Arabian Internet and Communications Services Co.

Consumer – Software & Services
SOLUTION AB: Saudi Arabia
12 June 2023

US$10.69bn	20.00%	US$10.61mn
Market Cap	Free Float	Avg. Daily Volume

Target price	370.00	10.8% above current
Current price	334.00	as at 11/06/2023

Existing rating

Underweight | Neutral | **Overweight**

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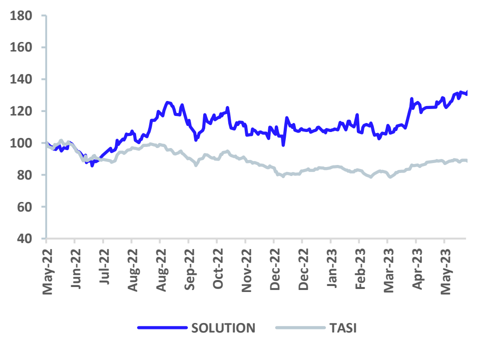
Performance (Rebased to 100)



Earnings

(SARmn)	2022	2023E	2024E
Revenue	8,805	10,960	12,543
Revenue growth	22.2%	24.5%	14.4%
Gross profit	2,011	2,430	2,864
Gross margin	22.8%	22.0%	22.2%
EBITDA	1,392	1,678	1,987
EBITDA margin	15.8%	15.3%	15.8%
Net profit	1,054	1,363	1,612
Net margin	12.0%	12.4%	12.9%
EPS	8.8	11.3	13.3
DPS	5.0	6.8	8.7
Payout ratio	57.0%	60.0%	65.0%
P/E	38.1x	29.7x	25.1x
RoE	37.7%	40.7%	41.1%

Source: Company data, Al Rajhi Capital.

Arabian Int. & Comm. Services Co. (Solutions)

TP revised to SAR370/sh; upgraded to Overweight

Solution has managed to post consistent revenue growth in the recent past, with the topline increasing by a 4-year CAGR of 21%. Being the market leader, we believe the company is set to benefit from Kingdom's push towards digital transformation. Solution's operates in a fragmented market, and going forward, is likely to grow via M&As aided by its strong balance sheet. We expect revenue to grow by 24% YoY in FY23 as against management guidance of 16-19% led by consolidation of Giza and CCC businesses. However, EBITDA margins may be a little subdued in 2023 versus 2022 due to the aforementioned consolidations. We foresee, the company's topline to grow at a 5-year CAGR of 14%. Hence, we resume our coverage with an Overweight rating on the stock. Our DCF-based TP of SAR 370 provides an upside of 11.0%. The stock also provides an FY23 dividend yield of 2.0% resulting in a total return of 13.0%.

Impressive revenue growth beats guidance: STC Solutions' revenue grew by 19.3% y-o-y in 1Q2023 to SAR2,676, modestly above our estimates of SAR2,554mn. The growth was driven by a sharp rise in revenues from IT Managed and Operational services by 27.4% YoY. On the other hand, Core ICT services also recorded a 17.7% YoY increase in revenues, but this was primarily driven by synergies from the Giza acquisition, while the core business remained subdued. Revenues in the Digital services segment registered a decent growth of 13.7%. The company also upgraded its revenue guidance range for FY23 from 11-13% previously to 16-19% while maintaining its guidance for EBITDA margins (13-15%) and Capex intensity (1.5-2%). We believe that the company will beat its revenue guidance and expect top-line growth of 24% YoY in FY23.

To recall, Solutions reported a strong beat on guidance in terms of the top line in FY22 where the revenues came in at SAR8,805mn registering a ~22% growth YoY vis-à-vis the guidance of 11-14% growth. EBITDA Margins were recorded at 15.8% as against the guided 13-15%.

Figure 1 **Actual versus Guidance**

(SAR mn)	FY22 Guidance	FY22 Actual	FY23 Guidance	FY23E
Revenue growth	11-14%	22.2%	16-19%	24.5%
EBITDA margin	13-15%	15.8%	13-15%	15.3%
Capex intensity	1.5-2%	1.3%	1.5-2%	1.2%

Source: Company data, Al Rajhi Capital

Figure 2 **Earnings summary**

(SAR mn)	1Q 2023	1Q 2022	y-o-y	4Q 2022	q-o-q	FY22	FY21	y-o-y
Revenue	**2,676**	**2,243**	***19.3%***	**2,438**	***9.8%***	**8,805**	**7,208**	***22.2%***
Gross Profit	606	494	*22.7%*	514	*17.9%*	2,011	1,708	*17.8%*
G. margin	*22.6%*	*22.0%*		*21.1%*		22.8%	23.7%	
Op. profit	357	313	*14.1%*	240	*48.8%*	1,160	899	*29.0%*
Op. margin	*13.3%*	*14.0%*		*9.8%*		13.2%	12.5%	
Net profit	**304**	**283**	***7.4%***	**197**	***54.3%***	**1,054**	**833**	***26.5%***
Net margin	*11.4%*	*12.6%*		*8.1%*		12.0%	11.6%	

Source: Company data, Al Rajhi Capital

Giza and CCC acquisitions to impact FY23 earnings: The company recently announced a couple of acquisitions including Giza Systems and Contact Center Company (CCC). CCC acquisition was finalized in April 2023 at an acquisition amount of SAR450mn implying a FY22 EV/EBITDA multiple of 4.4x. By way of the CCC acquisition, the company aims to expand its BPO product offerings and fuel growth in the IT and Managed services vertical. The company will consolidate CCC financials in the 2Q23 results.

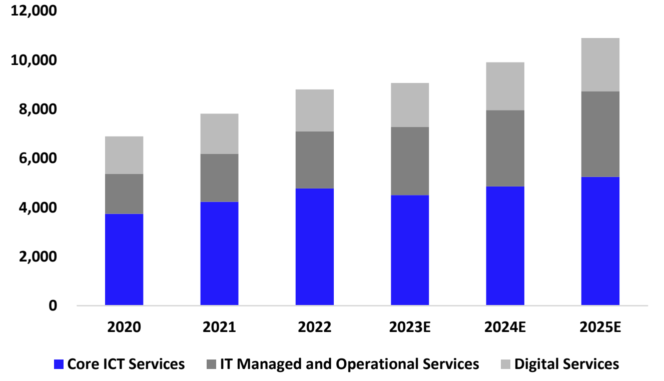
In October of FY22, Solutions announced the completion of the acquisition of 88.2% of Giza System and 34% of Giza Arabia. The purchase price was based on an enterprise value of USD158 mn (SAR592.5 mn) implying an EV/EBITDA 6.6x. The company was consolidated in 4Q22 and significantly aided the top line of Solution in 1Q 2023. The Giza acquisition contributed SAR428/290mn to the topline in FY22/1Q23 respectively.

Strong balance sheet to support Mergers and Acquisitions: In our view, the core business growth shall slow down but inorganic growth via M&As will go hand in hand owing to the highly fragmented market in the MENA region. Going forward, Solutions' strong balance sheet should aid in enabling growth through mergers and acquisitions strengthening the existing product portfolio. To put things into context the company can generate cash flow from operations amounting to SAR1.4bn annually and had net cash on its books to the tune of SAR2.8bn as of 1Q23.

Valuations: Going forward, we expect the company's revenue growth to be robust albeit at lower margins. We value the stock through DCF methodology using a WACC of 8.9% and terminal growth of 3% which implies a target price of SAR370/share. Thus, we revise our target price for the company to SAR370/sh from SAR242/sh earlier, implying an upside of 11.0% to the last close. The dividend yield for FY23 is expected to be 2.0% implying a total return of 13.0%. Hence, we resume our coverage on Solutions with an Overweight rating. The stock has rallied xx% YTD while since the start of June, it is up XX%. We expect some profit-taking to take place which will provide an ideal opportunity to accumulate on dips.

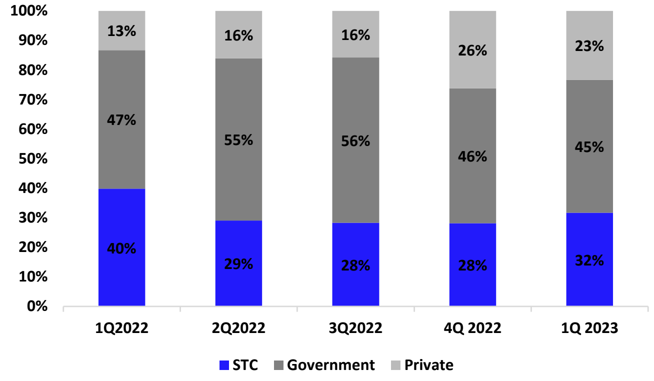
Risks: Key downside risks include**:** i) slower than expected growth in IT Managed and Operational services vertical; ii) delay in realizing synergies from the Giza and CCC acquisitions and iii) higher-than-expected fall in margins.

Figure 3 **Revenue breakdown by segment (SAR mn)**



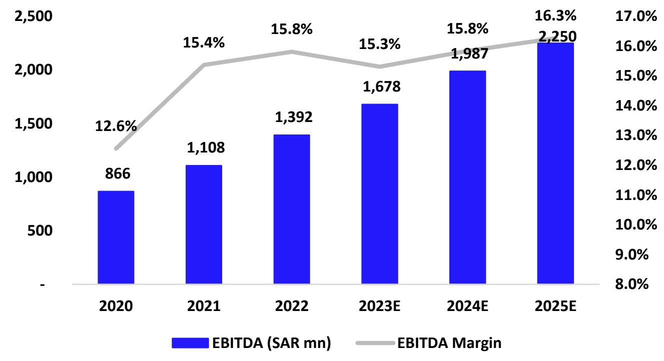
Source: Company Data, Al Rajhi Capital estimates

Figure 4 **Revenue breakdown by customer (SAR mn)**



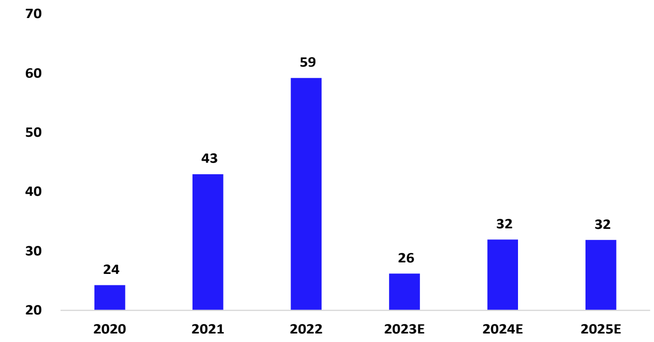
Source: Company Data, Al Rajhi Capital

Figure 5 **EBITDA (SAR mn) and Margins (%)**



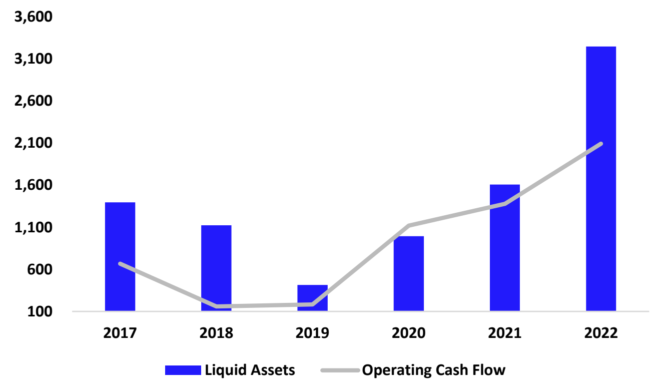
Source: Company Data, Al Rajhi Capital

Figure 6 **Cash Conversion Cycle (days)**



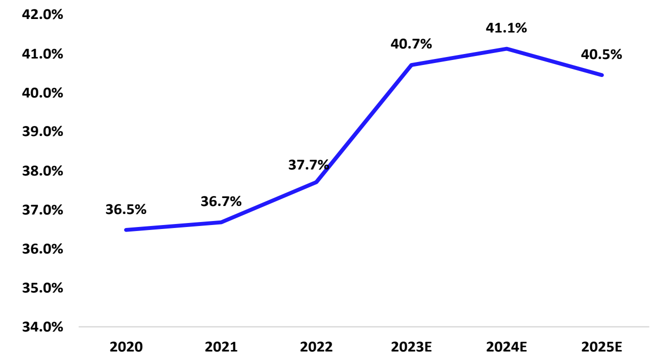
Source: Company Data, Al Rajhi Capital

Figure 7 **Operating Cash Flow Cycle (SAR mn)**



Source: Company Data, Al Rajhi Capital

Figure 8 **Return on Equity (%)**



Source: Company Data, Al Rajhi Capital

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"Neutral": We expect the share price to settle at a level between 10% below the current share price and 10% above the current share price on a 12 month time horizon.

"Underweight": Our target price is more than 10% below the current share price, and we expect the share price to reach the target on a 12 month time horizon.

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