by 2015

Zain Saudi is expected to launch operations in July 2008. Zain Saudi's management indicated the company is targeting a market share of 30% or more, but did not specify when it would achieve this. We feel a 30% market share is optimistic in a market where the penetration rate is above 100% and dominated by two strong mobile operators. We set our estimate for Zain Saudi subscribers lower than the management's target, but would upgrade our forecasts should Zain Saudi exceed our estimate. We expect Zain Saudi to attract 1.34 million subscribers at the end of 2008e, implying a market share of 4.0%, increasing to 15% in 2015e.

Figure 3.1: Zain Saudi Subscribers and Market Share Forecasts



Source: EFG-Hermes estimates

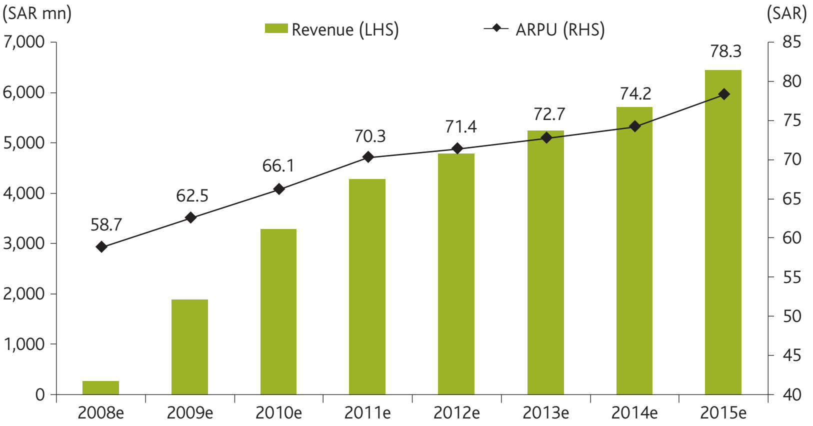
ARPU AND REVENUE

We expect an ARPU of USD16 at the end of 2008e

We expect an ARPU for Zain Saudi of SAR58.7 (USD15.7) at the end of 2008e, 23% lower than our estimate for Mobily and 49% lower than our estimate for STC. In Egypt, Etisalat Misr had an entry ARPU of USD6 at the end of 2007, versus USD12 for Vodafone Egypt and USD10 for Mobinil. We expect Zain Saudi's ARPU to start increasing gradually until it reaches SAR78.3 (USD21) in 2015e, as we expect the company to start focusing on: i) enhancing usage after the first two years, when we expect it to focus more on growing its subscriber base, especially business and high-usage subscribers, and ii) offering more value-added services.

We forecast that Zain Saudi will generate revenue of SAR263 million (USD70.2 million) in 2008e, after only five months of operations, and expect revenue to jump to SAR1,891 million in 2009e. We expect a five-year revenue CAGR of 25% to SAR5,706 million in 2014e.

Figure 3.2: Zain Saudi ARPU and Revenue Forecasts



Source: EFG-Hermes estimates

EBITDA AND MARGINS

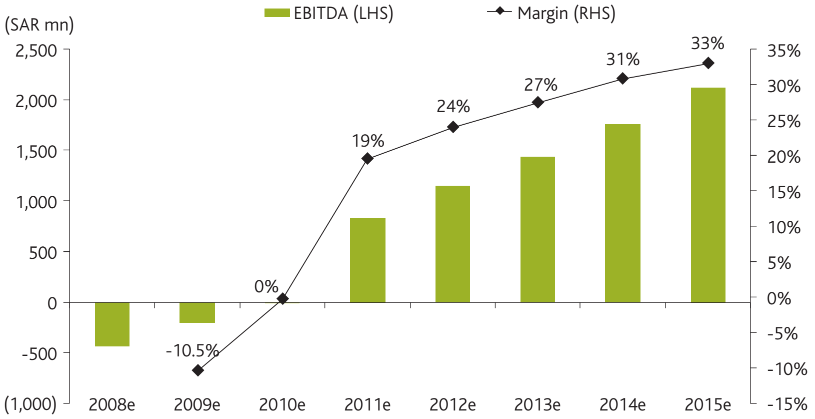
We expect EBITDA breakeven in 2011

We expect Zain Saudi to break even at an EBITDA level in 2011, three and a half years after it began operations. This is longer than Mobily took to break even on an EBITDA level. This is mostly because of Zain Saudi's lower ARPU levels in a market that is more aggressive than when Mobily entered. When Mobily started operations, tariffs were almost double the tariffs currently prevailing in the market.

Zain pays management fees to Zain Group

In addition to ordinary interconnection, SG&A, government and employee costs, Zain Saudi will pay management fees to Zain Group equal to 4% of revenue in the first two years, declining gradually to 2% of revenue in 2012. Zain Saudi will also pay Zain Group brand royalty fees equal to 0.7% of revenue.

Figure 3.3: Zain Saudi EBITDA and EBITDA Margin Forecasts



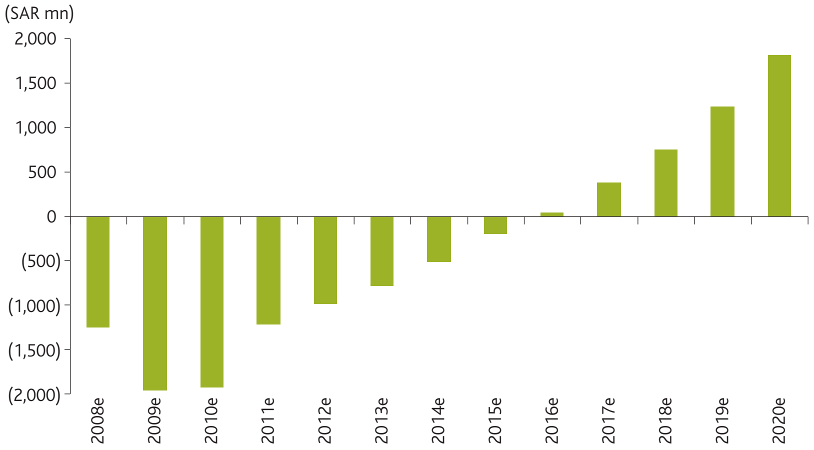
Source: EFG-Hermes estimates

EARNINGS

Earnings breakeven not before 2016

We expect Zain Saudi to report losses of SAR1,251 million at the end of 2008e. Based on our current forecasts, we do not expect that the company will be able to break even before 2016, given the high annual amortization expenses of the license, at SAR916 million, and the high interest expenses we expect will be incurred each year. Eight years to breakeven is similar in duration to what we forecast for Etisalat Misr. Even if Zain Saudi Arabia decides to capitalize a significant portion of this interest expense, we would not expect the company to achieve earnings breakeven before five to six years of operations.

Figure 3.4: Zain Saudi Earnings Forecasts



Source: EFG-Hermes estimates

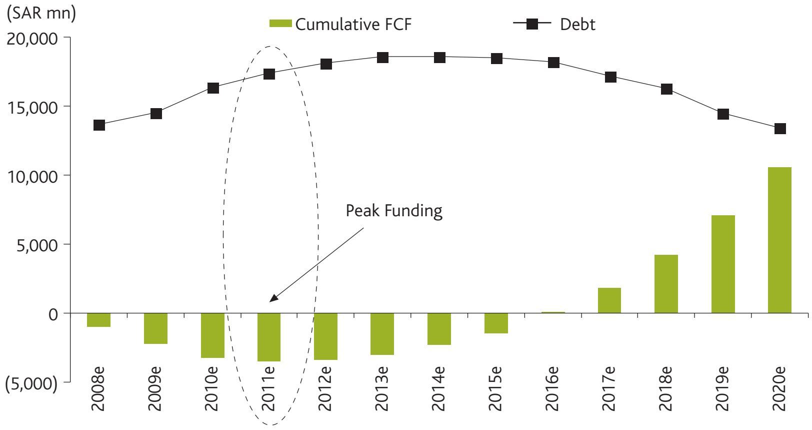
CAPITAL STRUCTURE

Zain Saudi's paid-in capital of SAR14 billion is divided into 1.4 billion shares of SAR10 each. We are forecasting a 50:50 debt-to-equity ratio in its first year of operations. The Communication and Information Technology Commission (CITC) required the company to pay 80% of the license fee, or SAR18.3 billion, no later than 28 July 2007. We expect the company's total debts at the end of 2008 will reach around SAR13.7 billion, as per the IPO's prospectus. These debts include vendor-financing facilities.

Peak funding requirement in 2011

According to our forecasts, Zain Saudi will reach its peak funding requirement of SAR3.5 billion in 2011e, which coincides with one of the highest point of debt levels for Zain. We forecast that debt, excluding vendor financing, will increase gradually to SAR15.3 billion in 2011e and SAR17.4 billion in 2015e.

Figure 3.5: Zain Saudi Cumulative FCF and Debt Forecasts



Debts include vendor-financing facilities, which are not charged interest and are included in the company's working capital

Source: EFG-Hermes estimates

CAPEX

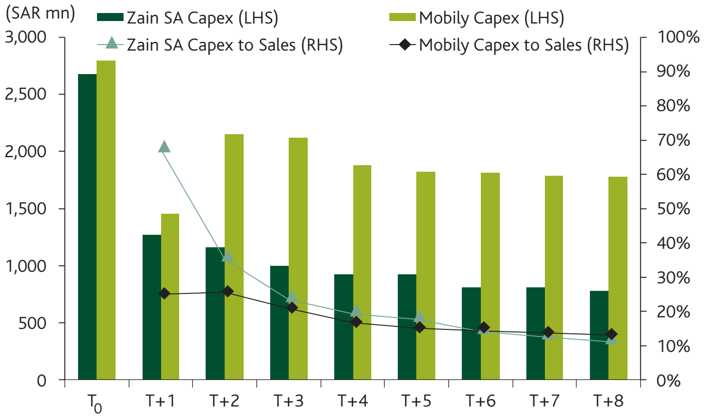
We forecast Zain Saudi to spend SAR2.7 billion in 2008

Zain Saudi is planning to launch operations with a network covering 53% of Saudi Arabia's population and a 3G network covering 43% of the population. We forecast that Zain Saudi will spend around SAR2.7 billion in capital expenditure on its network and infrastructure in 2008e, its first year of operations. This is slightly lower than Mobily's capex in absolute terms in 2005, also its first year of operations. We expect capital expenditures to drop to SAR1.3 billion in 2009e and to fall below SAR1.0 billion starting 2011e. Beyond that, we estimate capex will stabilize at around SAR720 million.

We assume exit capex-to-sales of 7%

Our capex forecasts imply a capex-to-sales ratio of around 67% in 2009e, falling to the low 20s by 2011e. We assume an exit capex-to-sales ratio of 7% in 2020.

Figure 3.6: Zain Saudi Capex and Capex-to-Sales Compared to Mobily (T_0 is the first year of operation)



Source: Mobily, EFG-Hermes estimates

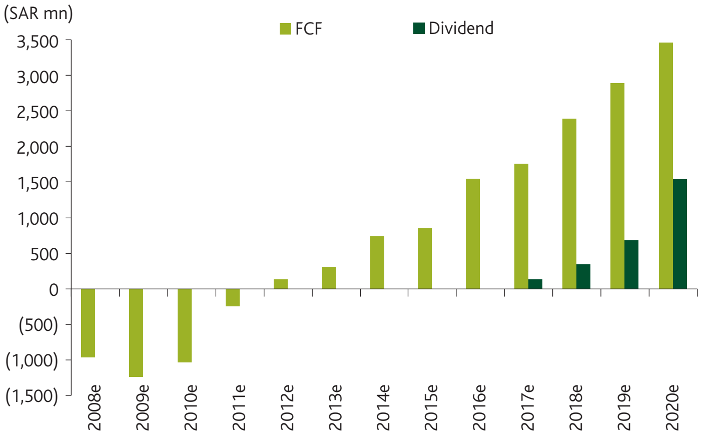
FREE CASH FLOW AND DIVIDENDS

We expect positive FCF in 2012

We do not expect Zain Saudi to generate positive free cash flow (FCF) before 2012. This is longer than it took Mobily to start generating positive FCF (which it did in its second year after it launched operations), as we are forecasting a lower revenue base, lower margins and a longer period to break even.

We expect that Zain Saudi will be able to pay dividends beginning in 2017, the year after earnings break even, with a payout ratio of 35%. We forecast the company will increase its dividends payout ratios to around 85% within three years beyond that.

Figure 3.7: Zain Saudi FCF and Dividends Forecasts



Source: EFG-Hermes estimates

IV. VALUATION

We use a DCF model to estimate an equity value range for Zain Saudi. We opted to use a valuation range at this stage, as opposed to estimating a specific fair value, given the uncertainties of valuing a start-up that has not yet commenced operations. Our estimate for the equity value of the company is between SAR15.0 billion and SAR25.1 billion based on two scenarios (low-case and high-case). Our estimated equity range for the company is lower than the company's current market capitalization by 35-61%. Although we are positive on the performance of the Saudi mobile sector, we initiate coverage of Zain Saudi with a ST/LT Sell recommendation to reflect the significant downside potential to our estimated equity value range.

Table 4.1 lists the main assumptions underpinning our forecasts for the low-case, base-case and high-case scenarios. For the sake of comparison, we provide the assumptions we are using to formulate forecasts for STC and Mobily.

Table 4.1: Main Assumptions for Zain Saudi Valuation

	Zain Saudi			Mobily	STC
	Low Case	Base Case	High Case		
ARPU in 2015 (SAR)	70.8	78.3	85.8	74.3	109.1
ARPU CAGR 2015-2020	1.2%	1.2%	1.2%	1.0%	1.0%
Market Share in 2015	13.6%	15.1%	16.6%	34.8%	50.1%
Market Share in 2020	17.8%	19.7%	21.7%	34.1%	46.2%
Subscribers 2015 (mn)	6.4	7.1	7.8	16.3	23.5
Subscribers 2020 (mn)	9.9	11.0	12.1	19.0	25.7
EBITDA Margin 2015	29%	33%	40%	41%	46%
EBITDA Margin 2020	35%	39%	43%	43%	48%
Cumulative FCF 2008-2015	(4,121)	(1,473)	2,355	23,163	134,448
Market Cap (SAR mn)	38,500	38,500	38,500	27,125	125,500
Estimated Equity Value (SAR mn)	15,000	20,859	25,059	42,800	202,054
Upside / Downside to Fair Value	-61%	-46%	-35%	58%	61%

Source: EFG-Hermes estimates

ARPUs

In our low-case scenario, we forecast an ARPU for Zain Saudi in 2008e of SAR52, increasing to SAR71 in 2015e and subsequently growing at a five-year CAGR of 1.2%. In our high-case scenario, we expect a higher ARPU for 2008e of SAR66, which is only 15% lower than that of Mobily, increasing to SAR86 in 2015e and subsequently growing at a five-year CAGR of 1.2%.

Subscribers and Market Share

The low-case scenario assumes 14% market share by 2015e (6.4 million subscribers), rising to 18% in 2020e (9.9 million subscribers). The high-case scenario assumes a 17% market share in 2015e (7.8 million subscribers), increasing to 22% in 2020e (12.1 million subscribers).

EBITDA

We forecast Zain Saudi to break even at an EBITDA level in 2011e under the low-case scenario, with an EBITDA margin of 12.9%. For the high-case, we forecast EBITDA breakeven in 2010e, with a 5.5% EBITDA margin for the year. For the longer term, we forecast that under the low-case scenario the EBITDA margin will be 29% in 2015e and 35% in 2020e. Under the high-case scenario, we forecast it will be 40% in 2015e and 43% in 2020e.

Cumulative FCF

Our free cash forecasts are based mainly on our revenue, costs and capex spending forecasts. We investigate the cumulative FCF generated by the operation between 2008 and 2015, which is the high-growth period of the company and a period for which cash-flow, because it is near term, has a relatively strong impact on valuation. In our low-case scenario, we forecast Zain Saudi will generate a cumulative negative FCF between 2008e and 2015e of SAR4,121 million. We forecast a cumulative positive FCF of SAR2,355 million in the high-case scenario.

Discount Rate-WACC

We use a risk free rate of 5.0% (equal to a 10-year Saudi development bond), an equity risk premium of 6.5% for our high-case scenario and 7.5% in the low-case, and a cost of debt of 6.38%. We use a higher cost of equity in the low-case because the cumulative negative FCF generated in the first seven years of operation requires the injection of more debt which, in our view, increases the financial risk and implies higher risk to equity holders. Given the start-up nature of the company, we used a moving weighted average cost of capital (WACC) in our DCF valuation model due to the significant Y-o-Y changes in the capital structure (debt/equity) during the first five to seven years of operations. We use a terminal growth rate of 3.5% after 2020, similar to the one we use for Mobily.

Capital Structure

In the low-case scenario, Zain Saudi breaks even at an earning level in 2019e, one year before the end of our forecast period. We forecast that the company will have to inject significant amounts of debt into operations and increase its paid-in capital by SAR2,500 million in 2016e.

RECOMMENDATION

We initiate coverage of Zain Saudi with a ST/LT Sell recommendation given the significant downside to our estimated equity value range. Zain Saudi's market capitalization is higher than Mobily's, which indicates to us that Zain Saudi's stock is overvalued and that Mobily's is relatively undervalued.

What are the assumptions that make up the current valuation?

Given the high valuation assigned by the market to Zain Saudi, we ran an exercise to examine the main operational and financial assumptions that are needed to justify the current market valuation. Below is a summary of our main findings:

- **ARPU:** In order to justify the current valuation we found that ARPU would need to reach the SAR100s level in 2015e, which would be around 30% higher than that of Mobily over the same period of time.

- **Market share:** Market share would need to eventually reach 30% by 2020 which, given our current penetration forecasts, implies a market share of net additions for Zain Saudi of around 65-85% during this time.

- **EBITDA and Earnings Breakeven:** EBITDA turning positive in 2010e after just two and a half years of operations, reaching an EBITDA margin of 17%. EBITDA margin should then reach 48% in 2015e, higher than that of Mobily (41%) and STC (46%). EBITDA margin would continue increasing to reach 53% in 2020. For earning, breakeven on an earnings level would need to be reached in 2011. Cost of equity 12.0% based on an equity risk premium of 7.0%.

In conclusion, we believe the probability of the forecasts underpinned by the aforementioned assumptions materializing is rather low. For instance, we do not believe it would be rational to assume that the EBITDA margin for Zain Saudi would be higher than that of STC or Mobily. If we were to assume a lower EBITDA margin, and in order to justify the current valuation, one would have to assume an ARPU level that would be higher than that of Mobily and presumably of STC. Given that the above key assumptions are interrelated, this means that it is extremely difficult, if not impossible, for us to model a rise in all three areas, which is what is needed to justify the current price. We believe that this exercise bodes well for our recommendation on the stock.

KEY SENSITIVITIES

Our valuation, like those for any mobile operator, is mostly sensitive to the following:

i) Subscribers and market share
ii) ARPUs
iii) The cost of equity and terminal growth rate
iv) Capex

Subscribers and ARPU Forecasts

In figure 4.2, we test the sensitivity of our valuation to a 5% to 10% change in subscribers and ARPU forecasts. Our valuation is highly sensitive to changes in the ARPU forecast, as a 10% change in ARPUs for each year of our forecast period leads to a -6% to +14% change in the equity value. A 10% change in subscribers, also for each year of our forecast period, leads to -8% to +10% change in the equity value.

Even if we assume that Zain Saudi will be able to reach 30% market share in 2020e, in line with management's target, we calculate the company's equity value would only rise to SAR25,328 million, which is almost the same value we reach in our high-case scenario, and still 34% below its current market capitalization. Under this scenario, the company would break even on an earnings level in 2014e according to our estimates.

Table 4.2: Sensitivity Analysis for Subscribers and ARPUs Forecasts

	Change in Subscribers				
Change in ARPUs	-10%	-5%	0%	5%	10%
-10%	19,741	19,455	19,547	19,899	20,439
-5%	18,883	19,262	19,859	20,614	21,489
0%	19,152	19,934	20,859	21,893	23,010
5%	20,014	21,081	22,251	23,501	24,813
10%	21,225	22,516	23,885	25,316	26,798

Source: EFG-Hermes estimates

EBITDA and Capex Forecasts

In figure 4.3 we test the sensitivity of our valuation to a 5% to 10% change in EBITDA and capex forecasts throughout our forecast period. The figure shows that the valuation is highly sensitive to changes in EBITDA forecasts, as a 10% change in EBITDA for each year of our forecast period leads to a -8% to +9% change in the equity value, while a 10% change in annual capex leads to -6% to +6% change in the equity value.

Table 4.3: Sensitivity Analysis for EBITDA and Capex Forecasts

	Change in EBITDA				
Change in capex	-10%	-5%	0%	5%	10%
-10%	20,419	21,271	22,157	23,068	24,002
-5%	19,737	20,607	21,508	22,433	23,378
0%	19,055	19,943	20,859	21,798	22,755
5%	18,374	19,279	20,211	21,162	22,131
10%	17,692	18,615	19,562	20,527	21,508

Source: EFG-Hermes estimates

Cost of Equity and Terminal Growth Rate

We test the sensitivity of our valuation to changes in our cost of equity and terminal growth rate. As with any start-up, the company's valuation is highly sensitive to the choice of the terminal growth rate, as it has a moderately greater impact on the valuation of start-ups relative to more mature companies with relatively stable cash flow growth.

Table 4.4: Sensitivity Analysis for Cost of Equity and Terminal Growth Rate

	Change in Cost of Equity				
Change in Terminal Growth Rate	11.0%	11.5%	12.0%	12.5%	13.0%
2.5%	18,251	16,914	15,662	14,487	13,382
3.0%	21,016	19,462	18,015	16,663	15,399
3.5%	24,404	22,563	20,859	19,279	17,810
4.0%	28,649	26,416	24,367	22,482	20,742
4.5%	34,125	31,334	28,801	26,494	24,385

Source: EFG-Hermes estimates

Financial Statements (December year end)

(SAR mn)	2008e	2009e	2010e	2011e	2012e	2013e	2014e	2015e
Balance Sheet								
Cash	1,316	197	195	159	147	170	99	321
Accounts Receivable	45	130	225	293	328	359	391	441
Inventory	35	191	317	342	364	377	388	431
Total Current Assets	**1,396**	**518**	**738**	**795**	**839**	**906**	**877**	**1,194**
PP&E (Net)	2,668	3,809	4,776	5,535	6,184	6,791	7,255	7,680
Intangibles (Net)	22,452	21,535	20,619	19,703	18,786	17,870	16,953	16,037
Total Assets	**26,515**	**25,862**	**26,133**	**26,032**	**25,809**	**25,566**	**25,086**	**24,911**
A/P	75	547	907	978	1,040	1,077	1,107	1,232
Vendor Financing	-	1,000	962	750	650	600	600	300
CPLTD	200	9,164	-	-	-	-	-	-
Total Current Liabilities	**275**	**10,711**	**1,869**	**1,728**	**1,690**	**1,677**	**1,707**	**1,532**
Vendor Financing	2,162	1,162	1,200	1,350	1,350	1,200	1,000	800
Shareholders Loans	2,164	3,200	3,000	3,000	3,000	3,000	3,000	3,000
Murabaha Agreement	9,164	-	11,200	12,300	13,100	13,800	14,000	14,400
Employee End of Service Benefit	1	1	1	1	2	2	2	3
Total Liabilities	**13,766**	**15,074**	**17,270**	**18,380**	**19,141**	**19,679**	**19,710**	**19,735**
Share Capital	14,000	14,000	14,000	14,000	14,000	14,000	14,000	14,000
Retained Earnings	(1,251)	(3,212)	(5,137)	(6,347)	(7,333)	(8,113)	(8,624)	(8,824)
Net Worth	**12,749**	**10,788**	**8,863**	**7,653**	**6,667**	**5,887**	**5,376**	**5,176**
Income Statement								
Revenue	**263**	**1,891**	**3,290**	**4,274**	**4,796**	**5,240**	**5,706**	**6,440**
Interconnect and Network Costs	(311)	(998)	(1,655)	(1,786)	(1,897)	(1,966)	(2,021)	(2,248)
Government Costs	(14)	(147)	(365)	(478)	(538)	(589)	(642)	(725)
Staff Costs	(280)	(534)	(617)	(658)	(678)	(691)	(705)	(719)
SG&A	(87)	(322)	(526)	(385)	(408)	(419)	(428)	(451)
Mgmt Agreement	(11)	(76)	(115)	(107)	(96)	(105)	(114)	(129)
Zain Brand Royalty fee	(2)	(13)	(23)	-(30)	(34)	(37)	(40)	(45)
EBITDA	**(441)**	**(198)**	**(12)**	**830**	**1,145**	**1,433**	**1,755**	**2,123**
EBITDA Margin	*-167.5%*	*-10.5%*	*-0.4%*	*19.4%*	*23.9%*	*27.4%*	*30.8%*	*33.0%*
Depreciation and Amortization	(471)	(1,047)	(1,108)	(1,155)	(1,191)	(1,232)	(1,259)	(1,299)
EBIT	**(912)**	**(1,245)**	**(1,120)**	**(325)**	**(46)**	**202**	**496**	**824**
Interest Expenses	(339)	(716)	(805)	(886)	(939)	(982)	(1,007)	(1,024)
PBT	**(1,251)**	**(1,961)**	**(1,925)**	**(1,210)**	**(985)**	**(780)**	**(511)**	**(200)**
Zakat	-	-	-	-	-	-	-	-
Net Income	**(1,251)**	**(1,961)**	**(1,925)**	**(1,210)**	**(985)**	**(780)**	**(511)**	**(200)**
Cash Flow Statement								
Cash Operating Profit after Tax	**(441)**	**(198)**	**(12)**	**830**	**1,145**	**1,433**	**1,755**	**2,123**
Change in Working Investment	2,157	231	138	(83)	(96)	(206)	(212)	(469)
Cashflow Post Chg in WI	**1,716**	**33**	**126**	**748**	**1,049**	**1,227**	**1,543**	**1,654**
Capex and Investments	(2,681)	(1,271)	(1,159)	(997)	(922)	(922)	(808)	(808)
Free Cash Flow	**(964)**	**(1,239)**	**(1,033)**	**(250)**	**126**	**305**	**736**	**846**
Net Financing	25,528	836	1,836	1,100	800	700	200	400
Interest and Others	(338)	(716)	(805)	(886)	(939)	(981)	(1,007)	(1,024)
Change in Cash	**24,226**	**(1,119)**	**(2)**	**(36)**	**(13)**	**23**	**(71)**	**223**

Source: Zain, EFG-Hermes estimates

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