Saudi Telecom Company (STC)

Disconnected International Acquisitions

TresVista Recommendation – Hold ★★★

CURRENT – SAR 37.70

TARGET – SAR 43.45

Investment Thesis:

Based on our analysis, we are initiating coverage of STC with a Hold rating. We have arrived at this valuation based on sum-of-the-parts using DCF, P/E 2010E for regional companies, and comparable company analysis using EV/EBITDA metric for 2010E. For our projections and valuation multiples, we have considered the current state of affairs for STC with the risks of increased competition priced in. The company has been increasing their subscriber base through acquisitions and investment in subsidiaries due to the domestic market saturation. Going forward, the company is considering various international acquisitions to foster the wireless growth and is planning to bring in new technology in their domestic wireline business to take advantage of the underpenetrated broadband segment. STC's inorganic growth strategy has enabled the revenue contribution from its international businesses to improve.

Validation:

STC is the largest integrated telecom company in Saudi Arabia. STC commands high market share and high margins in its Saudi operations. The company recognizes that their market share in Saudi has been declining due to increasing competition. As a consequence, STC has made acquisitions in several potential high growth markets. This will ensure net subscriber additions over the next few years. However, due to the declining ARPU's (Average Revenue per Unit) and a hike in interconnect and access costs the profitability from the international acquisitions have still not been realized. Going forward, the company is expected to leverage the already existing infrastructure in Saudi Arabia by providing value added services to mitigate erosion in the ARPU rates. However, with the introduction of Next Generation Network (NGN), we expect the company's ARPU rates in its wireline segment to stabilize over the forecasted years. We are bullish on the broadband operations of the company and we expect it to be the primary growth driver for the company over the forecasted years.

However, we are concerned about STC's strategy of acquiring minority stakes in Turkey and Malaysia. Additionally, the company has entered into countries which are witnessing intense competition. For example, the Indonesian, Kuwaiti, and Indian telecom markets are witnessing intense competition which has led to significant tariff cuts. The company's H1 2010 results have been disappointing and we expect earnings to come under pressure over the short-term as the company's operations in Kuwait, Bahrain and Indonesia are still in its nascent stages. Moreover, it will be challenging for the company to gain a foothold in these countries. Further risks to our recommendation include unforeseen competition within their core Saudi market; aggressive growth priced acquisitions, foreign exchange losses; and increased capital expenditure for acquisition of new subscribers.

Market Opportunity:

STC is witnessing favorable demographics with investments in heavily populated countries such as India and Indonesia and 60.0% of the population in the Saudi market is below 30 years. The overall demand for telecom services continues to grow amid increasing competition. Easing of regulatory framework pertaining to entry into new markets will lead to an increase in opportunities for diversification. The growth is expected to be driven by relatively underpenetrated markets such as India and Indonesia. We expect the underpenetrated broadband market in Saudi Arabia to drive STC's growth in the domestic wireline segment. The penetration rates in these markets are comparatively low and the company's subsidiaries have aggressive expansion plans. New technologies developed in this sector are leading to diversification of product portfolio and are creating more revenue generation opportunities by leveraging the existing infrastructure.

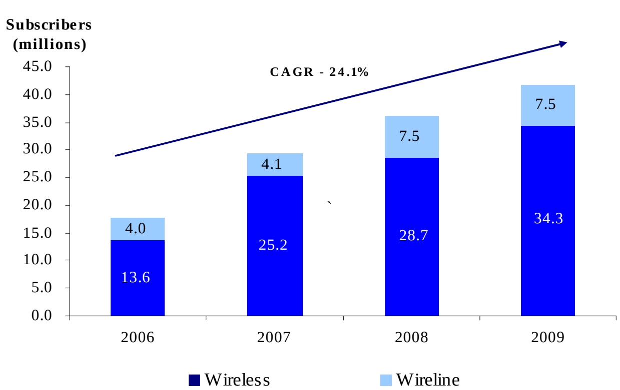
Sector – Telecommunication Services

Ticker	**STC**
Market Cap.	SAR 75,600.0 m
Enterprise Value	SAR 107,724.0 m
2009 Revenue	SAR 50,780.1 m

Per Share Data (August 2, 2010)	
Current Price	SAR 37.70
52 Week High	SAR 52.50
52 Week Low	SAR 34.00
% of 52 Week High	71.8%
Number of Shares	2,000.000 m

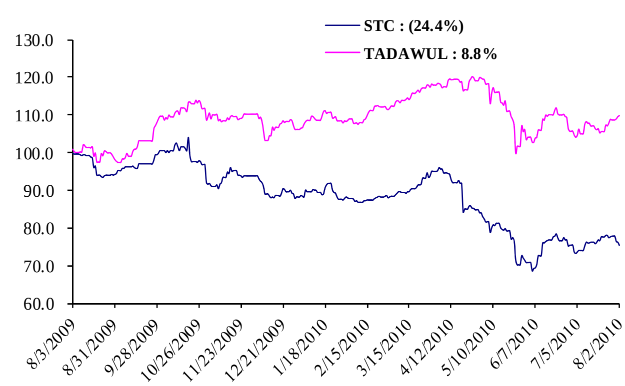
Multiples	
PE	
2009A	7.0x
2010E	9.8x
2011E	8.7x
EV/EBITDA	
2009A	5.2x
2010E	5.8x
2011E	5.2x

Total Subscribers



Source: Company reports

1 Year Stock Price Performance



Source: Bloomberg. Indexed

TresVista Financial Services: All prices are as of the closing of the previous trading day unless otherwise indicated. Prices are sourced from local exchanges via Bloomberg and other vendors. Investors should consider this report as only a single factor in making their investment decision. DISCLOSURES ARE LOCATED IN DISCLOSURE APPENDIX

Macroeconomic Overview

Saudi Arabia is enjoying strong economic growth, on the back of increased profits from oil exports, positive government policies and expansion in multiple sectors of the economy.

Demographics

Saudi Arabia's population grew by 2.5% y-o-y and stood at 25.5 million at the end of 2009. Forecasted growth rates peg future population growth at a CAGR of 2.6% over the next 5 years. The median age of the Saudi population is 22 years and more than 60.0% of the population is below the age of 30, which indicates a young, growing, and an increasingly affluent population. The Saudi workforce is composed predominantly of expatriates, who make up 88.4% of the workforce. The per capita GDP in 2009 was SAR 32,823.5.

Overall Economic Growth

The economic indicators for Saudi Arabia are positive; where in the economy is expected to grow by 3.8% in 2010 compared to 0.6% growth in 2009. Nominal GDP was SAR 837.0 billion in 2009 and is estimated to reach SAR 869.2 billion in 2010.

Oil contributes 89.0% to the national revenue, and oil exports comprise 90.0% of export. Saudi Arabia accounts for 21.0% of all global oil reserves. The non-oil sector sustained a growth rate of 3.8%. Oil prices have remained volatile and are expected to average at USD 75.0 in 2010 compared to USD 62.0 in 2009 as a result of which the economy is expected to post fiscal surplus. Overall, oil has enjoyed resurgence as a driver of the economy, contributing to half of the GDP, up from an average of 36.0% in the 1990s. Oil output will continue to be the driving force in the economy as the government is still looking for ways to diversify the economy.

Investments

The government has introduced various liberalization policies to increase investor confidence in the economy and also to improve the foreign direct investment scenario. Further, fuelling the FDI growth is the development of new economic cities and special economic zones.

According to the 2009 World Investment Report, Saudi Arabia experienced an inward flow of approximately USD 38.0 billion of foreign direct investment, the highest in the United Nations Economic and Social Commission for the Western Asia (ESCWA) region.

Saudi Arabia's strong trade and investment relations with emerging economies like China and India, coupled with strong government spending has ensured that the country is not largely impacted by the current economic turmoil.

Monetary Policy

Monetary policy has been stable; the SAR-USD peg forces the Saudi Arabian Monetary Authority (SAMA) to follow the US Federal Reserve's monetary policy. SAMA had matched US Fed cuts by reducing reverse repo amounts but keeping the repo rates steady. The inflation recorded for 2009 was at 5.1%.

Due to a spike in the oil prices coupled with interest rate cuts, Saudi Arabia is experiencing high inflation. The economy is being pressurized by inflation and is limited to tackle the domestic function due to lack of an independent monetary policy. Further, the peg with the USD results in the decline in prices of imported food products when the USD declines against major currencies.

The regulatory authority is disappointing, with regulatory frameworks being underdeveloped in the nation, proving to be a hurdle to long-term economic growth.

Political stability

Politically, there has been growing tension between Saudi Arabia and Iran, as both countries aim to be centers of power and influence in the Middle East. The House of Saudi has shown its ability to handle volatility and political risks, leading to a stable outlook.

Bank Credit

Total annual bank credit in 2009 declined for the first time since 2001, reflecting the country's continued nervousness about rising defaults and loan losses. According to SAMA, credit offered by Saudi banks declined to SAR 736.9 billion in Q4 2009 from SAR 744.8 billion in Q4 2008. The fall in Q4 2009 was the worst in the last 13 months as credit to the private sector fell to SAR 708.7 billion.

Banks are well capitalized and profitable and we do not foresee a crisis. Defaults by two major family firms have led to concerns over the solvency of private family businesses, which will make international borrowing expensive.

Sector Overview

Saudi Arabia Telecom Sector Overview:

The Saudi government opened up its telecom sector in 1998, with the creation of STC. Till 2004, STC enjoyed a monopoly in both the fixed line and wireless segments. In 2004, UAE based Mobily entered the mobile services market with aggressive expansion plans. In August 2008, a third mobile license was awarded to Zain Saudi resulting in increased competition, with Zain making significant inroads in the sector.

The young and dynamic population in Saudi Arabia suggests that the market will see higher rates of uptake of new technology. High prices of oil and a growing economy have encouraged the growth and use of mobile phones and higher spending on telecom services.

MENA Market Liberalization

The deregulation of the MENA telecom market as a whole has ensured increasing competition and is pushing the penetration rates higher as cellular services in particular have become increasingly affordable. Most of the countries in the MENA region now have more than one mobile licenses issued to operators which has caused considerable fall in the ARPU rates. The markets which were initially under the complete monopoly of the respective governments have been liberalized and thus the focus of the industry has started to move towards value added services to command a higher market share.

Wireless Services

Despite being the largest telecom market in the GCC region, Saudi Arabia’s penetration rate of 177.0% in 2009 is relatively lower than that of UAE’s 228.0%, Qatar’s 203.0% and Bahrain’s 190.0%.

The wireless segment in Saudi Arabia is currently being driven by the competition between Mobily, STC, and Zain. Till recently, the market faced poor segmentation, but competition has improved and all providers are adopting aggressive marketing plans. The effect of competition on penetration is significant, with mobile penetration increasing from 42.0% in 2005 to 177.1% in 2009. Competition is also driving down the ARPU, hence impacting the respective company’s revenues.

New technologies like Wimax, coupled with the historically poor broadband penetration in Saudi Arabia offer growth opportunities. Both Mobily and STC are using the roll out of 3G and 3.5G to establish a dominant position in this sector. Mobily and STC already offer USB mobile products. STC introduced its 3G services in June 2006 and has introduced 3.5G services in some areas, and continues to expand its network.

Wireline Services

Fixed line subscriber growth has been stagnant. The subscriber base stood at 14.0 million as of 2009 indicating a penetration rate of 54.9%. The introduction of NGN technology will create a positive trend in ARPU rates for STC and also further push the penetration rates marginally.

In 2007 consortiums led by PCCW, Verizon, and Batelco won licenses to operate within Saudi Arabia. The granting of 3 licenses for the fixed line segment simultaneously indicates that the government is aware of the need for investment in this sector and is committed to improving penetration and growth in this segment

ADSL broadband demand is expected to be the driver for future growth in this segment. Saudi broadband internet providers have been rated among some of the worst in the world, and the cost of a broad band connection is higher than that of other comparable countries. STC’s network is based on copper wires, and signal loss limits broadband penetration to regions with a 5km radius of a local exchange. STC plans to upgrade its network to an all IP network to compete and improve service quality.

The broadband market is largely under penetrated and as a result STC aims to replace the existing copper wires to fiber optics (NGN) for high speed internet access up to 100 GBps. Additionally, NGN will also enable significant cost savings as they require lower repairing and maintenance costs.

The explosion of broadband is expected to be the primary growth driver for STC in the local market. This explosion will significantly assist the telecom players in the region in maintaining the ARPU rates which are otherwise on the decline. The broadband penetration which currently lags at 3.3% is expected to touch the 58.0% mark by 2015.

STC is strongly leveraging its wireline network to attract customers, offering them a single handset for mobile, fixed, and data services, with a single contract and billing system to cover them all. Mobily is aiming to implement a Fixed to Mobile Substitution strategy and taking market share from STC. Its Mada product allows users to make mobile based calls as if they were on a fixed line from a location of their choice.

Current MENA Telecom Industry Dynamics

The telecom markets in the MENA region are saturated or are nearing saturation. The telecom players are looking at inorganic growth opportunities which focus on international acquisitions in order to keep their organizations in the growing kind. The focus to fund such acquisitions has been on internal financing due to the limited accessibility to external funds following the downturn in the financial sector. The companies have considerably reduced their capex plans and are now concentrating entering into network and infrastructure sharing arrangements. These factors coupled with stable operating performances are expected to allow the telecom players to maintain low Debt to EBITDA levels.

Market Dynamics							
(All figures in millions)	Saudi Arabia	Kuwait	Turkey	South Africa	Malaysia	Indonesia	India
Population	25.2	3.5	70.5	49.3	27.8	231.5	1,199.1
Wireless - Penetration	177.1%	110.2%	102.0%	101.5%	95.7%	65.9%	39.3%
Wireline - Penetration	54.9%	18.5%	25.6%	N.A.	N.A.	N.A.	N.A.
Subscribers							
Wireless	45.200	3.896	71.969	50.069	26.574	152.540	471.420
Wireline	14.000	0.510	18.200	N.A.	N.A.	N.A.	N.A.
Total Subscribers	59.200	4.406	90.169	50.069	26.574	152.540	471.420

Markets and Demographics for Secondary Regions:

Turkey

As of 2009, the population of Turkey stood over 70.5 million. The penetration rates in 2009 in Turkey were 102.0% in the wireless segment and 25.6% in the wireline segment. Turkey is the largest telecom market in Central and Eastern Europe, Middle East, and Africa. Three players compete in the mobile services market: Turkcell, Vodafone, and Avea. The fixed line segment is dominated by Turk Telekom, which has a 96.0% market share. The market has been fully liberalized since 1980 with an autonomous sector authority (TA). The government's aim has been to ensure competition and entry into different markets. The incumbent state owned telecom operator was fully privatized in 2005. Taxes in Turkey account for a 56.0% share of mobile service costs, twice as high as the nearest country (Uganda). With Oger and Vodafone entering the market, it is hoped that the government may be persuaded to reduce taxes in order to increase penetration as well as encourage competition in the country.

India

With a population base of 1,199.1 million as of 2009, and a mobile penetration rate of 39.3%, the Indian telecom sector has witnessed the fastest growth in the world in 2009. India is the third largest mobile market in the world with 471.3 million recorded mobile subscribers. This is expected to grow by 16.1% to 547.2 million subscribers in 2010. The country is divided into 23 circles and licenses are auctioned by the government to roll out services within them. This sector is flooded with competition as all the major global telecom players see immense growth potential. As of 2009, there are as many as 21 telecom players in the country with Bharti Airtel being the market leader. With the opening and liberalization of the Indian telecom industry, the market has exploded. A high population base combined with a low penetration rate presents high growth opportunity for the market players to increase their subscriber base. A benign regulatory environment, dropping handset costs, and rising incomes are all contributing to growth which has made the fastest growing cellular market in the past year. Licenses are restricted only by the total amount of spectrum available; as a result of which there is significant competition in the sector. The level of competition has lowered ARPU levels. The intense competition is expected to bring about substantial consolidation due to price pressures and high operating costs. However, there are many regulatory restrictions on M&A's in the Indian telecom sector. Consolidation is not allowed for three years after the grant of a license. Also, no consolidation is allowed if the number of operators in a circle falls below four.

Indonesia

The fourth most populous country in the world had a population of 231.5 million in 2009. A large portion of the population earns income on daily, weekly or biweekly, due to which prepaid connections are more popular than post-paid connections. The Indonesian telecom sector currently hosts eight service providers with Telekomunikasi, XL Axiata, and Indosat amongst the major players. However, we believe this scenario will undergo a change in the long term due to consolidation. Indonesia's mobile market expanded by 25.4% in 2009 bringing the total number of subscribers to 175.2 million thereby representing a penetration rate of 73.8%. The Indonesian telecom sector is divided into three segments: full mobility; limited mobility (fixed wireless); and fixed wireline. Full mobility offers mobile facilities inclusive of roaming, while limited mobility licenses do not offer roaming but charge 1/3rd the price of a full mobile service. Currently, full mobility is the most popular licenses, accounting for 82.0% of market share. The predominance of full mobility is attributed to it being the first service to be made available. Limited mobility represents 10.0% of market share and fixed wireline the remaining 8.0%. Mobile broadband growth has been a major driver of the market performance, and we expect this trend to continue during 2010 and beyond.

Malaysia

Malaysia's population as of 2009 stood at 27.8 million. As of 2009, the penetration levels in Malaysia have touched 95.7% making the market relatively saturated with a minimal potential for growth. The Malaysian telecom sector is currently flooded with three major players. As of 2009, Celcom's and DiGi's market shares were 33.6% and 25.6% respectively. The balance 40.8% market share was under Maxis'. Maxis' premium positioning is under threat from its competitors Celcom and DiGi as they have shifted focus on developing data services and enhancing their higher-end subscribers market. The other telecom players are expected to initiate price wars in order to grab maximum possible market share. Growth opportunities are still seen in mobile revenues, but fixed line incomes are expected to continue to decline. Rising disposable incomes are expected to encourage growth in handset ownership and the consumption of mobile services. The market has seen significant consolidation since 2002 with high levels of competition between the major players. ARPU values are expected to reduce going forward owing to intensified competition. The Malaysian telecom sector is expected to undergo major structural changes with incumbent operators asserting themselves in the market, while the new operators initiate a price war.

South Africa

With a population of 49.3 million in 2009 and a healthy penetration rate of 101.5%, South Africa is becoming an exciting destination for the global telecom players. The market hosts three major players MTN, Vodacom, and Millicom. There have been some interesting movements in the South African telecom sector in terms of development of risks associated with the regulatory uncertainty around mobile termination rates in South Africa. The defense of high termination rates is based on the access versus usage trade-off. High termination rates tend to lead to subsidies for mobile adoption such as cheap SIM cards and handset subsidies. This in turn has lead to rapid penetration. The mobile penetration rates have since outdone the penetration rates in the wireline sector over the past few years.

Kuwait

The third-smallest country by population (of 3.5 million) in the Middle East, Kuwait enjoys the second-highest GDP per capita with a population largely in the age group of 16-40. The country has a relatively high level of fixed-line penetration with an under penetrated market. Kuwait's telecom market has scope for development, with low mobile and broadband penetration, but relatively higher fixed line-penetration when compared to other GCC member countries. The entry of Kuwait's third operator Viva has shaken up the market considerably. The move by Viva to the calling-party-pays concept has ensured the entire market to move from its current industry trend. This has resulted in loss of revenue and market share for the existing two operators in Kuwait. As of today the Kuwait telecom market hosts three telecom operators. The intensifying competition in the Kuwait telecom sector is causing the ARPU rates to decline. The telecom sector is regulated by the Ministry of Communications with the telecom sector less liberalized than the other GCC members. Internet services in Kuwait are highly regulated with censorship systems intercepting data. The country does not have an independent telecom regulator and thus lacks proper regulatory framework.

Company Overview

Description:

Saudi Telecom Company ("STC"), established in 1998, is Saudi Arabia's largest telecom service provider and the only integrated service provider. STC provides fixed-line, mobile and internet services in Saudi Arabia, Turkey (Oger Telecom), Indonesia (PT Narindo Telepon Seluler), Kuwait (Viva), Malaysia (Maxis), India (Aircel), and South Africa (Cell C), through its subsidiaries. Within Saudi Arabia, the company operates through its five business units: Al Hatif (landline), Al Jawal (mobile), STC Online (online bill payments), Saudi Net (internet services), and Saudi Data (data solutions). In Saudi, wireless revenue accounted for 59.2% of operating revenue and 82.1% of the total subscriber base for STC. STC's market share dropped to 46.5% in Saudi Arabia in 2009, from 53.1% in 2008 in the wireless segment, due to intensified competition in the market.

History:

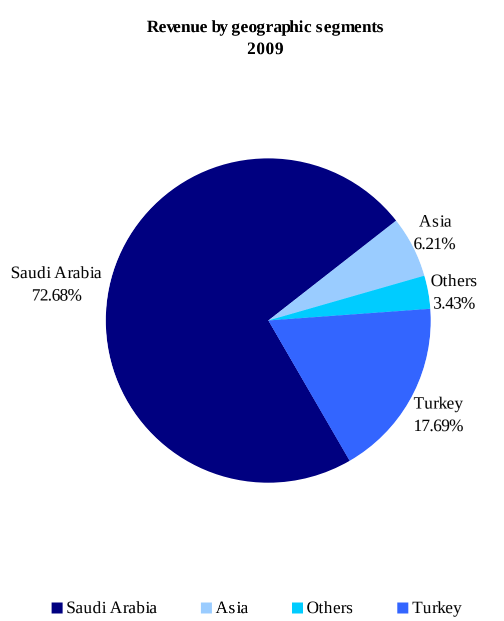
The company was established in 1998 as a result of a royal decree to restructure the Post, Telegraph and Telephone Ministry. The Saudi government had indicated its desire to fully privatize the company. In 2002, 20.0% of STC's shares were put up in a public float, with another 10.0% divided equally between a pension fund and the General Organization for Social Insurance in Saudi Arabia. The company enjoyed a monopoly in both the fixed and wireless markets for several years, till Etihad Etisalat (Mobily) won Saudi Arabia's second mobile services licenses in July 2004. In 2006, Mobily won another mobile license and in 2007 Kuwait's Mobile Telecommunication Company won the country's third license, further increasing the competition. In 2007, STC had 64.0% of mobile market share, with the remaining 36.0% controlled by Mobily. In April 2007, the Saudi government granted fixed line licenses to Verizon, Batelco and PCCW, increasing the competitors for the company. In 2008, the company acquired a stake in Oger Telecom and it also has invested in Bahrain under the banner Viva, whose operations have started in 2010.

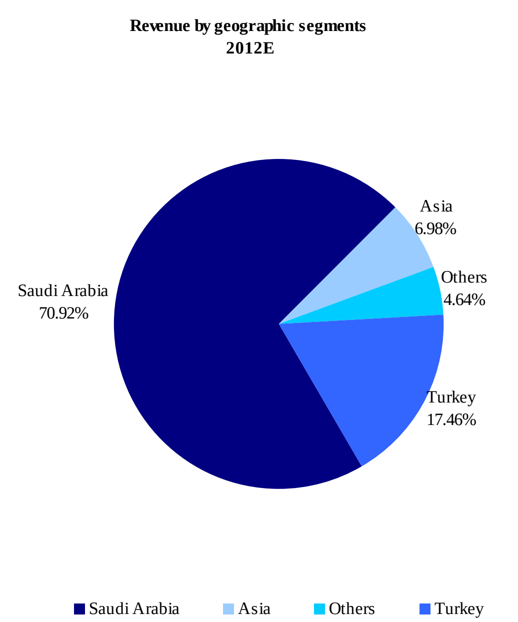
Shareholders	%
Government of Saudi Arabia	70.0%
Genral Org. for Social Insurance	7.0%
Public Pension Fund	6.6%
Total Institutional	**83.6%**
Float	16.4%
Total	**100.0%**

Board of Directors	Position
Dr Mohammed Suleiman Al Jasser	Chairman
Mohammed Bin Abdullah Al Kharashi	Vice Chairman
Mohammed Bin Umran Al Umran	Director
Abdulaziz Bin Habdan Al Habdan	Director
Abdulrahman Bin Abdulaziz Mazi	Director
Ibrahim Bin Ali Al Hassan	Director
Mohammed Bin Saleh Al Dahham	Director
Dr. Hammad Bin Suleiman Al Qasoumi	Director
Khaled Bin Abdulrahman Al Rajhi	Director

Source: Zawya

Revenue Segmentation by Geography





** Asia includes Malaysia (4.6%), Indonesia (0.2%), and India (1.7%). Others include South Africa (3.0%) and Kuwait (0.3%)*

Source: Company reports, TresVista estimates

Subsidiaries and Associates			
Name	**% Owned(1)**	**Country**	**Description**
Arabian Internet & Communications	100.0%	Saudi Arabia	The company is involved in providing internet services, transmission and processing of information and the operations of communications projects.
STC Bahrain	100.0%	Bahrain	Saudi Telecom won the license to operate Bahrain's third GSM mobile telecommunications network, in March 2009, for BHD86.7 million (USD229 million). The company launched its services a year later, under the brand name, Viva Bahrain. Within the first 2 weeks of operations, it gained 50,000 subscribers. Viva Bahrain expects to gain a 20% share of the mobile telecommunications market and up to a 40% share of the broadband market in Bahrain, within first two years of operation.
PT Narindo Telepon Seluler	51.0%	Indonesia	An Indonesian telecom service provider, NTS originally obtained a license to offer GSM services in Indonesia, and was focused on East Java. NTS was granted Indonesia's second 3G license in 2004. NTS' network is currently limited to Jakarta, Bandung and Surabaya with long term plans to expand over the rest of the islands. Maxis' owned a 95.0% equity stake in NTS. In 2005, it divested a 51.0% stake to STC, reducing its holding to 44.0%.
Gulf Digital Media Holding	51.0%	Bahrain	Gulf DTH F.Z. L.L.C., is the operating company behind Persian Gulf digital pay TV broadcaster Showtime Arabia, based at Dubai Media City, United Arab Emirates in the Middle East.
Tejari Saudi Arabia	50.0%	Saudi Arabia	Established in 2006, the company is intended to provide services related to e-commerce.
Arab Submarine Cables	48.6%	Saudi Arabia	Responsible for the creation, leasing, operation and maintenance of a under-sea cable between the republic of Sudan and Saudi Arabia, it began services in June 2003.
Arab Satellite Communication Organization	36.7%	Saudi Arabia	
Arabsat	36.6%	Saudi Arabia	Arabsat was established by the Arab league in 1976 and currently offers regional telephony, television and radio broadcasting, restoration services and leasing capacity to its member states, and any public or private enterprise within its
Oger Telecom	35.0%	Turkey	Oger Telecom provides fixed-line, mobile and internet services primarily in Turkey and South Africa. Through its subsidiaries, Turk Telekom and Avea, it provides fixed line, broadband internet, and mobile telecom services within Turkey. Its subsidiary, Cell C offers mobile communication services to customers in South Africa.
Cell C	26.3%	South Africa	Cell C is a dual band mobile service provider in South Africa. It began operations in June 2001 and by 2006 it had 3.2 million subscribers.
Newtel Mobile Telecommunication	26.0%	Kuwait	Kuwait's third mobile telecom operator, it is slated to begin operations in October 2008. It is licensed to provide all types of mobile communications within the constraints of Shariah. 50.0% of its capital comes public sources, 26.0% from STC, and the remainder is held by government bodies.
Kuwait Telecom Company	26.0%	Kuwait	STC won the bid for the KTC license for KWD248.7 million (USD901 million), in November 2007. The Shariah-compliant KTC underwent an IPO in August 2008, on the Kuwait Stock Exchange, offering 50.0% of its shares for public subscription, to raise KWD 26.4 million (USD 98.7 million). Viva had captured 10.0% of Kuwait's market share by May 2009. The company's goal is to reach a 20.0% market share by the end of 2010.
Binariang GSM - Maxis	25.0%	Malaysia	Maxis Communications is the leading integrated telecom service provider in Malaysia. As of May 2008, Maxis was stated to have a market share of 41.7% with a subscriber base of 10 million within Malaysia. It also has mobile business operations in India, Indonesia, and Sri Lanka through its subsidiaries Aircel, NTS, and Sri Lanka Telecom.
Turk Telekom	19.1%	Turkey	Turk Telkom is the worlds 13th largest telehone company with 18.2 million fixed lines as of 2007. It controls 96.0% of fixed line market share, and 16.0% of market share in the mobile telecom sector through its subsidiary, Avea.
Aircel	18.5%	India	Aircel is Maxis' 74.0% owned mobile services subsidiary in India. It initially operated within 10 of 23 telecom circles and, after winning licenses for the remaining circles in Q1 07, plans to roll out services nation wide by 2010. The company serves 11.9 million subscribers as of June 2008 and plans to invest USD 4.0 to USD 5.0 billion in the next three years.

(1) Percent owned includes all direct and indirect holdings through subsidiaries.

Financial Performance

2009 Results

- Total revenue grew 7.0% y-o-y from SAR 47.5 billion in 2008 to SAR 50.8 billion in 2009 due to customer acquisitions in their international operations
- The ARPU rates in 2009 declined by 8.6% y-o-y in the wireless sector and 16.8% in the wireline sector
- The combined subscriber base increased from 36.212 million in 2008 to 41.721 million in 2009 which were mainly driven by customer acquisitions in their international ventures
- The gross margins have been experiencing a decline due to the increment in the access charges and the repair maintenance due to increasing competition, increase in the access charges paid to the government, and the implementation of newer technological networks (NGN). The growth of administrative and marketing expenses of 32.2% y-o-y in 2009 due to heavy promotional activities in the overseas businesses have caused the EBITDA margins to drop in 2009
- The company has witnessed marginal decrease in their EBITDA y-o-y from SAR 21.7 billion in 2008 to SAR 20.6 billion in 2009. The primary reason for this marginal decline is the intensifying competition which is creating price pressures in the telecom sector
- The company's net income in the year 2009 fell marginally by 1.6% due to falling domestic market share to competitors and falling international call rates.

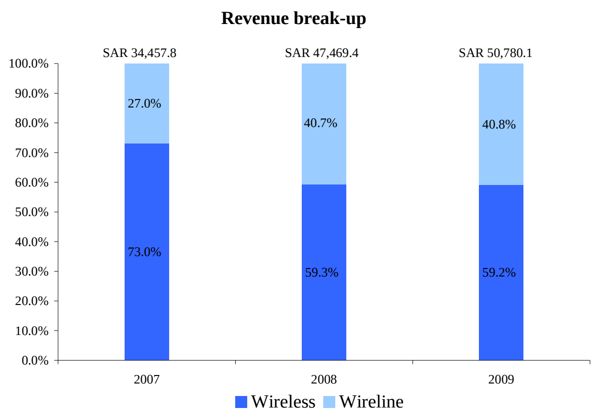
H1 2010 results

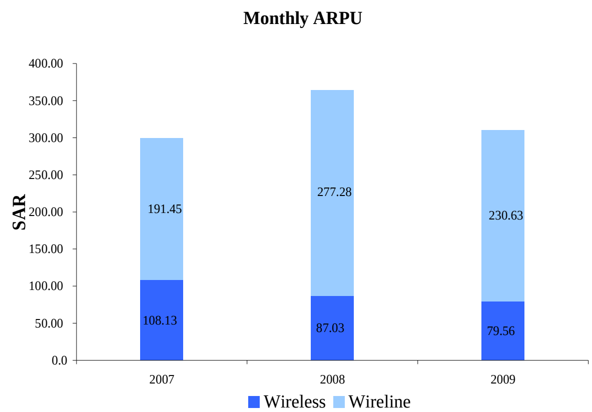
- H1 2010 revenues marginally increased 1.2% y-o-y from SAR 24.8 billion in H1 2009 to SAR 25.1 billion in H1 2010.
- EBITDA declined y-o-y by (16.6%) to SAR 8,963.7 whereas the margins declined to 35.7% in H1 2010 from 43.3% on account of higher access charges and marketing expenses. The EBITDA margins declined on account of lower prices of international calls, higher fees related to using external networks (international interconnections) and high capex for its international business
- Net profit declined y-o-y to (30.0%) to SAR 3,834.0.

Particulars	**2007**	**2008**	**2009**	**H1 2010**
(All figures in SAR millions, except per share data.)				
Revenues				
Wireless	25,164.7	28,132.7	30,052.2	N.A.
Wireline	9,293.1	19,336.7	20,727.9	N.A.
Total	SAR 34,457.8	SAR 47,469.4	SAR 50,780.1	SAR 25,110.9
EBIT	12,617.9	15,335.1	12,813.6	4,698.1
EBITDA	16,716.2	21,742.7	20,612.3	8,963.7
Net Income	12,021.7	11,037.8	10,863.4	3,834.0
EPS	6.01	5.52	5.43	1.92
EBIT margins	36.6%	32.3%	25.2%	18.7%
EBITDA margins	48.5%	45.8%	40.6%	35.7%
Revenue/Subscriber				
Wireless	999.1	980.6	877.1	N.A.
Wireline	2,266.6	2,570.4	2,779.8	N.A.
Capex	8,339.2	34,358.9	16,154.1	5,147.1

STC operates within two segments, wireline and wireless. The contribution from wireline revenue has stagnated. Wireless revenues contributed to 59.2% of total revenue for FY09. Wireless as a segment has been witnessing growth, as the company expands aggressively to maintain market share in the face of competition. The operations of STC have historically been limited to the Saudi Arabian market. In Q1 2009, the company acquired a license to operate in Bahrain via Viva Bahrain, which gives them exposure to the Bahrain telecom sector.

Operating Performance





Strategy

- *Broadband*

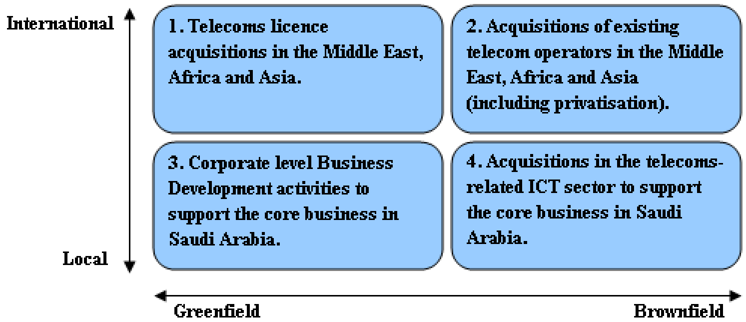
STC has incurred heavy capital investments in the NGN technology and are looking at it seriously to tap into the ADSL market not only domestically but also internationally. This will enable the company to offer high-end internet service such as IPTV and will help it to tap into the underpenetrated local market and aims to dominate the broadband segment.

- *International Acquisitions*

The company is facing increasing competition in the Saudi market, where it had been enjoying a monopoly till 2007. With increasing competition and the entry of third competitor in 2008, STC is playing to defend its market within the Kingdom, and seeking to gain market share by growing inorganically. The timing of expansion into the Indian market through Maxis has witnessed significant appreciation in value. All their international investments are in highly competitive markets and this gives them a lot of potential to enter into markets that can promise them long term stability in revenues and growth. The company has also set up a strategic investment unit to look into potential investment opportunities internationally as it looks out for good consolidation opportunities in order to meet capital expenditure requirements in the light of stiffening competition domestically.

- *10 x 10*

The company announced a 10x10 strategy, wherein the aim was to have 10.0% of the group's revenues from sources outside Saudi Arabia by 2010. This goal has been over accomplished and the international operations are already 27.6% to the total revenues in 2009.



Source: STC Investor Relations Presentation, September, 2009.

News and Developments:

07/18/10 – STC and Mobily announced the completion of the technical interconnect link of their two networks which would benefit the subscribers. This link covers 90.0% of the populated areas in the country.
06/28/10 – STC announced its desire to take 10.0% to 15.0% stake in GTL Infrastructure Ltd., Reliance Infratel entity.
06/06/10 – STC indicated that they were seeking a 55.0% stake in Vodafone Egypt which has been valued at around US$4.3 billion.
05/23/10 – STC approaches CISCO Tech for hosting services in Saudi Arabia.
04/26/10 – STC announced that it would consider issuing new debt to fund their growth targets.
04/05/10 – STC launched the fastest broadband internet service in the region with speeds up to 100 Mbps

- The CEO announced that the company was considering to expand its operations in other regions including Africa

Valuation and Price Target:

Discounted Cash Flow and Dividend Discount Model

We have projected STC's future earnings on a geographical basis and split between their wireless and wireline business. The key assumptions are (i) subscriber growth, (ii) ARPU growth, and (iii) cost margins. Subscriber growth is driven by assumptions on the penetration and market share of STC and its subsidiaries. Saudi Arabia remains the principal market of operations and contributor to profits. Despite declining market share, we assume the company is able to maintain its subscriber levels due to increased penetration levels. We forecast that ARPUs will erode by 4.8% per year, in line with the global trend of ARPUs declining as markets become more competitive and developed. As a function of new entrants and increased competition, STC's margins of 40.6% will not be sustainable. We have margins from Saudi operations declining to 36.0% by 2014. However, we feel that STC's infrastructure upgrades combined with its market position, will allow it to offer value added services.

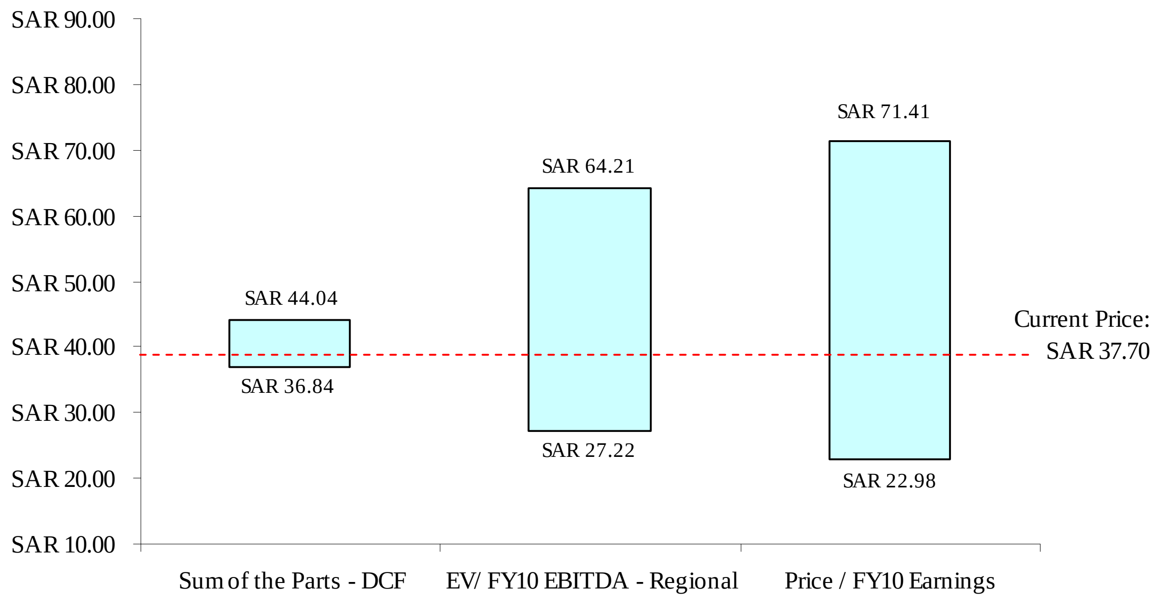
The developing markets are in various stages of development. Indonesia and India are expected to generate high cash flows drive the growth of the company.

Sum-of-the-Parts: Discounted Cash Flow

We projected cash flows on a market by market basis. Based on the relevant risk free rates, market risk premiums, and regional comparable betas, we discounted the free cash flows generated by each market to arrive at a sum-of-the-parts valuation. We assumed that in the absence of additional invested capital, declining margins and eroding ARPUs in the industry will result in a negative perpetuity growth.

Comparable Company Analysis:

We also valued the company based on its trading multiple vs. its comparables. Compared to its regional comparables, STC is trading at a discount based on 2010 EV/EBITDA (5.4x vs. 6.2x). We believe that the future contribution of the subsidiary and growth markets has been fully factored into the market price.



Based on both our DCF and our comparable company analysis, we reiterate our HOLD recommendation of STC and a price target of SAR43.45.

Key Investment Highlights:

Key Investment Merits:

- The company is a market leader in Saudi in both the wireless and wireline segment and enjoys strong government backing.
- Due to the improving economic climate in Saudi Arabia and around the world, the number of expatriates in the country has gone up causing the penetration rates to rise beyond 150.0%. This presents potential for additional subscriber growth.
- In the fixed line segment, the company has begun to upgrade its existing network (to NGN) to take advantage of the growing ADSL market. Also, significant capex requirements for fixed line businesses enabling high speed connectivity will make it difficult for new players to pose a threat to STC's position.
- The company is looking at other revenue models like fixed line and wireless broadband connectivity to maintain the otherwise falling ARPU levels in the face of rising competition. STC plans to concentrate on value added services in the wireless sector in order to drive and maintain the ARPU rates and subscriber base.
- The telecommunications industry worldwide has been witnessing significant growth in net subscriber addition. The easing regulatory framework is providing all the global telecom players a strong opportunity to expand their subscriber bases through international business acquisitions.
- STC, through its acquisitions, is expanding into high growth markets which are expected to be a major driver for future growth thereby limiting the risks inherent in any one market.
- The company is one of the lowest leveraged compared to its peers and can take advantage of its low debt to EBITDA ratio and high credit rating of "A+" by S&P to further leverage itself.
- The company has strong operating cash flows and has consistently paid significant dividends.

Key Investment Risks:

- The entry of new competitors in Saudi has led to STC fighting to maintain the market share and prevent it from falling which in turn is causing the ARPU rates to fall. Any further unforeseen competition will lead to further erosion of ARPUs, affecting the margins.
- Use of latest technology by new competitors could force STC to upgrade its network to remain competitive, incurring significant capital expenditures in the process. Any substantial capital expenditures will have to be funded internally consuming up their free cash flows due to the limited exposure to bank financing in Saudi Arabia. This can cause the company's growth rates to be subdued.
- The increase in access charges, repairs and maintenance costs, and interconnection costs coupled with the declining international call rates has caused the profit margins to plunge.
- Though the company has expanded into high growth markets, their saturation and competition levels may pose a serious threat to their efforts of gaining substantial market share.
- The emergence of Mobile Virtual Network Operators (MVNO's) in any of its markets can create the potential for several new competitors (Virgin Mobile has recently entered India).
- Due to the increasing contribution to the revenues from the international businesses, the company is exposed to foreign exchange risk whose magnitude can significantly hamper the operational cash flows.

Valuation – Discounted Cash Flow Analysis

(SAR in millions)

Saudi Telecom Company - DCF Some of Parts Valuation

Discounted Cash Flow - 5 Years

(In SAR millions, except per share data)

	Risk Free Rate	Market Risk Premium	Beta	Debt/ Cap	Cost of Debt	WACC	PV of Cash Flows	Perpetuity Growth	PV of Terminal Val.	PV of Ending Book Value	Contribution to EV
Wireless											
Saudi Arabia	3.1%	8.3%	0.88	29.3%	4.4%	8.6%	12,371.9	(0.5%)	SAR 23,328.3	17,689.0	SAR 35,700.2
Malaysia	3.9%	8.4%	1.00	29.3%	4.4%	10.0%	2,754.5	(0.5%)	5,269.2	919.3	8,023.7
Indonesia	8.3%	10.9%	0.91	29.3%	4.4%	14.2%	230.5	(0.5%)	480.2	209.3	710.7
India	7.6%	5.3%	0.86	29.3%	4.4%	9.9%	652.9	(0.5%)	2,066.7	1,249.9	2,719.6
Kuwait	3.1%	8.3%	1.13	29.3%	4.4%	10.1%	264.2	(0.5%)	752.0	196.4	1,016.2
South Africa	8.5%	12.5%	1.09	29.3%	4.4%	16.9%	2,090.1	(0.5%)	2,763.1	578.4	4,853.1
Turkey	9.6%	7.3%	0.63	29.3%	4.4%	11.3%	2,078.4	(0.5%)	4,476.6	1,234.2	6,555.1
Wireline											
Saudi Arabia	3.1%	8.3%	0.88	29.3%	4.4%	8.6%	1,709.5	(0.5%)	965.8	20,965.8	22,675.4
Turkey	9.6%	7.3%	0.63	29.3%	4.4%	11.3%	7,382.7	(0.5%)	14,160.1	6,344.3	21,542.8

Enterprise Value

Sensitivity to WACC Calculation	Perpetuity Growth (1.0%)	(0.5%)	0.0%	Less: Net Debt
(0.50%)	105,317.6	108,324.2	111,656.9	23,580.0
(0.25%)	103,168.6	106,007.1	109,144.8	23,580.0
0.00%	101,113.4	103,796.8	106,755.3	23,580.0
0.25%	99,145.8	101,685.6	104,478.9	23,580.0
0.50%	97,259.9	99,666.6	102,307.4	23,580.0

Equity Value

	Perpetuity Growth (1.0%)	(0.5%)	0.0%
(0.50%)	81,737.6	84,744.2	88,076.9
(0.25%)	79,588.5	82,427.1	85,564.8
0.00%	77,533.4	80,216.8	83,175.3
0.25%	75,565.8	78,105.6	80,898.9
0.50%	73,679.9	76,086.6	78,727.4

Share Price

Sensitivity to WACC Calculation	Perpetuity Growth (1.0%)	(0.5%)	0.0%
(0.50%)	40.87	42.37	44.04
(0.25%)	39.79	41.21	42.78
0.00%	38.77	**40.11**	41.59
0.25%	37.78	39.05	40.45
0.50%	36.84	38.04	39.36

Equivalent Exit LTM EV/EBITDA Multiple

	Perpetuity Growth (1.0%)	(0.5%)	0.0%
(0.50%)	3.0x	3.2x	3.4x
(0.25%)	2.9x	3.1x	3.3x
0.00%	2.9x	3.0x	3.2x
0.25%	2.8x	3.0x	3.1x
0.50%	2.8x	2.9x	3.0x

Public Company Comparable Trading Analysis

USA and Other Global Comparables

Comparable Companies

Company Information (USD in millions except per share information)

Source: Bloomberg

Company	Enterprise Value[(1)] / Revenue			Enterprise Value / EBITDA			Enterprise Value / EBIT			Price / EPS			Price / BVPS
	LTM	FY2010	FY2011	LTM	FY2010	FY2011	LTM	FY2010	FY2011	LTM	FY2010	FY2011	LTM
U.S.A Comparables													
AT&T Inc [(2)]	1.83x	1.82x	1.80x	5.4x	5.2x	5.0x	10.1x	9.2x	8.7x	12.3x	11.3x	10.6x	1.51x
Verizon Communications Inc [(2)]	1.67x	1.69x	1.68x	5.5x	5.2x	5.0x	11.4x	9.6x	9.1x	N.A.	13.3x	12.8x	0.99x
Telephone & Data Systems Inc	0.62x	0.62x	0.62x	2.7x	2.6x	2.6x	7.6x	7.7x	7.6x	10.1x	19.7x	19.9x	0.39x
Low	**0.62x**	**0.62x**	**0.62x**	**2.7x**	**2.6x**	**2.6x**	**7.6x**	**7.7x**	**7.6x**	**10.1x**	**11.3x**	**10.6x**	**0.39x**
Mean	**1.38x**	**1.38x**	**1.36x**	**4.5x**	**4.3x**	**4.2x**	**9.7x**	**8.8x**	**8.5x**	**11.2x**	**14.8x**	**14.4x**	**0.96x**
Median	**1.67x**	**1.69x**	**1.68x**	**5.4x**	**5.2x**	**5.0x**	**10.1x**	**9.2x**	**8.7x**	**11.2x**	**13.3x**	**12.8x**	**0.99x**
High	**1.83x**	**1.82x**	**1.80x**	**5.5x**	**5.2x**	**5.0x**	**11.4x**	**9.6x**	**9.1x**	**12.3x**	**19.7x**	**19.9x**	**1.51x**
Other Global Comparables													
Deutsche Telekom AG	1.47x	1.51x	1.54x	4.3x	4.8x	4.8x	11.2x	11.2x	11.2x	20.2x	14.0x	13.7x	1.03x
BCE Inc	2.13x	2.11x	2.09x	5.3x	5.2x	5.2x	10.1x	10.0x	10.0x	12.1x	11.5x	11.1x	1.32x
Turk Telekomunikasyon AS [(2)]	2.26x	2.22x	2.13x	6.1x	5.4x	5.0x	10.0x	8.5x	7.8x	11.0x	9.6x	8.8x	4.08x
Turkcell Iletisim Hizmetleri AS	1.95x	1.91x	1.81x	5.8x	5.7x	5.3x	9.0x	8.9x	8.3x	12.6x	10.4x	9.6x	2.14x
Millicom International Cellular SA [(2)]	3.28x	3.02x	2.75x	7.4x	6.7x	6.0x	12.6x	11.4x	10.2x	11.8x	16.5x	14.1x	5.52x
Telekom Malaysia Bhd	1.68x	1.65x	1.60x	4.8x	4.8x	4.6x	14.1x	14.3x	13.4x	14.1x	22.2x	20.2x	1.57x
Bharti Airtel Ltd	3.15x	2.87x	2.52x	7.7x	7.4x	6.5x	12.7x	13.6x	11.7x	13.2x	15.4x	13.2x	3.98x
Sri Lanka Telecom Ltd	1.51x	N.A.	N.A.	5.1x	N.A.	N.A.	29.8x	N.A.	N.A.	N.A.	N.A.	N.A.	1.45x
Low	**1.47x**	**1.51x**	**1.54x**	**4.3x**	**4.8x**	**4.6x**	**9.0x**	**8.5x**	**7.8x**	**11.0x**	**9.6x**	**8.8x**	**1.03x**
Mean	**2.18x**	**2.19x**	**2.06x**	**5.8x**	**5.7x**	**5.4x**	**13.7x**	**11.1x**	**10.4x**	**13.6x**	**14.2x**	**13.0x**	**2.64x**
Median	**2.04x**	**2.11x**	**2.09x**	**5.6x**	**5.4x**	**5.2x**	**11.9x**	**11.2x**	**10.2x**	**12.6x**	**14.0x**	**13.2x**	**1.86x**
High	**3.28x**	**3.02x**	**2.75x**	**7.7x**	**7.4x**	**6.5x**	**29.8x**	**14.3x**	**13.4x**	**20.2x**	**22.2x**	**20.2x**	**5.52x**
Saudi Telecom Co. [(2)]	**2.11x**	**2.05x**	**2.00x**	**5.7x**	**5.4x**	**5.2x**	**10.3x**	**9.0x**	**8.9x**	**8.2x**	**8.6x**	**8.6x**	**1.50x**

(1) Enterprise Value = Market Value of Equity + Short-term Debt + Long-term Debt +Minority Interest + Preferred Equity - Cash and Marketable Securities.

(2) LTM as of June 30, 2010

Public Company Comparable Trading Analysis

GCC and Other Regional Comparables

Comparable Companies

Company Information (USD in millions except per share information)

Source: Bloomberg

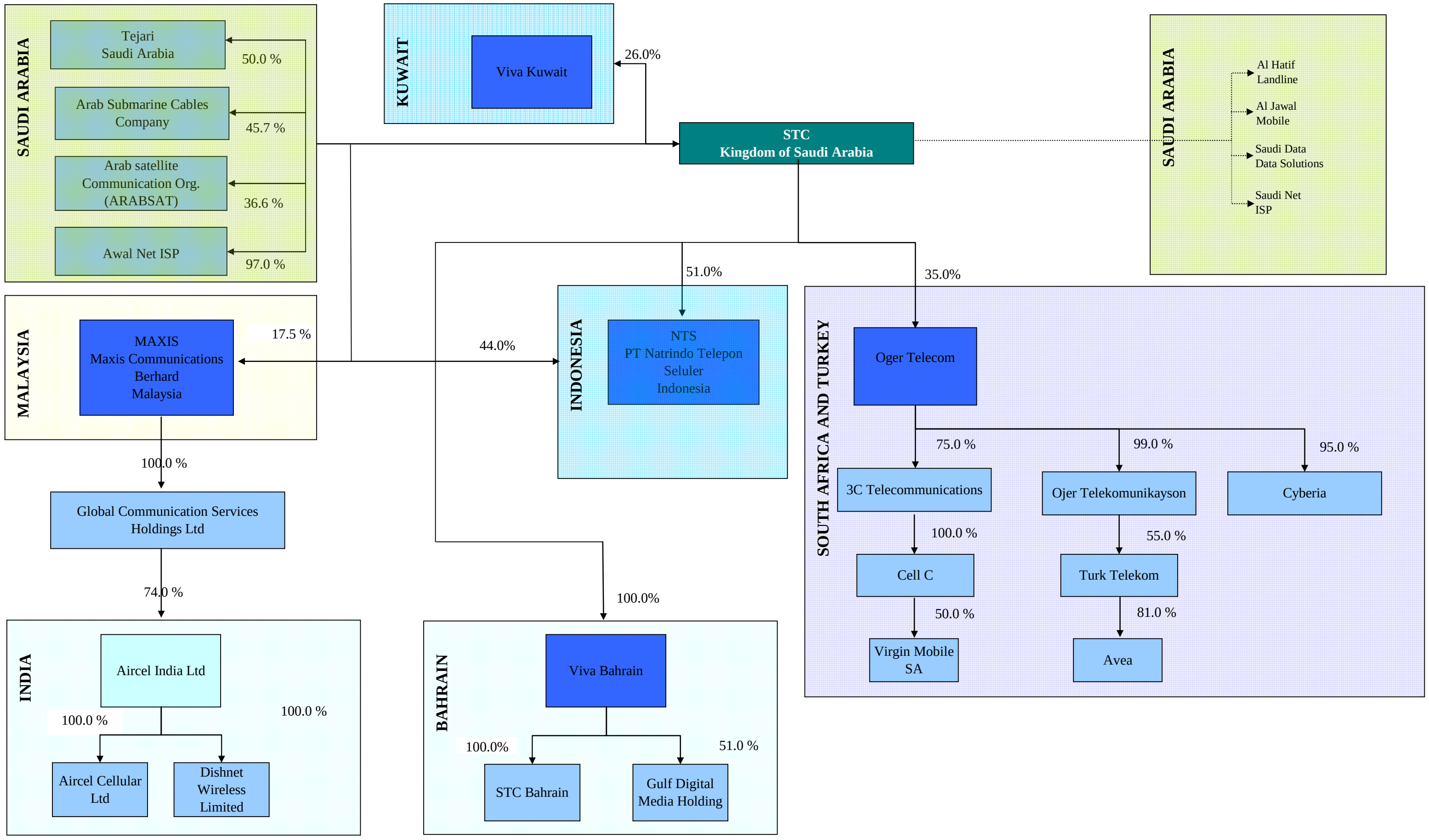
Company	Enterprise Value[1] / Revenue			Enterprise Value / EBITDA			Enterprise Value / EBIT			Price / EPS			Price / BVPS
	LTM	FY2010	FY2011	LTM	FY2010	FY2011	LTM	FY2010	FY2011	LTM	FY2010	FY2011	LTM
G.C.C Comparables													
Emirates Telecommunications Corporation [2]	2.03x	1.77x	1.57x	8.6x	7.2x	5.0x	18.5x	13.1x	8.2x	27.7x	18.5x	11.8x	3.22x
Mobile Telecommunications Co KSC	3.22x	3.60x	3.66x	7.4x	8.2x	8.2x	14.1x	11.5x	10.8x	30.2x	7.1x	11.9x	2.05x
Qatar Telecom QSC	2.58x	2.40x	2.22x	4.3x	5.2x	4.8x	12.1x	10.8x	9.8x	7.3x	8.9x	8.4x	0.79x
Etihad Etisalat Co [2]	3.07x	2.99x	2.75x	8.3x	8.0x	7.3x	12.3x	12.2x	11.1x	10.8x	10.7x	9.8x	2.90x
National Mobile Telecommunications Company (KSC)	1.91x	1.83x	1.71x	4.1x	4.8x	4.5x	6.7x	9.2x	8.4x	8.5x	5.9x	5.2x	1.87x
Oman Telecommunications Co	2.10x	2.12x	2.09x	4.2x	4.2x	4.2x	6.3x	7.7x	6.7x	7.5x	7.7x	7.6x	2.26x
Low	**1.91x**	**1.77x**	**1.57x**	**4.1x**	**4.2x**	**4.2x**	**6.3x**	**7.7x**	**6.7x**	**7.3x**	**5.9x**	**5.2x**	**0.79x**
Mean	**2.48x**	**2.45x**	**2.33x**	**6.2x**	**6.3x**	**5.7x**	**11.7x**	**10.8x**	**9.2x**	**15.3x**	**9.8x**	**9.1x**	**2.18x**
Median	**2.34x**	**2.26x**	**2.16x**	**5.9x**	**6.2x**	**4.9x**	**12.2x**	**11.2x**	**9.1x**	**9.7x**	**8.3x**	**9.1x**	**2.15x**
High	**3.22x**	**3.60x**	**3.66x**	**8.6x**	**8.2x**	**8.2x**	**18.5x**	**13.1x**	**11.1x**	**30.2x**	**18.5x**	**11.9x**	**3.22x**
Other Regional Comparables													
MTN Group Ltd	2.11x	2.01x	1.79x	5.1x	4.9x	4.3x	7.5x	7.0x	6.2x	15.1x	12.3x	10.3x	3.03x
Maroc Telecom SA	4.46x	4.41x	4.24x	7.9x	7.5x	7.2x	10.1x	10.0x	9.8x	14.2x	14.1x	13.7x	5.71x
Telecom Egypt SAE	2.64x	2.62x	2.69x	7.4x	5.6x	6.0x	12.7x	12.7x	13.4x	9.3x	9.9x	10.4x	1.09x
Low	**2.11x**	**2.01x**	**1.79x**	**5.1x**	**4.9x**	**4.3x**	**7.5x**	**7.0x**	**6.2x**	**9.3x**	**N.A.**	**N.A.**	**1.09x**
Mean	**3.07x**	**3.01x**	**2.91x**	**6.8x**	**6.0x**	**5.8x**	**10.1x**	**9.9x**	**9.8x**	**12.9x**	**N.A.**	**N.A.**	**3.28x**
Median	**2.64x**	**2.62x**	**2.69x**	**7.4x**	**5.6x**	**6.0x**	**10.1x**	**10.0x**	**9.8x**	**14.2x**	**12.3x**	**10.4x**	**3.03x**
High	**4.46x**	**4.41x**	**4.24x**	**7.9x**	**7.5x**	**7.2x**	**12.7x**	**12.7x**	**13.4x**	**15.1x**	**N.A.**	**N.A.**	**5.71x**
Saudi Telecom Co. [2]	**2.11x**	**2.05x**	**2.00x**	**5.7x**	**5.4x**	**5.2x**	**10.3x**	**9.0x**	**8.9x**	**8.2x**	**8.6x**	**8.6x**	**1.50x**

(1) Enterprise Value = Market Value of Equity + Short-term Debt + Long-term Debt +Minority Interest + Preferred Equity - Cash and Marketable Securities.

(2) LTM as of June 30, 2010

Company Structure

Subsidiaries



Source: Company filings

Disclosure Appendix

Stock Rating Key:

★★★★★	**5-STARS (Strong Buy)**: Total shareholder return, is expected to outperform the broad market benchmark by a wide margin and we highly recommend that investors buy the stock.
★★★★☆	**4-STARS (Buy)**: Total shareholder return, is expected to outperform the broad market benchmark and we recommend that investors buy the stock.
★★★☆☆	**3-STARS (Hold)**: Total return is expected to be in line with the overall expected market return in the short and long term and we do not recommend a Buy or Sell.
★★☆☆☆	**2-STARS (Sell)**: Total shareholder return is expected to underperform the broad market benchmark and the stock is not anticipated to show a gain.
★☆☆☆☆	**1-STAR (Strong Sell)**: Total shareholder return is expected to underperform the broad market benchmark by a wide margin and the stock is anticipated to falling in price on an absolute basis.

Other important disclosures:

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TresVista Financial Services Pvt. Ltd. is a Mumbai-based firm that provides research, analytics, M&A advisory, and other customized services. TresVista partners with financial institutions globally to enable them to rise above the competition in today's crowded marketplace. Through our team of highly trained associates, our clients are able to increase and manage their operational capacity in a cost-effective manner. TresVista's role is to be decided upon by the clients' needs and the tasks at hand, be it exploring an arbitrage opportunity, analyzing prospective investments, or conducting due-diligence on a cross-border acquisition. TresVista's flexibility is instrumental to its goal of helping clients reach higher heights. Our clientele include investment banks, private equity firms, hedge funds, debt lenders, and other financial services institutions.