

Solutions by STC

Target Price: SAR 335.00
Upside/ (Downside): (0.7%)

Recommendation

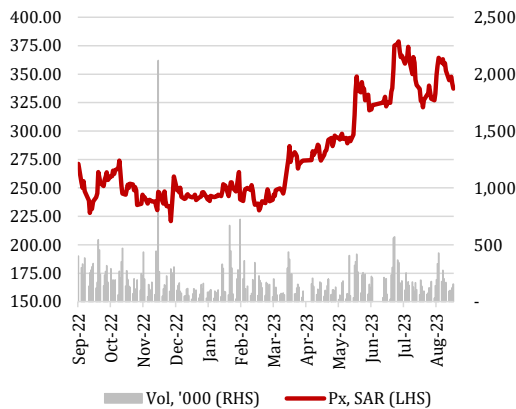
Recommendation	Hold
Bloomberg Ticker	SOLUTION AB
Current Market Price (SAR)	337.20
52wk High / Low (SAR)	392.20/216.80
12m Average Vol. (000)	181.2
Mkt. Cap. (USD/SAR mn)	105,206/40,464
Shares Outstanding (mn)	120.0
Free Float (%)	20%
3m Avg Daily Turnover (SAR'000)	62,311.2
6m Avg Daily Turnover (SAR'000)	49,822.0
P/E'23e (x)	32.9
P/B'23e (x)	12.7
Dividend Yield '23e (%)	1.9%

Price Performance:

1 month (%)	5.1
3 month (%)	0.4
12 month (%)	27.5

Source: Bloomberg, valued as of 07 Sep 2023

Price-Volume Performance



Source: Bloomberg

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- **An expanding market share (19.8% in 2022 vs. 13.8% in 2018) in the backdrop of a growing market size driven by the Kingdom's digital transformation initiatives bodes well for long-term growth.**
- **While the government and stc remain dominant revenue providers, the private sector's share is gradually rising which reduces customer concentration risk. Geographical concentration has also eased a bit at Solutions venture outside KSA with recent acquisitions.**
- **Strong revenue growth, expanding margins, and a solid net cash position translate into healthy fundamentals.**
- **After around 15% price appreciation since our last report, we believe the stock is fairly valued at current levels.**

We review our coverage of Solutions by STC and raise our target price to SAR 335.00 (previously, SAR 330.00), as we raise our FY 2023 revenue and net profit estimate slightly after better-than-expected 1H 2023 earnings and a favorably revised top-line growth guidance by the company. However, post about a 15% run-up in the stock price since our last report, the target price indicates a downside of 0.7% from the current market price, and thus we assign a **Hold** rating (previously, Accumulate). Currently, the stock trades at FY'23e P/E of 32.9x and EV/EBITDA of 21.9x, above its 3-year daily average blended forward TTM P/E of 28.0x and EV/EBITDA of 19.0x.

Investment Thesis

Strong fundamentals with good prospects, but seems fairly valued with limited upside from current levels

- With the backing of strong partner STC, and a leading market share, Solutions looks well set to capitalize on the ICT sector opportunities, which is estimated to grow at a healthy 12%-13% CAGR during 2022-26.
- FY 2023 top-line and bottom-line growth revised upwards sharply from 15-16% and 10-11% to 21-22% and 16-17%, respectively with revised company guidance, strong sustained business growth, and better than expected profitability.
- Asset light business model and solid return to shareholders with the RoE averaging between 35% and 40% during FY 2018-2022
- Liquidity position to remain solid with an expected improvement in profitability, low capex requirements, and negligible debt servicing needs. Ample liquidity should also ensure sustained dividend payments (average dividend payout during FY20-22 ~57%).

Year	FY20	FY21	FY22	FY23e	FY24e	FY25e
Revenues (SAR mn)	6,891.4	7,208.3	8,805.1	10,713.8	12,040.1	13,350.6
Net income (SAR mn)	701.8	832.9	1,052.9	1,229.7	1,420.6	1,629.7
Gross margin	20.6%	23.7%	22.8%	25.8%	25.8%	26.0%
Net profit margin	10.2%	11.6%	12.0%	11.5%	11.8%	12.2%
RoE	44.1%	39.7%	41.6%	41.1%	41.0%	40.0%
FCF (SAR/share)	3.4	8.4	15.4	7.9	12.9	14.4
DPS (SAR/share)	3.3	4.0	5.0	6.5	7.2	8.0
Dividend Yield	NA	2.1%	2.1%	1.9%	2.1%	2.4%
P/E (x)		27.1x	27.7x	32.9x	28.5x	24.8x
P/BV (x)		9.9x	10.4x	12.7x	10.8x	9.2x

Source: Company Reports, U Capital Research

*Dividend Yield, P/E, and P/Book from FY23 onwards are calculated on current price

Investment thesis

Top line's fast-paced expansion expected to continue amid a favorable macro environment

Solutions has sustained strong growth momentum of FY 2022 in all its business segments during 1H 2023. The IT Managed & Operational Services posted the highest growth rate (+34% YoY; FY 2022: +19.4% YoY) during the first half, partially supported by CCC which started contributing since April 2023, as we mentioned in our previous report. Growth in the Digital Services segment, which encompasses in-demand products and services like data centers, cloud services, IoT, and cybersecurity, also accelerated (+15.0% YoY vs. +7.4% YoY in FY 2022), in line with our expectations. The Core ICT Services vertical remained the dominant revenue provider as it increased 23% YoY (FY 2022: +30.0% YoY). Underpinned by its LEAP strategy, Solutions looks confident to scale new heights, with its leading market positioning and the Kingdom's long-term digital transformation objectives. This is well reflected in the upward revision made by the company of its FY 2023 revenue growth estimates to the 19%-22% range from the 16%-19% range, previously. Accordingly, we now expect Solutions FY 2023 growth to be between 21% and 22% as compared to 16%-17%, earlier. This is expected to be driven both through organic and inorganic routes. The company continues to secure new projects and inked over 200 projects during 1H 2023, which is likely to take care of organic business expansion, whereas recently acquired entities Giza and ccc, which contributed 12% and 3% of 1H 2023 revenue, should also provide a meaningful contribution. We estimate that the Core ICT services segment will remain a significant revenue contributor for the company going forward, as the company will continue to leverage its relationship with the telecom major stc. During 1H 2023, stc contributed 32% of the total revenue, while in early June 2023, Solutions signed another 2-year contract with stc worth slightly over SAR 380mn, the financial impact of which will start appearing from 3Q 2023.

Fig. 1: Revenue estimated to maintain double-digit growth...

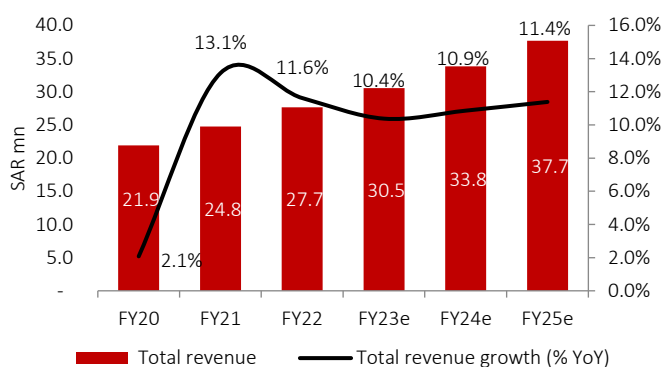
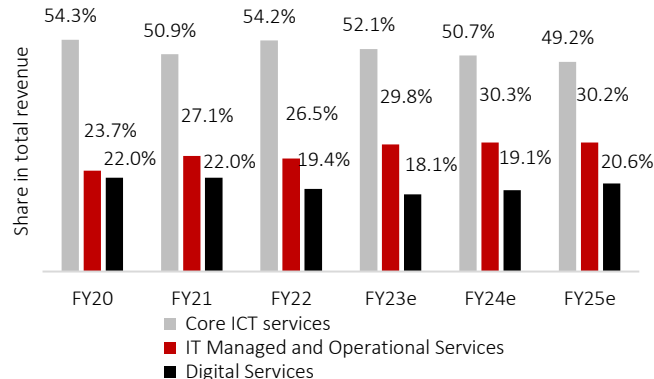
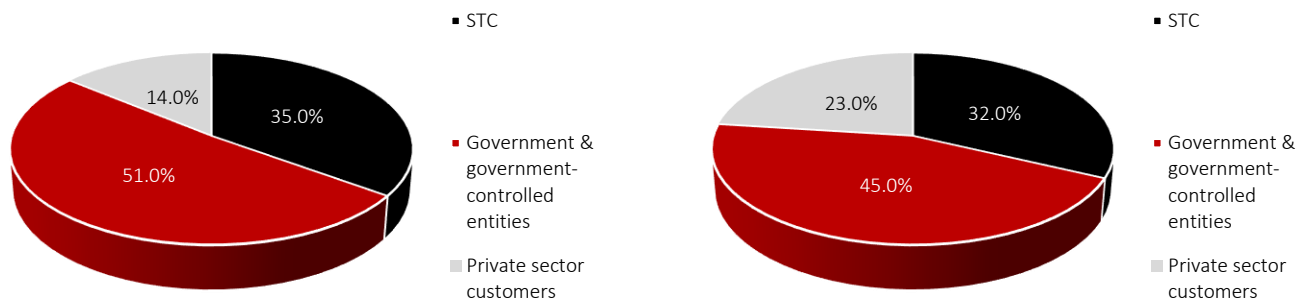


Fig. 2: ...driven by Core ICT, but other segments' share rise



Source: Company Reports, U Capital Research

Fig. 3: STC and government remain dominant revenue providers, however, the private sector's contribution is likely to grow gradually



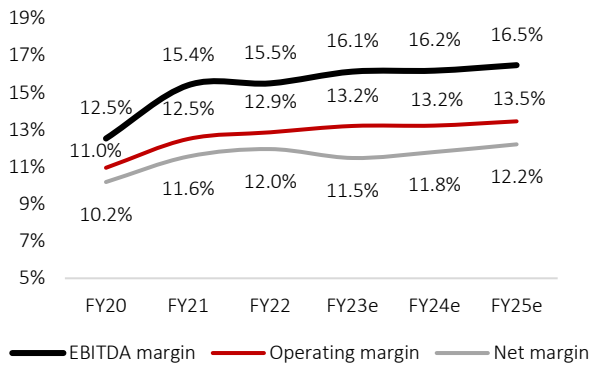
Source: Company Reports, U Capital Research

Source: Company Reports, U Capital Research

FY 2023 profitability revised up on better-than-expected margins in 1H 2023

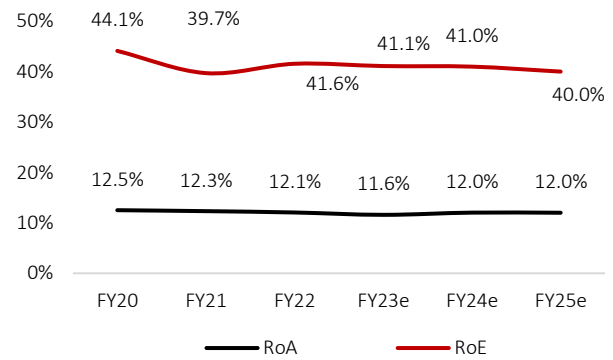
Solutions' margins have improved largely since FY 2019, and we expect this trend to continue as the enhancement of internal efficiencies through process automation and optimal resource utilization is one of the key pillars of the company's LEAP strategy. Solutions has generated better than expected margins at all levels (gross, operating, and net) during 1H 2023, as gross margin expanded by 181 bps YoY since a large and relatively lower-margin project undertaken in 1H 2022 weighed on the profitability. Hence, we raise our FY 2023 gross, operating, and profit margin estimate by slightly over 230 bps, 59 bps, and 11 bps YoY, respectively.

Fig. 4: Margins seen largely in an uptrend



Source: Company Reports, U Capital Research

Fig. 5: RoE and RoA are expected to remain largely stable

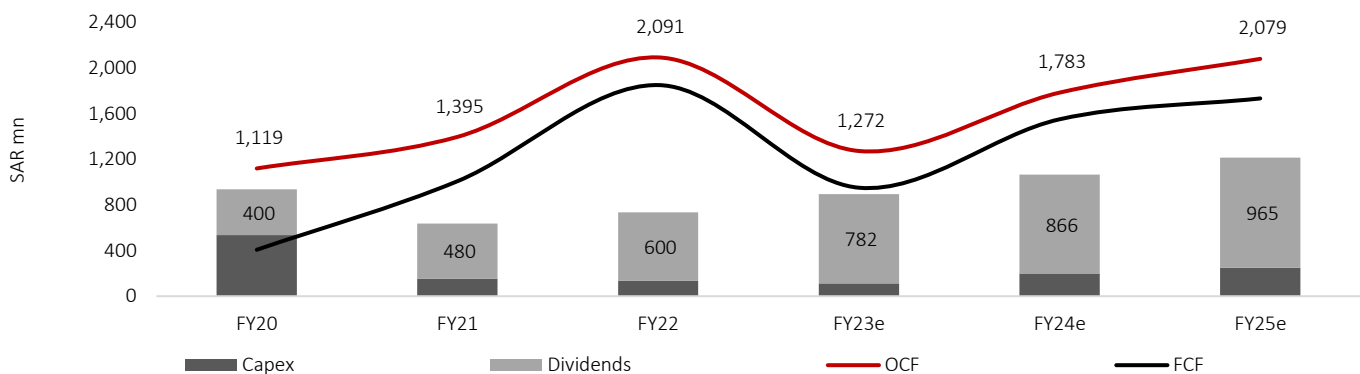


Source: Company Reports, U Capital Research

Solid cash flow generation with healthy profitability and negligible debt servicing to provide the company with the requisite wherewithal to pursue its inorganic growth strategy

Solutions is following an asset-light business model wherein the company's organic capital expenditure (capex) requirements have remained low, hovering in the range of 1-2% of revenue over the last two years. Going forward, the company's capex requirements are estimated to remain in a similar range, considering the management's capex intensity guidance for FY 2023e. Given our expectations for profitability to remain largely in an uptrend, relatively stable, and low capex requirements, we expect free cash flow generation to remain healthy and growing over our forecast period, likely reaching about SAR 2bn by FY 2027 vs. nearly SAR 1bn in FY 2023e. This would further boost Solutions' coffers, thereby supporting it to fulfill its organic and inorganic business expansion plans.

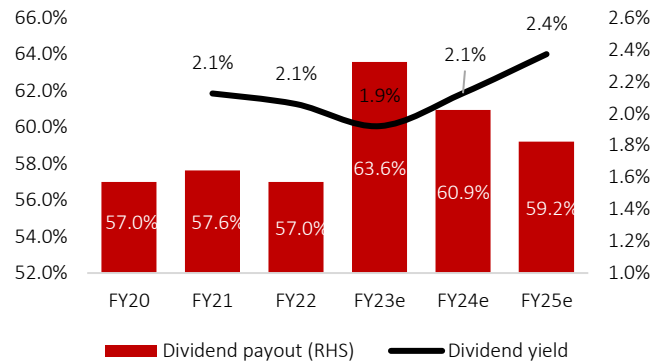
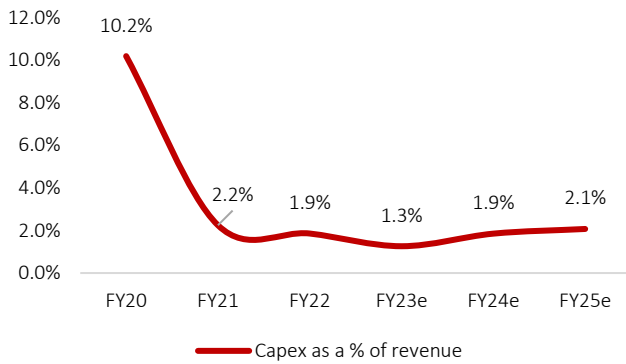
Fig. 6: Business is estimated to continue generating solid cash flows going forward



Source: Company Reports, U Capital Research

Source: Company Reports, U Capital Research

Fig. 7: Capex requirements are estimated to remain stable at ~2%, while we expect dividend payout to rise



Source: Company Reports, U Capital Research

Source: Company Reports, U Capital Research

M&A to continue playing a crucial role in Solutions' long-term growth strategy

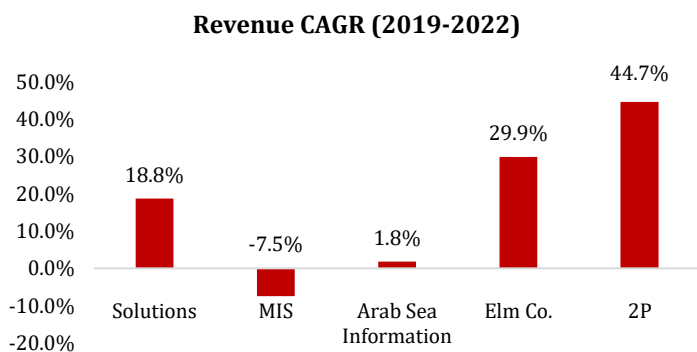
Solutions completed two acquisitions in October 2022 and April 2023 of Egypt-based Giza Systems and KSA-based Contact Center Company (ccc) which cumulatively generated about 15% of the company's 1H 2023 top line. Solutions entered into another M&A deal on 18th June 2023 under which it will buy a 40% stake in Devoteam Middle East. Consideration for this transaction will be based on an enterprise value of circa SAR 740mn.

While Giza's acquisition opens the door for Solutions to a new geography in Egypt, CCC's acquisition aids it in enhancing its offerings in the Business Process Outsourcing (BPO) space, Investment in Devoteam will enable the company to build its capabilities in business transformation and digital consulting in the Gulf region. M&A is set to remain a key strategy for Solutions' to realize its business expansion goals and retain its industry leadership position, as the company intends to benefit from a fragmented IT industry in the MENA region.

ICT Sector Benchmarking

In the section below, we benchmark major Saudi IT companies, namely, Solutions by STC (Hold), MIS (Hold), Arab Sea Information (Not covered), Elm Co. (Not covered), and 2P (Perfect Presentation; Not covered). We conclude that Solutions has generated consistent top-line increases, margin expansion, and cash flow growth even during the pandemic period, which is commendable, and explains its market share gain. MIS' financial performance has been a bit volatile, but the company registered good growth last year driven by the data centers business. Among the remaining, Elm Company has also largely maintained good financial metrics.

Fig. 8: Solutions' revenue is nearly 40% more than the combined revenue of the other four companies



Source: Company filings, U Capital Research

Fig. 10: Solutions' OCF/net income has consistently risen

Fig. 9: Only Solutions posted consistent YoY net margin expansion during 2019-2022

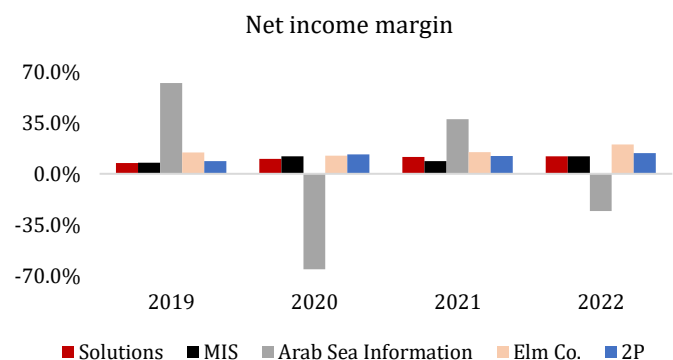
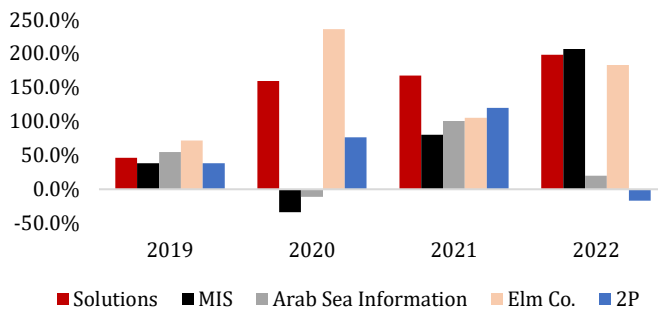
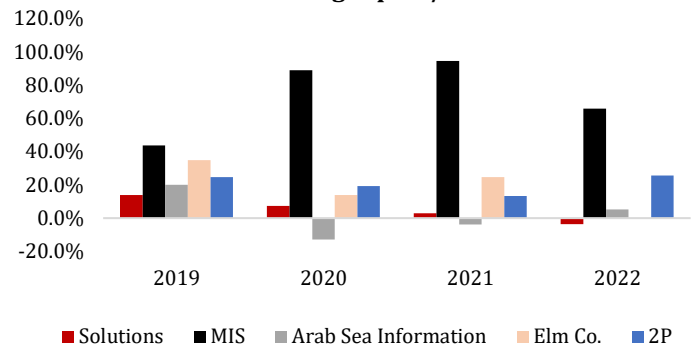


Fig. 11: MIS has the highest net working capital/revenue ratio

Operating cash flow/net income



Net working capital/revenue



Source: Company filings, U Capital Research

Fig. 12: Solutions has largely remained debt-free

Total debt/net worth

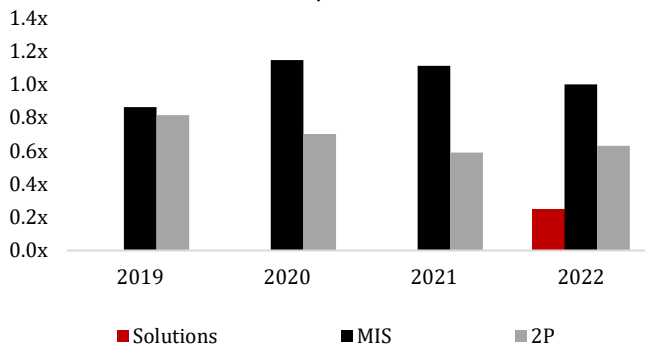
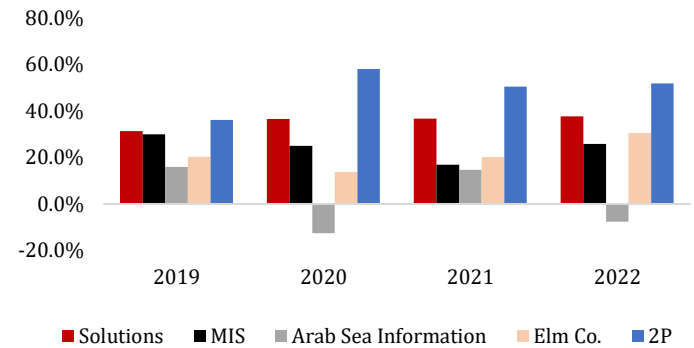


Fig. 13: 2P's RoE is the highest, followed by Solutions

RoE



Source: Company filings, U Capital Research, Arab Sea, and Elm have remained debt-free during 2019-2022

Fig. 14: 2P had the largest revenue share of the government (over 80%), with MIS standing second (over 70%) in 2022

Revenue from government and related entities

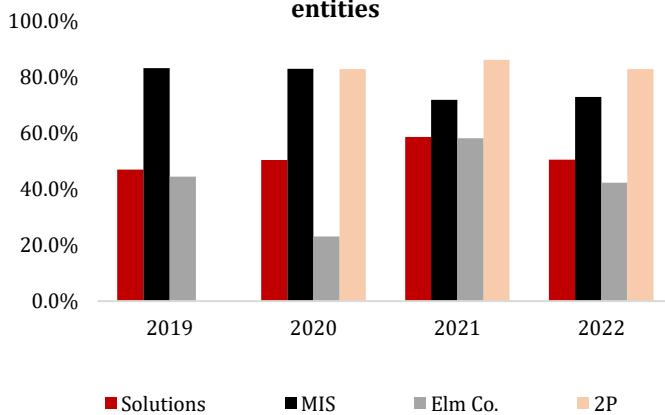
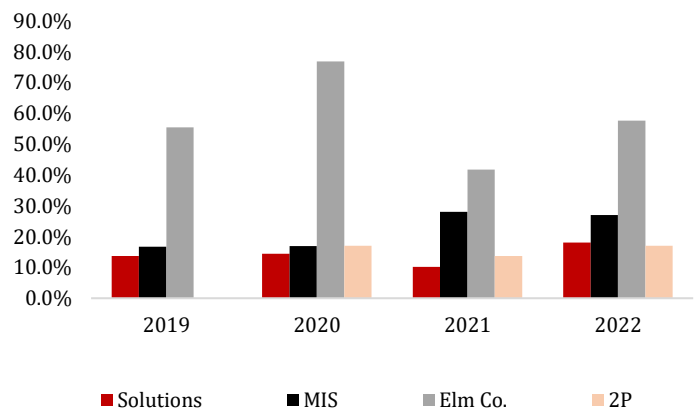


Fig. 15: Elm has the largest share of the private sector in its revenue

Revenue from private entities



Source: Company filings, U Capital Research; *information for Arab Sea is not available, though it says most of the revenue is from the private sector

Valuation

Our target price is based on blended valuation methodologies – (i) DCF and (ii) Relative Valuation (using P/E).

We have increased our target price for Solutions to SAR 335.00 (previously, SAR 330.00). Driven by cost optimization initiatives and a focus on higher-margin products and services, Solutions posted healthy profitability during the first two quarters of FY 2023, which surpassed our estimates. Thus, on the back of better-than-previously estimated margins, we increased our FY 2022-FY2027e earnings CAGR to 15% from 13% higher, which led to an upward revision in our target price. At the current market price, the target price indicates a downside of 0.7%. Accordingly, we rate the company **Hold** (previously, Accumulate) as we believe most of the positives are already baked in at the current valuation levels. Currently, the stock trades at FY'23e P/E of 32.9x and EV/EBITDA of 21.9x, above its 3-year daily average blended forward TTM P/E of 28.0x and EV/EBITDA of 19.0x.

Risks

Key downside risks:

- i) A less-than-expected gain or erosion in the market share of one or more business verticals, leading to below-estimated revenue growth.
- ii) Below-expected margins, resulting partly from the company executing any lower-than-average margin projects.
- iii) Any major macroeconomic weakness weighs on the government spending on the sector, since the government accounts for a significant portion of the company's total revenue.

Key upside risks:

- i) Above estimated top-line growth driven by one or more business segments gaining more than expected market share.
- ii) Any new business investment generates more-than-estimated returns, considering that the company intends to keep exploring M&A activities for its business growth.

Valuation

Solutions

(Currency)	SAR
DCF (70.0% weight)	
PV of Free Cash Flows (mn)	
Year 1	929
Year 2	1,407
Year 3	1,462
Year 4	1,526
Year 5	1,616
Terminal Value	40,589
PV of Terminal Value	29,625
Less: Debt	(744)
Less: Minority interest	(27)
Less: Employee retirement benefits	(400)
Add: Cash & bank balances	2,635
Add: Investments	-
Equity value (mn)	38,029
Outstanding Shares (mn)	120.0
Assumptions	
Risk Free Rate (%)	4.3%
Adjusted Beta	0.85
Risk Premium (%)	3.7%
Cost of Equity (Ke) (%)	7.5%
WACC (%)	7.6%
Target Price	316.91
P/E based Relative Valuation (30.0% weight)	
Target P/E multiple (x)	36.8
EPS FY 2023e	10.25
Target Price	377.21
Weighted Average Target Price	335.00
Current Market Price	337.20
Upside/(Downside), %	-0.7%

Recommendation

Hold

Source: Company Financials, Bloomberg, U Capital Research

Peer Group Valuation

Name	Mkt Cap (SAR mn)	Last Px (SAR)	Px Change 1M, %	Px Change 3M, %	Px Change YTD, %	EV/EBITDA '23e, (x)	P/E'23e, (x)	ROE'23e, (%)	Div Yield' 23e, (%)	FCF Yield TTM (%)
IT Services										
Al Moammar Information	4,608.0	153.60	-6	2	65	26.6	31.2	44.7%	1.0%	-2.7%
Arab Sea Information	693.0	69.30	-7	-22	8	na	-41.4	-12.5%	0.7%	0.0%
Elm Co	62,768.0	784.60	14	41	136	40.9	39.1	38.0%	0.4%	2.6%
Perfect Presentation	3,504.0	23.36	1	0	33	24.6	na	53.5%	0.3%	-3.9%
Arabian Internet & Comm.	40,464.0	337.20	5	0	39	22.4	30.7	41.7%	1.5%	4.4%
Average						28.6	14.9	33.1%	0.8%	1.4%
Median						25.6	30.9	41.7%	0.7%	0.0%

Source: Bloomberg, U Capital Research, na - not available, nm - not meaningful; *valued as of 07 Sep 2023; Note - EV/EBITDA, P/E, RoE, & Dividend Yield of MIS, as well as RoE of Perfect Presentation are current

Fig. 8: KSA IT sector - Price to Earnings & Dividend Yield

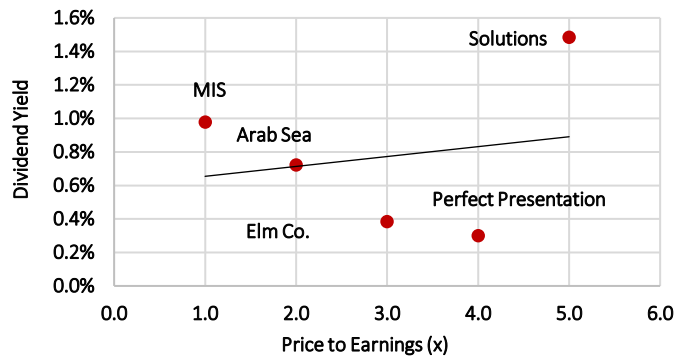
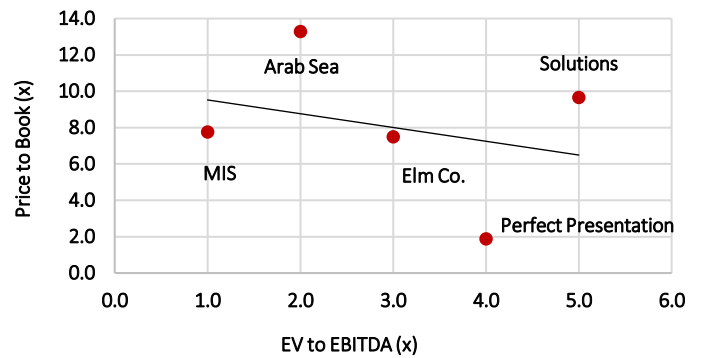


Fig. 9: KSA IT sector - Price to Book & EV to EBITDA



Source: Bloomberg, U Capital Research; As of 04 Sep 2023

Key financials

In SAR mn, except stated otherwise	FY20	FY21	FY22	FY23e	FY24e	FY25e
Income Statement						
Revenue	6,891	7,208	8,805	10,714	12,040	13,351
Cost of sales	(5,469)	(5,500)	(6,794)	(7,947)	(8,930)	(9,876)
Gross profit	1,422	1,708	2,011	2,767	3,110	3,475
General and administration expenses	(460)	(462)	(605)	(744)	(835)	(925)
Selling and distribution expenses	(159)	(196)	(246)	(609)	(683)	(755)
(Impairment)/reversal of impairment of accounts receivable	(46)	(151)	0	-	-	-
Operating profit	755	901	1,132	1,414	1,592	1,795
Finance costs	-	-	-	(90)	(91)	(91)
Finance income	(1)	3	38	140	141	178
Profit before zakat	754	904	1,171	1,423	1,644	1,886
Zakat expense	(52)	(71)	(118)	(189)	(218)	(250)
Profit attributable to shareholders of the company	702	833	1,053	1,230	1,421	1,630
Balance Sheet						
Cash and cash equivalents	993	1,608	544	1,874	2,732	3,771
Trade and other receivables	2,804	3,021	4,345	4,076	4,501	4,881
Contract assets	1,505	1,256	1,277	1,872	2,410	2,869
Right of use assets	72	55	41	41	31	20
Property and equipment	594	551	473	348	212	80
Total assets	6,335	7,173	10,282	10,920	12,683	14,461
Contract liabilities	336	354	488	523	792	945
Lease liabilities	48	31	16	5	4	3
Trade and other payables	1,974	1,931	2,573	2,622	2,943	3,282
Total liabilities	4,411	4,902	7,459	7,703	8,905	10,013
Share capital	1,200	1,200	1,200	1,200	1,200	1,200
Retained earnings	610	960	1,432	1,757	2,312	2,976
Equity Attributable to Shareholders	1,924	2,271	2,794	3,187	3,742	4,406
Cash Flow Statement						
Net cash generated from operating activities	1,119	1,395	2,091	1,272	1,783	2,078
Net cash generated from investing activities	(536)	(171)	(3,191)	772	(199)	(250)
Net cash (used in) provided by financing activities	(4)	(610)	57	(695)	(726)	(789)
Cash and cash equivalents at the end of the period	993	1,608	544	1,874	2,732	3,771
Key Ratios						
Gross margin (%)	20.6%	23.7%	22.8%	25.8%	25.8%	26.0%
EBITDA margin (%)	12.5%	15.4%	15.5%	16.1%	16.2%	16.5%
Operating margin (%)	11.0%	12.5%	12.9%	13.2%	13.2%	13.4%
Net margin (%)	10.2%	11.6%	12.0%	11.5%	11.8%	12.2%
ROA	12.5%	12.3%	12.1%	11.6%	12.0%	12.0%
ROE	44.1%	39.7%	41.6%	41.1%	41.0%	40.0%
Current Ratio (x)	1.4x	1.4x	1.4x	1.5x	1.5x	1.6x
Capex/Sales	7.8%	2.1%	1.5%	1.0%	1.6%	1.9%
Debt-Equity Ratio	0.0x	0.0x	0.3x	0.2x	0.2x	0.2x
EPS	5.8	6.9	8.8	10.2	11.8	13.6
BVPS	16.0	18.9	23.3	26.6	31.2	36.7
DPS	3.3	4.0	5.0	6.5	7.2	8.0
Dividend Payout Ratio	57.0%	57.6%	57.0%	63.6%	60.9%	59.2%
Dividend Yield (%)	NA	2.1%	2.1%	1.9%	2.1%	2.4%
P/E (x)	0.0x	27.1x	27.7x	32.9x	28.5x	24.8x
P/BV (x)	0.0x	9.9x	10.4x	12.7x	10.8x	9.2x
EV/EBITDA (x)	0.0x	19.1x	19.2x	21.9x	19.0x	16.5x
Price as at period end*	-	188.2	242.8	337.2	337.2	337.2

Source: Company Reports, U Capital Research


*Current market price is used for forecast periods


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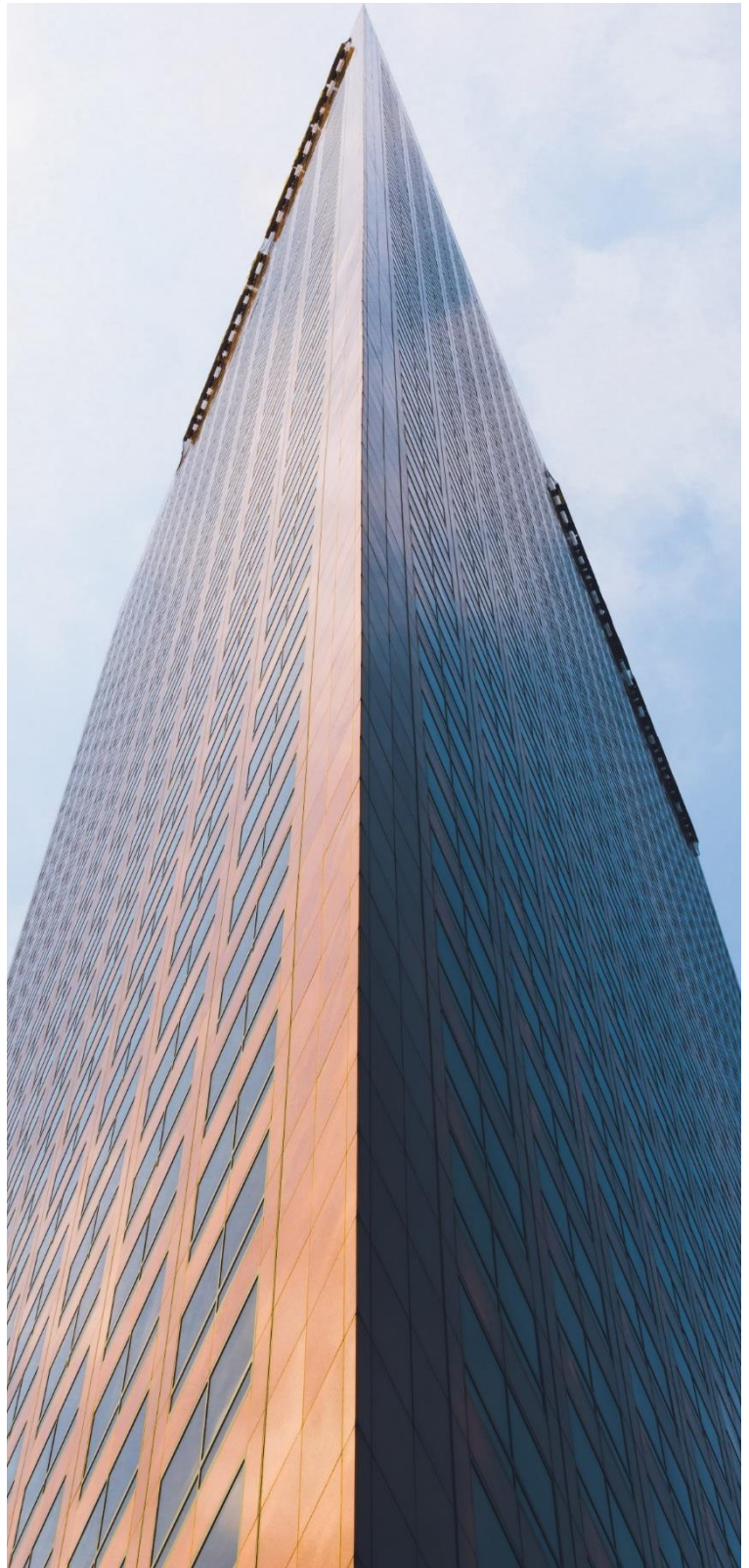
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Disclaimer

Recommendation

BUY	Greater than 20%
ACCUMULATE	Between +10% and +20%
HOLD	Between +10% and -10%
REDUCE	Between -10% and -20%
SELL	Lower than -20%

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