Saudi Telecom Sector: High Penetration levels, Weak economic outlook, limiting growth

The Saudi telecom sector starts 2016 with a number of challenges i) weak oil prices, ii) high subscriber penetration levels in voice and data, iii) finger print registration of SIM cards, iv) limited growth avenues, and v) a cut in government spending.

Mobile subscribers base at the end of 2015 (extrapolated from 3Q-2015 CITC1 numbers) is expected to stand at 53.9mn subscribers, jump of 2.28%YoY. Mobile subscribers penetration level is expected to stand at 171% in 2015. However one major positive for the subscribers growth is the 15.7% YoY expected growth in postpaid subscriber base which in 3Q-2015 stood at 7.6mn. Prepaid subscriber base growth till 3Q-2015 remained muted, for 2015 prepaid subscriber growth is expected to stand at 0.29%YoY.

For 2016, we expect postpaid and prepaid growth trajectory to continue on the same path, where postpaid subscribers growth will out weight the prepaid subscribers growth. We believe this is a healthy sign for the sector as postpaid subscribers tend to produce higher ARPU2 and the switchover rate is comparatively lower. On the prepaid front the sector will faces challenges, as the new regulation by the government to finger print all SIM cards can result in a number of prepaid subscribers being wiped out; resulting in a lower number of prepaid subscribers.

Data Growth slowing down

Data in 2015, was being touted as the major growth driver and it has not disappointed as internet penetration levels in Kingdom has improved significantly in 2015. Mobile data subscriber in 2015 are expected to stand at 36.6mn subscribers depicting penetration level of near 120% and growth of 25.8% YoY. We believe going forward, in 2016, growth in mobile data subscribers is expected to taper given the high penetration level.Fixed broadband subscriber base for the sector has also shown significant growth as household penetration level are expected to stand at 53% in 2015. The total number of households subscribers is expected to stand at 3.82mn. The strongest performance has been seen by the fixed wireless subscriptions, which are expected to post a strong jump of 44.4%YoY, in 2015. ADSL subscriber are expected to stand at 1.5mn depicting a growth of 9.6%YoY for 2015. For 2016, with household penetration near 50%, the room for growth is ample, however strong growth in mobile broadband might cannibalize fixed broadband growth.

Market Share a major issue

The sector has a total of 54mn subscribers, out of which the market share for the 3 players (STC, Mobily and Zain) is a bit difficult to decipher. What is quite evident is that STC is the largest player in the market and in our view holds somewhere between 49%-52% of the market the rest is being shared between Zain and Mobily. Zain in its recent announcement highlighted that its subscribers base at the end of 2015 stood at 12.4mn, depicting a market share of 23%. Leaving Mobily with a market share in the range of 25% to 28%.

1 Communication and Information Technology Commission
2 Average Revenue per Unit
Mobily: Weak Operating performance, Limited growth potential, Debt issue partly resolved, we update our recommendation "Neutral".

4Q-2015 result positive, however not promising: The company in 4Q-2015 posted earnings of SAR 11mn, as compared to a loss of SAR 2.1bn in 4Q-2016. The result is a positive change for the company especially after continuous losses in the last couple of quarters, however our doubts about the company are still intact, as revenue stream is still underwhelming and the high depreciation cost is still eating up the company’s profitability. The company’s quarterly financial expenses has almost doubled partly due to the rise in interest rates and partly due to the higher rates charged by the debt holders given the fiasco of the financial performance. The company still faces a number of issues i) a depleting market share ii) Lower ARPUs iii) FTTH contract cancelation, about which the company has not issued any further statement, iv) re-negotiation of international loans terms, and v) Intense competition from Zain, Virgin Mobiles and STC.

Debt issue partly resolved, a payment of SAR 2.9bn made: The company’s total debt at the end of 2015 stood at SAR 14.3bn as compared to SAR 17.0bn in 2014. According to the company cash flow statement the company made a payment of SAR 2.9bn in its loan re-payment. After the financial performance of 2013 and 2014, the company cut a few of its loans covenants which resulted in the entire long terms loans being classified as current portion. The company has been able to re-negotiate with local debt holders to reset some of its covenants, as SAR8.4bn of long term has been de-classified from current portion of long term loans. As for the international lenders the management is working towards re-negotiations, however the logistics of gathering the debt holders has resulted in the delay.

We believe, that given the weak financial performance and higher risk, the re-negotiation of loans might have potentially resulted in higher interest rate being charged to the company; which can further deteriorate its profitability.

Intense competition in the market: High penetration levels in the voice and data segment, leaves little room for growth in the sector. All the 3 major players in the market are facing intense competition to maintain or improve their market share. Mobily being under the financial trouble is finding it difficult to improve its market share, benefiting Zain in the process. Zain in 2015 has shown a marked improvement in its subscriber base which currently stands at 12.4bn. STC on the other hand does not seems to be losing ground given the fiasco of the financial performance. The company still faces a number of issues i) a depleting market share ii) Lower ARPUs iii) FTTH contract cancelation, about which the company has not issued any further statement, iv) re-negotiation of international loans terms, and v) Intense competition from Zain, Virgin Mobiles and STC.

Zain Arbitration unresolved: The Arbitration with Zain regarding the difference in revenue calculation is still in process. The dispute is over the payment of services for using the Mobily network. According to Mobily, Zain has to pay SAR 2.2bn, however Zain is of the view that the receipt is much lower. Mobily so far has already taken a provision of SAR 2.0bn on its outstanding account receivables from Zain, which leaves SAR 200mn uncovered. The company will be impacted negatively if the decision goes against it. However the impact will be limited to net of the remaining SAR 200mn (since 2.0bn provision has already been expensed out). However, if it goes in Mobily’s favor, This will result in cash receipt of SAR 2.2bn. This will impact our cash flows as provision on accounts receivables will decrease and cash will increase.
STC: Healthy Financial Performance, Strong Market Share, Healthy Dividend yield; however positives priced in. We maintain our price target and update our Recommendation to “Neutral”.

4Q-2015 profitability underwhelming, however revenues stayed strong: STC in 4Q-2015 posted earnings of SAR 1.95bn, despite of a 15% YoY jump in revenues. 4Q-2015 net profitability showed a fall of 16%QoQ and 18.5%YoY. The prime reason for the weak bottom line was the higher than expected selling and marketing expenses, which were 31% higher than last quarter.

Overall in our view the company’s performance for 2015 was acceptable given the 10.9%YoY jump in revenues, and a flattish growth of 2.6%YoY in operating income. Net income for 2015, was impacted by non-operating expenses, which stood at a loss of SAR -1.37bn as compared to a gain of SAR0.5mn. The major non-operating factors are booking of SAR 406 expense for early retirement program and the depreciation of the Turkish lira. The company’s investments accounted for under equity method posted a loss of 379mn as compared to a loss of 261mn in 2014.

As market reaches maturity STC rethinks its strategy: Given the high penetration levels of voice and data, the growth opportunity from traditional telecom sources are limited. For STC to remain competitive in the market and sustain its position as market leader, the company will have to re-think its strategy. One step that the company has taken is to shift its focus from the traditional telecom service to a comprehensive enterprise solution provider. For that the company is investing heavily to improve and expand its network, in order to provide seamless high speed services to its corporate clients. The company is of the view that for 2016 it will invest nearly SAR 8bn on CAPEX to improve its network coverage, FTTH/FTTX coverage and data centres. According to the company Enterprise business unit overall revenues increased by 16%YoY during the 4Q-2015, driven mainly by the 20%YoY increase in Business sector data services revenues.

FFTH and FTTX network: The company’s FFTH/FTTX network has improved significantly as in 2015 it was trying to reach nearly 1.5mn housing units. During 4Q-2015 FFTH customer base increased by 30%YoY and 10%QoQ. The absence of competition in the FFTH network provides STC with an opportunity to cement its position as the leading data provider in the Kingdom.

Strong Cash flow to support Dividend Policy: STC announced its 3 years Dividend policy committing quarterly dividends of SAR 1/share. Effectively paying SAR 4/share per fiscal year. The total dividend on current number of shares outstanding is SAR 8.0bn. The company in 2015 generated operating cash flow of SAR 20.8bn, depicting an Operating Cash Flow to Net income ratio(CFO/NI) of 222%. The company has historically maintained healthy operating cash flows, going forwards we expect the company to post CFO/NI ratio of nearly 200%, with CAPEX expectation of around SAR 8bn for 2016, we believe the company will have ample room to pay out dividends and maintain a healthy cash position.

No debt requirement for CAPEX: The company is looking to invest SAR 8.0bn in CAPEX for 2016. We believe with assets of SAR 97.7bn and a debt to equity ratio of 12%, the company has enough room to finance its expansion through debt. However the management is of the view that all its expansion will be internally financed, given STC’s healthy cash position.
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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.

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