Arabian Internet and Communications Services Co.

Solutions I Investment Update

Pressurized by displays of muted revenue growth in H1-24; drivers for H2-24 in place, with major upside risks to the stock to warrant a revised "Overweight" recommendation

Solutions recorded a bottom line of SAR 453 (up 33.3% Y/Y, and 28.1% Q/Q) for Q2-24, in support of a one-off SAR 68.3mn in other income, and a lower zakat. Revenue came in at a muted 2.6% growth Y/Y (down 1.3% Q/Q), as a result of two Eid holidays coinciding during Q2-24, impact of the Egyptian Pound devaluation on Giza, and longer sales cycles with government entities. This sets the firm to require a 12.0% Y/Y increase in its H2-24 revenue to meet its low threshold of its revenue guidance. GP margin came at 25.1% (down 200bps Y/Y and up 300bps Q/Q) with the ccc segment facing one-off pressures on its margins due to business reshuffling. Results were supported by lesser OPEX, decreasing by 8% Y/Y in H1-24 as a part of OPEX optimization initiatives. Solutions' H1-24 performance displays challenges in maintaining market share due to increased competition, sensitivity to market conditions and seasonality. As of such, we revised down our FY23-28E revenue CAGR forecast at 7.4%, punctuating at a NI CAGR of 12.7% for the same period. We look forward to the drivers in place to support H2-24E results towards the maintained guidance. With a net cash holding of SAR 1.22bn (up 12% Q/Q), and a net D/E of c. -0.4x, we see Solutions well in place to support a major acquisition as well as future dividends. Furthermore, atop potential acquisitions, and a SAR 12bn backlog, we see there are tremendous upside risks to the stock stemming from major contract awardations and ahead of Vision 2030 initiatives which we await more visibility on. We revised our stance to an "Overweight" recommendation at a TP of SAR 331.0 per/share, as the stock has declined by nearly 26.2% from its yearly peak on the back of soft revenue growth, which we expect to be normalized for the year.

Q2-24 results supported by other income from disposal of non-core business line; revenue growth seeming muted as a result of holidays, EGP devaluation, and longer government-sales cycles: Solutions recoded a Q2-24 bottom line of SAR 453mn (up 33.3% Y/Y and 28.1% Q/Q), supported by a one-off other income from the SAR 68.3mn sale of their fleet management business to an STC subsidiary- the product previously contributed <1% of Solutions' revenue. A lesser zakat charge kept the result buoyant. Solutions recorded a revenue of SAR 2,771mn for the period (up 2.6% Y/Y and down 1.3% Q/Q), punctuating H1-24 revenue growth at 3.8% Y/Y. Management indicates that the flat-ish revenue performance was driven by the seasonality of two Eid breaks taking place in the quarter, and a recently longer sales cycle from government clients. Furthermore, revenue was weighed down in H1-24 by the devaluation of the Egyptian pound (c. 35% against the dollar in Q1-24), due to Giza's purchases from its suppliers, despite c. 60% of their revenue being denominated in SAR and USD. Giza contributes a significant c. 10% of the stock's revenue; previously 12% during H1-23. Revenues from Solutions' core business declined 7% Y/Y in Q2-24, Egyptian-Pound-burdened Giza declined 28% Y/Y while ccc increased 183% as a result of a reshuffling of projects between Solutions to ccc, namely business processing services and manpower solutions. As a result, revenues from core ICT services in H1-24 declined by 2% Y/Y, Digital Services fell by 1% Y/Y for the same period, while IT Managed and Operational Services grew 17% Y/Y due to the consolidation of ccc which falls under the segment. Revenue from STC grew 20% during H1-24, while revenues sourced from government and private sector clients fell 3% Y/Y and 5% Y/Y, respectively, for the period. We forecast an FY23-28E revenue CAGR at 7.4%.

Gross margin sequential improvement and lesser OPEX aided results: Results showed an improvement from the two previous quarters of lackluster GP margins, at 25.1%, sitting above its three year average of 23.4% as a result of the current project mix. GP Margins decreased 200bps Y/Y and increased 300bps Q/Q (down 130bps Y/Y on an H1-24 basis). The pressure on GP margins in H1-24 came a result of the project mix for the half, with a decrease in connectivity services which previously had higher margins as compared to other services and products. Furthermore, ccc's GP margins were burdened with one-off costs and charges related to the reshuffling of businesses; ccc's GP margins ended Q2-24 at significantly declined 6.6% (down 16.8 pcp Y/Y, and 5.5 pcp Q/Q). Solutions' and Giza's GP margins showed improvement at 110bps Y/Y (510bps Q/Q), and 680bps Y/Y (12.6 pcp Q/Q), respectively. The pressurized margins were offset by a 14.0% decrease in OPEX Y/Y, reaching SAR 296mn in Q2-24, and 546 across H1-24 (down 8% Y/Y). OPEX-to-revenues fell 130bps Y/Y in H1-24 as a result of management's initiatives on cost optimization and OPEX control as a part of their strategy to enhance results going forward. We estimate GP margins at a range of 23.7%-24.0% from FY24E-FY26E before improving thereafter.

Recommendation	**Overweight**
Target Price (SAR)	**331.0**
Upside / (Downside)*	**17.9%**

Source: Tadawul *prices as of 04st of August 2024

Key Financials

in SAR mn, (unless specified)	FY22	FY23	FY24E	FY25E
Revenues	8,805	11,041	11,955	13,012
Growth %	22.2%	25.4%	8.3%	8.8%
Net Income	1,054	1,195	1,603	1,709
Growth %	27.0%	13.4%	34.1%	6.7%
EPS	8.78	9.96	13.35	14.24
DPS	5.0	6.0	8.0	9.3

Source: Company reports, Aljazira Capital

Key Ratios

	FY22	FY23	FY24E	FY25E
Gross Margin	22.8%	23.5%	23.7%	23.8%
OP Margin	13.2%	12.6%	13.9%	14.2%
Net Margin	12.0%	10.8%	13.4%	13.1%
EBITDA Margin	15.8%	15.1%	17.2%	17.4%
RoE	37.3%	35.6%	40.3%	37.4%
P/E (x)	27.6	35.1	21.0	19.7
P/B (x)	10.3	12.5	8.5	7.4
EV/EBITDA (x)	21.4	25.6	16.6	15.1
Dividend Yield	2.1%	1.7%	2.9%	3.3%

Source: Company reports, Aljazira Capital

Key Market Data

Market Cap (SAR bn)	33.7
YTD%	-19.8%
52 weeks (High)/(Low)	409.8/264.0
Share Outstanding (bn)	120.0

Source: Company reports, Aljazira Capital

Price Performance

Source: Tadawul, Aljazira Capital

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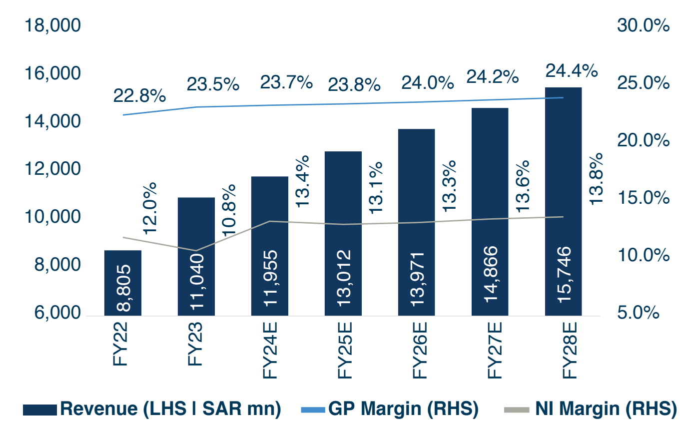
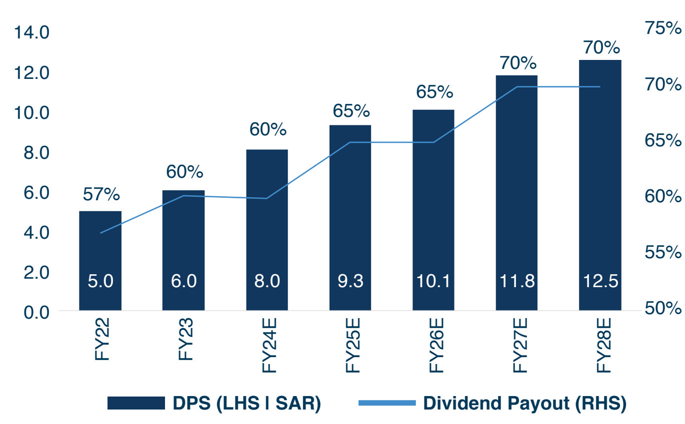
Fig 1. Revenue growth in the intermediate term to be driven by large deals signed with government, and contract deliverables



Sources: AlJazira Capital, Company Financials

Fig 2. Healthy balance sheet in support of future dividend payouts



Sources: AlJazira Capital, Company Disclosures

Visibility for H2-24 growth seen in project awardation and backlog growth; revenue forecasts revised down to CAGR 7.4% (FY23-28E) due to displays of maturity, longer recognition, appearance of seasonal sensitivity, and competition: Some uncertainties on reaching the revenue growth guidance, which requires a minimum 12% Y/Y growth in H2-24, were pacified with visibility provided by management on upcoming top line drivers; and sticking to an FY24E guidance of 8-11%. Management's confidence stems from signing sizable deals with government entities, which with the longer sales cycles (delaying the conversion of sales to revenues), will be recognized in H2-24E to FY25E. Furthermore management expects that some of Giza's sales were postponed as some of their customers were awaiting a devaluation of the EGP. A growing current SAR 12bn backlog offers further assurance of future growth for H2-24E. Growth in H2-24 is expected to be skewed towards the Core ICT Services as management looks towards large deliverables due in H2-24. IT and Managed services are expected to be supported by one off charges due to contracts deploying during H2-24. However, we see Solutions as a mega-player in the market at 23% market share in the fragmented sector, and due to such, they are bound to growing mostly in line with the market's ICT market's growth, without much new businesses to target besides SMEs. Furthermore, at their current market share, Solutions has been having to take a hit on pricing on its services for the government segment, in order to maintain its market share due to an increasingly competitive market. Furthermore, we see more display in seasonality as due to their segments which could delay revenue recognitions in the future. Due to such we forecast an FY23-28E top line CAGR of 7.4%, down from our previous forecast of 7.7%, yet we do recognize that there are very significant upside risks that can materialize to significantly improve this current forecast. Yet without visibility on those upside risks today (ie. acquisitions, and large scale contract awardations), we estimate an FY23-28E net income CAGR at 12.7% for the stock, supported normalizing of ccc's GP Margins upon moving past its one off costs from segment reshuffling (which saw TTM GP margin averages at 20.4%, as compared to its current 6.6%), as well as GP Margin initiatives- yet pricing pressures are expected to leave GP margins at a range of 23.7%-24.0% from FY24E-FY26E before improving thereafter. We expect OPEX-to-revenues to improve from the current 9.8% in H1-24, to stabilize at 9.3% in FY27E.

Solid balance sheet, with nearly 19% of assets in cash, could spur the revival of future growth via acquisitions: As the legacy business slows down while the recent acquirees support growth, we look forward to Solutions' future acquisitions to justify an upwardly revised estimate in performance. Management indicated that they are continuously looking for candidates, and any possible targets would announced at the relevant time. Net cash grew 12% Q/Q to SAR 1.22bn from SAR 1.09bn in Q1-24 as a result of investment in working capital during the previous quarter. Operating cashflow remained negative as of H1-24, with improvements during the quarter due to working capital optimization that is expected to normalize operating cashflows in the coming periods. However, the firm's balance sheet strength positions it well to undergo further acquisitions, or even absorb shocks in capital needs as it sits on a net cash position of SAR 1.2bn, and a net debt to equity of -0.37, placing it well ahead of any potential deals to be financed internally or largely internally, while also maintaining its dividend payout of 60%. Net D/E improved to -0.37x from -0.31x the previous quarter, while cash total cash and murabaha holdings grew 6% Q/Q. Furthermore, we believe the Solutions network provides many channels for value-adding synergies should an acquisition take place.

Major upside risks to the stock's valuation await more visibility, yet warrant an overweight recommendation on the stock given limited downside risk: We are optimistic towards the stock's upside risks to its valuation stemming from their acquisition activities to revive high double digit growth, as well as large scale government projects ahead of Vision 2030 initiatives on sports, entertainment, infrastructure and otherwise. Furthermore, large contract awardations are subject to show a spike in revenue recognitions; yet without any current visibility on such events, we recognize these possibilities as tremendous upside risks to the stock's valuations and could warrant further revision in revenue estimates. On the Giza front, stability in the EGP could result in less shocks on the segment's consolidation of financials with Solutions, as Giza is reported to have displayed healthy financial performance, and growth, on an EGP basis.

AJC view and valuation: Solutions, at its size, market share and involvement in the economy, faces the challenges of maintaining its growth- as it remains highly sensitive to the current economic conditions at short terms. As a result, the stock declined nearly 26.2% from its yearly high, post Q1-24 earnings, which displayed muted revenue growth, and lagging the company's guidance on FY24 top line performance. Solutions' latest results, however, extended the run on subdued revenue growth, yet the drivers behind the firm's flat-ish revenue performance is seeming to be situational events as due to seasonality, EGP devaluation, and longer sales cycles expected to materialize by H2-24E. These displays, however, are a sign of the challenges that Solutions faces in short and intermediate terms at any given period. Longer recognition cycles, partially due to seasonality, and further burdens of competition lead us to revise down our FY23-28E revenue CAGR to 7.4%. However, with over SAR 1.2bn in net cash and Murabaha holding, and a net D/E of nearly -0.4 D/E, and a commitment towards more M&A activity, we see that Solutions is well placed to pursue further value adding acquisitions that could potentially revive the stock towards high double digit growths. Yet without visibility on that today, we recognize this potential event as a major upside risk to the stock's valuation. Furthermore, major contract awardations from the private sector, or government ahead of Vision 2030 initiatives is also a major upside risk to the valuation. With a backlog of nearly SAR 12bn, and assurance on major contract awardations, and contract deployments to take place during H2-24 and FY25E, we see the stock has limited downside potential, given the firm's holistic profile as well and balance sheet strength which enables to support its payout ratio of nearly 60%, as we expect its FY24E and FY25E DPS to reach SAR 8.0 and SAR 9.3, respectively, at current dividend yields of 2.7% and 3.2%. We value the stock using a blended, 50% DCF valuation (WACC = 9.4% and terminal growth rate = 3.0%) and 50% on PE valuations (25.0x on FY25E estimates) to arrive at a revised "**Overweight**" recommendation and TP of **SAR 331.0 per share**.

Valuations:

DISCOUNTED FREE CASH FLOW TO FIRM

Year to Dec (SAR mn)	FY23E	FY24E	FY25E	FY26E	FY27E	FY28E	Terminal Value
NOPAT	1,386.9	1,661.7	1,852.1	2,027.2	2,204.7	2,371.1	
Add: Depreciation and Amortization	282.3	399.6	405.9	405.6	409.9	428.2	
EBITDA	1,669.2	2,061.3	2,258.0	2,432.8	2,614.6	2,799.3	
Change in working capital	(437.6)	(118.2)	62.5	114.6	168.2	185.0	
Capex	(112.0)	(259.7)	(282.5)	(303.2)	(288.0)	(299.5)	
Free cash flow	**1,119.6**	**1,683.4**	**2,038.1**	**2,244.2**	**2,494.8**	**2,684.8**	**40,223.7**
Enterprise value							35,589.0
Less: Net debt							1,221.0
Less: Minority interest							-27.9
Equity value							36,782.1
No of shares outstanding (mn)							120.0
Fair value (SAR/share)							**306.5**
Current price (SAR/share)							281.0
Expected capital gain							9.1%

PE Valuation

Net income (FY25E)	1,708.5
PE Multiple	25.0
Implied market capital	42,716.9
No. of shares outstanding	120.0
Fair value (SAR/share)	**355.9**
Current price (SAR/share)	281.0
Expected capital gain/loss	26.7%

Valuation Summary

Method	Fair Value	Weight	Weighted Value
DCF	306.5	**50%**	153.3
PE	355.9	**50%**	178.0
Target Price			**331.0**
Current Price (SAR/share)			281.0
Expected Capital Gain/loss			17.9%

Fig 4. Key Financials

Amount in USD mn, unless otherwise specified	FY20	FY21	FY22	FY23	FY24E	FY25E	FY26E	FY27E	FY28E
Income statement									
Revenues	6,891	7,208	8,805	11,040	11,955	13,012	13,971	14,866	15,746
Y/Y	**31.1%**	**4.6%**	**22.2%**	**25.4%**	**8.3%**	**8.8%**	**7.4%**	**6.4%**	**5.9%**
Cost of Sales	(5,469)	(5,500)	(6,794)	(8,443)	(9,121)	(9,911)	(10,621)	(11,272)	(11,907)
Gross profit	**1,422**	**1,708**	**2,011**	**2,598**	**2,834**	**3,101**	**3,350**	**3,594**	**3,839**
Selling, marketing and distribution expenses	(205)	(347)	(246)	(496)	(434)	(471)	(501)	(529)	(555)
Administrative expenses	(460)	(462)	(605)	(715)	(739)	(778)	(822)	(861)	(913)
EBITDA	**966**	**1,108**	**1,392**	**1,669**	**2,061**	**2,258**	**2,433**	**2,615**	**2,799**
Finance charges	(3)	-	(16)	(76)	(75)	(53)	(45)	(40)	(36)
Finance income	2	-	54	145	143	144	130	126	123
(Impairment)/reversal of impairment in receivables and contract assets	-	-	(0)	-	-	-	-	-	-
Share of profit of associate	-	-	1	0	3	3	3	3	3
Gain from sale of subsidiary	-	-	-	-	-	-	-	-	-
Other income	(2)	2	(27)	(52)	21	(10)	(9)	(3)	(3)
Operating profit	**754**	**901**	**1,172**	**1,405**	**1,755**	**1,936**	**2,106**	**2,291**	**2,459**
Zakat	(52)	(71)	(118)	(210)	(152)	(227)	(247)	(267)	(284)
Net income	**702**	**830**	**1,054**	**1,195**	**1,603**	**1,709**	**1,859**	**2,024**	**2,174**
Y/Y	**78.2%**	**18.3%**	**27.0%**	**13.4%**	**34.1%**	**6.7%**	**8.8%**	**8.9%**	**7.4%**
EPS (SAR)	**5.8**	**6.9**	**8.8**	**10.0**	**13.4**	**14.2**	**15.5**	**16.9**	**18.0**
DPS (SAR)	**3.3**	**4.0**	**5.0**	**6.0**	**8.0**	**9.3**	**10.1**	**11.8**	**12.6**
Balance sheet									
Assets									
Cash & bank balance	993	1,608	544	2,588	1,990	2,555	3,243	3,962	4,748
Accounts receivable	2,804	3,021	4,345	4,364	4,356	4,611	4,808	4,949	5,083
Inventories	112	274	322	249	269	262	249	230	207
Other current assets	1,661	1,544	4,172	3,096	4,141	4,510	4,854	5,182	5,506
Property & Equipment	594	551	473	390	295	218	181	147	127
ROU assets	72	55	41	50	88	123	147	160	165
Other non-current assets	98	121	385	779	1,035	954	864	764	651
Total Assets	**6,335**	**7,173**	**10,282**	**11,516**	**12,174**	**13,233**	**14,346**	**15,394**	**16,487**
Liabilities & owners' equity									
Total current liabilities	4,068	4,634	6,656	7,195	7,300	7,782	8,239	8,666	9,087
Total non-current liabilities	343	268	803	968	902	880	887	900	921
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	329	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	3,353	3,973	4,570	5,220	5,827	6,479
Total equity & liabilities	**6,335**	**7,173**	**10,282**	**11,516**	**12,174**	**13,233**	**14,346**	**15,394**	**16,487**
Cashflow statement									
Operating activities	1,119	1,380	2,091	1,715	1,315	2,150	2,323	2,523	2,689
Investing activities	(536)	(155)	(3,190)	1,036	(461)	(330)	(353)	(341)	(357)
Financing activities	(4)	(610)	57	(689)	(1,349)	(1,195)	(1,249)	(1,431)	(1,518)
Change in cash	579	615	(1,042)	2,062	(495)	625	721	750	814
Ending cash balance	**993**	**1,608**	**546**	**2,585**	**1,990**	**2,555**	**3,243**	**3,962**	**4,748**
Key fundamental ratios									
Liquidity ratios									
Current ratio (x)	1.4	1.4	1.4	1.4	1.5	1.5	1.6	1.7	1.7
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%	23.7%	23.8%	24.0%	24.2%	24.4%
Operating Margins	11.0%	12.5%	13.2%	12.6%	13.9%	14.2%	14.5%	14.8%	15.1%
EBITDA Margin	14.0%	15.4%	15.8%	15.1%	17.2%	17.4%	17.4%	17.6%	17.8%
Net Margins	10.2%	11.5%	12.0%	10.8%	13.4%	13.1%	13.3%	13.6%	13.8%
Return on assets	11.1%	11.6%	10.3%	10.4%	13.2%	12.9%	13.0%	13.1%	13.2%
Return on equity	36.5%	36.6%	37.3%	35.6%	40.3%	37.4%	35.6%	34.7%	33.5%
Market/valuation ratios									
EV/sales (x)	NA	NA	3.4	3.9	2.9	2.6	2.4	2.3	2.2
EV/EBITDA (x)	NA	NA	21.4	25.6	16.6	15.1	14.0	13.0	12.3
EPS (SAR)	5.8	6.9	8.8	10.0	13.4	14.2	15.5	16.9	18.0
BVPS (SAR)	16.0	18.9	23.5	27.9	33.1	38.1	43.5	48.6	53.5
Market price (SAR)*	NA	NA	242.8	349.8	281.0	281.0	281.0	281.0	281.0
Market-Cap (SAR mn)	NA	NA	29,136	41,976	33,720	33,720	33,720	33,720	34,001
Dividend yield	NA	NA	2.1%	1.7%	2.9%	3.3%	3.6%	4.2%	4.5%
P/E ratio (x)	NA	NA	27.6	35.1	21.0	19.7	18.1	16.7	15.6
P/BV ratio (x)	NA	NA	10.3	12.5	8.5	7.4	6.5	5.8	5.2

Sources: AlJazira Capital, Company Financials

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RATING TERMINOLOGY

1. Overweight: This rating implies that the stock is currently trading at a discount to its 12 months price target. Stocks rated "Overweight" will typically provide an upside potential of over 10% from the current price levels over next twelve months.
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.

Disclaimer