Arabian Internet and Communications Services Co.

Solutions I Investment Update

Cost intensive Q4-23 signaled a new normal; mixed bag of revenue results necessitate further momentum from acquisitions going forward

Most recent quarterly reporting from Solutions displayed a change in business conditions- summarized with robust revenue growth, and a more pronounced Q4 cost seasonality as a result of contract finalizations in Q3. Much of the growth in revenue, however, was attributed to the full year consolidation of Giza, as well as the growth in Solutions' core business (6% Y/Y). Therefore we are looking for recent acquisitions to carry on the revenue growth expected in the medium term going forward (FY23-26 CAGR 9.2%), as the core business shows signs of muted growth. Solutions also displayed a more pronounced seasonality in its Q4-23 cost base, which management indicates could become a new-normal as a result of accelerated government contract activities in the Q2 and Q3 periods. We revised our outlooks to reflect revenue guidances and visibility, as well as the cost base now present in Solutions' business model to reach an expected FY23-26 NI CAGR of 11.5%. We maintain our view that the key to Solutions' growth lies in the success of its acquisition strategies to extend its growth trajectory. We revise-down our recommendation to "Neutral" at the same target price of SAR 363.5 per share.

More to come from acquisitions, as consolidations carried the weight of growth for the year: Revenue for Q4-23 displayed growth in Solutions' core business, and namely from the Core ICT segment, as Q4-23 revenue reached SAR 2,868mn (up 38.3% Y/Y and 2.6% Q/Q). On an annual scale, Solutions' top line grew 25.4% Y/Y after a 22.2% growth in the previous year with IT & Managed Services leading the growth at 40% growth Y/Y for the segment, while Digital Business posted a lackluster 4.7% growth for the year. It is in FY23's revenue contribution, however, where we find the potential growth sources for the firm going forward; Solutions' core business, the base of revenue constituting 81% of its FY23 top line, maintained growth at only a 6% Y/Y. While a full-year consolidation of Giza majorly supported FY23's top line, we expect that Giza's potential is yet to come as management indicates that it has grown nearly 20% Y/Y over a period where it was not consolidated under Solutions yet. Future contract completions from Giza's new KSA engagements are expected to elevate its revenue contributions, as Giza's role in the Kingdom is still at its early stages- its contract lengths range from only 6 months to two years. Our estimate for an FY23-26 revenue CAGR of 9.2% largely depends on increased revenue contributions from acquired entities.

Seasonality in Q4's cost is a 'new normal' for the firm, as government contract activities slow down during the end of the year: The catalyst behind missing quarterly net income estimates by 35.4% at SAR 162mn is the sequential drop in GP margins which reached just 16.2% for the quarter (previous quarter at 28.5%). Solutions attributes this drastic slide in margins to government contract completions taking place in Q2 and Q3 for the year. Management indicates that this is a new normal, as we have also had reportings of a similar effect from other Software & Services providers. OPEX-to-revenues, on the other hand, positively declined 370bps Q/Q and 410bps Y/Y for the quarter. On an annual scale GP margins and OPEX-to-revenues improved by 70bps Y/Y and 30bps Y/Y respectively.

Devoteam remains a point of interest to observe as it is pending to be to be consolidated in Q1-24. Other M&A transactions still yet to mature: A 40% share in tech focused consulting firm Devoteam was purchased fully in cash at an enterprise value of approximately SAR 741.7mn and is set to be consolidated in Q1-24. Devoteam's mother company has previously displayed low single digit net-margins (when not at losses) before the firm was delisted. We are optimistic in Solutions' turnaround abilities, as it has done with a currency risk ridden Giza while improving its margins during its consolidation with Solutions. However, we do expect that Devoteam's direct contribution will be outshined by its indirect contribution to other segments as the professional services provider upsells solutions from Solutions. We look to Giza, CCC, and Devoteam to restructure the growth sources for Solutions, as the firm is also able to undergo further M&A transactions while they stand at a net D/E of -0.81.

Recommendation	Neutral
Target Price (SAR)	363.5
Upside / (Downside)*	-0.6%

Source: Tadawul *prices as of 21th of Feb 2024

Key Financials

in SAR mn, (unless specified)	FY23E	FY24E	FY25E	FY26E
Revenue	11,040	12,212	13,367	14,369
Growth %	25.4%	10.6%	9.5%	7.5%
Net Income	1,196	1,327	1,520	1,658
Growth %	13.5%	11.0%	14.5%	9.1%
EPS	10.0	11.1	12.7	13.8

Source: Company reports, Aljazira Capital

Key Ratios

	FY23E	FY24E	FY25E	FY26E
GP Margin	23.5%	23.6%	23.9%	24.0%
Net Margin	10.8%	10.9%	11.4%	11.6%
RoA	10.4%	10.8%	11.5%	11.8%
RoE	36.3%	34.8%	34.9%	33.6%
P/E (x)	35.1	33.1	28.9	26.5
P/B (x)	12.7	11.5	10.1	8.9
EV/EBITDA (x)	25.6	23.2	21.0	19.4
Dividend Yield	1.6%	1.8%	2.3%	2.5%

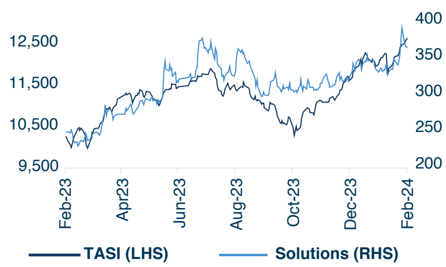
Source: Company reports, Aljazira Capital

Key Market Data

Market Cap (SAR bn)	43.9
YTD%	4.9%
52 weeks (High)/(Low)	398.4/230
Share Outstanding (bn)	120.0

Source: Company reports, Aljazira Capital

Price Performance



Source: Tadawul, Aljazira Capital

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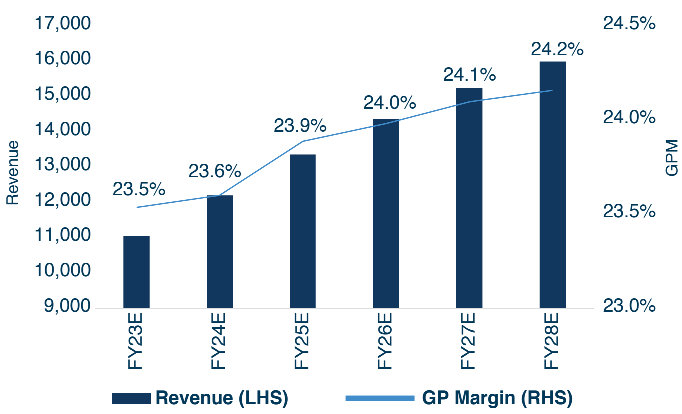
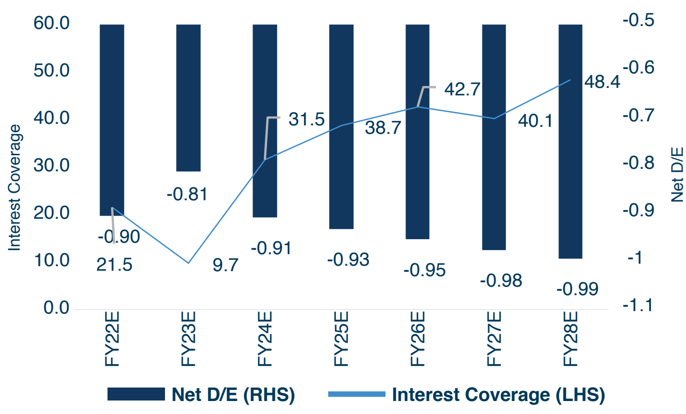
Fig 1. Performace to be carried by acquisitions going forward



Sources: AlJazira Capital, Company Financials

Fig 2. Balance sheet strength in support of extending M&A strategy



Sources: AlJazira Capital, Company Financials I Net D/E considers Murabaha holdings

Lesser financing costs and mitigated exchange rate risk to be offset by shrunken finance income: Giza's Egyptian Pound exposure is being mitigated via denominating Giza sales in Egypt in Saudi Arabian Riyals or Dollars. Foreign exchange risk made the bulk of the loss on their 'other losses' item to make 97.7% of the item reported in their latest breakdown. More currency mitigation is expected to gradually diminish these losses to normal as contracts are completed or rolled over. When consolidating Solutions' Murabaha holdings income, finance costs, and other income/losses- we expect the net change on all those items consolidated from FY23 to FY24 to be a negative change of SAR 48.5mn to pressure the bottom line further for FY24.

AJC view and valuation: Solutions remains an economic leader in our view as it holds the largest market share of its sector at almost 20%. FY23's results, however, shed light on a slowing-down revenue growth from Solutions' core business (excluding acquisition) which grew only 6% Y/Y in a sign of a maturing business. We therefore point to the risk of flatter growth for the firm should the acquisitions not pick up the remainder of the revenue growth forecasted for the coming periods. Furthermore, its financial position places Solutions well to expand in its M&A strategy further; We expect FY23 to report a net debt-to-equity (including Murabaha contracts) at -0.81x and improve further to -0.93x by FY25, granting Solutions more headroom for further inorganic expansions and additions onto their business. We estimate FY23's ROA at 10.4% to improve by 140bps by FY26 while NI CAGR stretches 11.5% for the same period. Our outlook for FY24's revenue stands at low double digits to reach SAR 12,212mn, at a gross profit margin expanding just 10bps over FY23's base. This punctuates to a net income of SAR 1,327mn for the year (up 11.0% Y/Y). Similarly, FY25's revenue is expected at a high single digit growth, and a more improved GPM at a 30bps growth over FY24. The expected results are anticipated to finalize at a net income of SAR 1,519.8mn for FY25, a 14.5% growth. We remain cautious on acquisitions' performance until they become more visible, while remaining optimistic on Solutions' acquisition track record and the strategic specifications underlining Solutions. We revise our recommendation to "**Neutral**" at a target price of **SAR 363.5 per share.**

Fig 4. Key Financials

Amount in USD mn, unless otherwise specified	FY20	FY21	FY22	FY23E	FY24E	FY25E	FY26E	FY27E	FY28E
Income statement									
Revenues	6,891	7,208	8,805	11,040	12,212	13,367	14,369	15,257	16,000
Y/Y	**31.1%**	**4.6%**	**22.2%**	**25.4%**	**10.6%**	**9.5%**	**7.5%**	**6.2%**	**4.9%**
Cost of Sales	(5,469)	(5,500)	(6,794)	(8,442)	(9,330)	(10,174)	(10,923)	(11,580)	(12,134)
Gross profit	**1,422**	**1,708**	**2,011**	**2,599**	**2,882**	**3,193**	**3,446**	**3,677**	**3,865**
Selling, marketing and distribution expenses	(205)	(347)	(246)	(496)	(553)	(606)	(649)	(687)	(718)
Administrative expenses	(460)	(462)	(605)	(715)	(766)	(823)	(882)	(935)	(979)
Finance charges	(3)	-	(16)	(73)	(68)	(49)	(41)	(35)	(31)
Finance income	2	-	54	142	50	46	45	51	45
Other income	(2)	2	(27)	(52)	(12)	(6)	(5)	(2)	(2)
Operating profit	**754**	**901**	**1,172**	**1,405**	**1,532**	**1,754**	**1,913**	**2,070**	**2,180**
Zakat	(52)	(71)	(118)	(210)	(205)	(234)	(256)	(277)	(292)
Net income	**702**	**830**	**1,054**	**1,196**	**1,327**	**1,520**	**1,658**	**1,793**	**1,888**
Y/Y	**78.2%**	**18.3%**	**27.0%**	**13.5%**	**11.0%**	**14.5%**	**9.1%**	**8.2%**	**5.3%**
EPS (SAR)	**5.8**	**6.9**	**8.8**	**10.0**	**11.1**	**12.7**	**13.8**	**14.9**	**15.6**
DPS (SAR)	**3.3**	**4.0**	**5.0**	**5.5**	**6.6**	**8.2**	**9.0**	**10.5**	**10.9**
Balance sheet									
Assets									
Cash & bank balance	993	1,608	544	2,693	2,928	3,283	3,685	4,074	4,900
Accounts receivable	2,804	3,021	4,345	4,364	4,418	4,702	4,907	5,059	5,144
Inventories	112	274	322	249	450	502	545	587	632
Other current assets	1,661	1,544	4,172	3,096	3,584	3,919	4,323	4,704	4,655
Property & Equipment	594	551	473	390	329	274	204	124	56
ROU assets	72	55	41	54	54	53	49	45	43
Other non-current assets	98	121	385	638	557	476	388	289	177
Total Assets	**6,335**	**7,173**	**10,282**	**11,483**	**12,320**	**13,210**	**14,101**	**14,881**	**15,606**
Liabilities & owners' equity									
Total current liabilities	4,068	4,634	6,656	7,195	7,558	7,930	8,228	8,450	8,580
Total non-current liabilities	343	268	803	992	932	914	925	942	966
Paid -up capital	1,200	1,200	1,200	1,200	1,200	1,200	1,200	1,200	1,200
Statutory reserves	120	203	309	-	158	310	360	360	360
Other reserve	(7)	88	9	(60)	(60)	(60)	(60)	(60)	(60)
Retained earnings	-	(181)	(156)	(154)	(154)	(154)	(154)	(154)	(154)
Total owners' equity	1,924	2,271	2,823	3,295	3,830	4,365	4,949	5,490	6,061
Total equity & liabilities	**6,335**	**7,173**	**10,282**	**11,483**	**12,320**	**13,210**	**14,101**	**14,881**	**15,606**
Cashflow statement									
Operating activities	1,119	1,380	2,091	1,176	1,599	1,745	1,906	2,039	2,109
Investing activities	(536)	(155)	(3,190)	1,387	(447)	(297)	(393)	(388)	28
Financing activities	(4)	(610)	57	(414)	(817)	(1,033)	(1,077)	(1,231)	(1,284)
Change in cash	579	615	(1,042)	2,149	335	415	436	420	853
Ending cash balance	**993**	**1,608**	**546**	**2,693**	**2,928**	**3,283**	**3,685**	**4,074**	**4,900**
Key fundamental ratios									
Liquidity ratios									
Current ratio (x)	1.4	1.4	1.4	1.4	1.5	1.6	1.6	1.7	1.8
Quick ratio (x)	1.3	1.3	1.4	1.4	1.4	1.5	1.6	1.6	1.7
Profitability ratios									
GP Margin	20.6%	23.7%	22.8%	23.5%	23.6%	23.9%	24.0%	24.1%	24.2%
Operating Margins	11.0%	12.5%	13.2%	12.6%	12.8%	13.2%	13.3%	13.5%	13.6%
EBITDA Margin	14.0%	15.4%	15.8%	15.1%	15.7%	15.8%	15.9%	16.0%	15.8%
Net Margins	10.2%	11.5%	12.0%	10.8%	10.9%	11.4%	11.6%	11.8%	11.8%
Return on assets	11.1%	11.6%	10.3%	10.4%	10.8%	11.5%	11.8%	12.1%	12.1%
Return on equity	36.5%	36.6%	37.3%	36.3%	34.8%	34.9%	33.6%	32.7%	31.2%
Market/valuation ratios									
EV/sales (x)	NA	NA	3.4	3.9	3.6	3.3	3.1	2.9	2.8
EV/EBITDA (x)	NA	NA	21.4	25.6	23.2	21.0	19.4	18.1	17.6
EPS (SAR)	5.8	6.9	8.8	10.0	11.1	12.7	13.8	14.9	15.6
BVPS (SAR)	16.0	18.9	23.5	27.5	31.9	36.4	41.2	45.7	50.1
Market price (SAR)*	NA	NA	242.8	349.8	365.8	365.8	365.8	365.8	365.8
Market-Cap (SAR mn)	NA	NA	29,136	41,976	43,896	43,896	43,896	43,896	44,262
Dividend yield	NA	NA	2.1%	1.6%	1.8%	2.3%	2.5%	2.9%	3.0%
P/E ratio (x)	NA	NA	27.6	35.1	33.1	28.9	26.5	24.5	23.4
P/BV ratio (x)	NA	NA	10.3	12.7	11.5	10.1	8.9	8.0	7.3

Sources: AlJazira Capital, Company Financials

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2. Underweight: This rating implies that the stock is currently trading at a premium to its 12 months price target. Stocks rated "Underweight" would typically decline by over 10% from the current price levels over next twelve months.
3. Neutral: The rating implies that the stock is trading in the proximate range of its 12 months price target. Stocks rated "Neutral" is expected to stagnate within +/- 10% range from the current price levels over next twelve months.
4. Suspension of rating or rating on hold (SR/RH): This basically implies suspension of a rating pending further analysis of a material change in the fundamentals of the company.

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