11 September 2003

Recommendation
Reduce*

Upside/Downside
-4.0%

Target Price
SAR411.53

Current Price
SAR428.50*

Reuters Code
7010.SE

Market Cap
SAR128,550 mil.

Enterprise Value
SAR127,729 mil.

Number of Shares Outstanding
300 mil.

Average Weekly turnover
SAR2,392 mil.

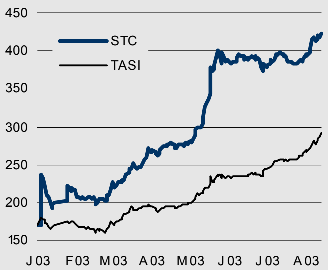
52-Week high/low
SAR431.75/170.00 (10Sep03/23Jan03)

Absolute Performance
12%/111%/152% (1M /3M/YTD)

Performance Relative to TASI
-17%/30%/71% (1M /3M/YTD)

Shareholders' Structure

70%	**Government**
20%	**Free float**
5%	**Public Pension Fund**
5%	**Gen. Org. for Social Insurance**



* Refer to back cover for investment ratings. Price as of 10 September 2003.

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Saudi Telecommunication Co.

Telecom sector | Saudi Arabia

"On seventh sky"

From a state monopoly to a market-driven, fast growing corporation

Since its incorporation in May 1998 STC has gone through major restructuring programs encompassing the company's network, branding and operational capabilities. These efforts resulted in strong growth in the company's operations: revenues and EBITDA grew at CAGR of 18% and 24% respectively since 1999. Net income followed, posting a YoY increase of 64% in 2000 to SAR3,953 million. However, non-recurring expenses in 2001 and 2002, and an increase in commercial provisioning charges in 2002 resulted in a temporary drop in net income to around SAR3.5 billion in 2001 and 2002. When net income is restated to exclude non-recurring/temporary increase in expenses, STC would report a CAGR of 36% since 1999. During these four years wireless operations were the growth driver while wireline operations were more or less stable.

Two growth phases ahead

We expect STC to go through two growth phases during our five-year forecast period: in the two years ending in 2004 STC will enjoy strong growth in revenues, EBITDA and net income (CAGR of 10%, 28%, 63% respectively). Wireless operations will remain the engine for growth and its contribution to revenues and net income will gradually increase. With the introduction of competition in the wireless market in 4Q04, STC will enter the second phase: a phase of stable earnings that will persist till the end of our forecast period. Wireless net adds will be almost halved, wireless blended ARPU will gradually ease down and the company will report stable revenues. An increase in marketing and advertising expenses will put the company's margins under pressure resulting in a drop of 8% in net income to SAR8,762 million, where it will remain stable thereafter.

We valued STC at SAR411.53/share, 4.0% lower than current market price

We valued STC using DCF and a comparison-based valuation vs. European and MENA operators on the basis of 2003e and 2004e P/E. We believe a valuation based on comparable EV/EBITDA multiples is unrealistic given the fact that STC net profit margins are higher than its peer group due to its low gearing level and to a lesser extent its favorable tax environment. We arrived at a fair value using DCF of SAR399.12, whereas the comparison-based valuation generated a fair value of SAR 423.95/share. By taking an average of the two fair values, we arrived at a target price per share of SAR411.53, 4.0% lower than the current market price of SAR428.50. Accordingly, we assigned STC a "Reduce" recommendation.

Indicator*	2001a	2002a	2003e	2004e	2005e	2006e	2007e
Revenues (SAR mil.)	19,781	23,547	25,595	28,580	28,043	28,454	28,513
EBITDA (SAR mil.)	7,809	8,053	11,195	13,143	12,385	12,395	12,377
EBITDA margin	39.5%	34.2%	43.7%	46.0%	44.2%	43.6%	43.4%
Net income (SAR mil.)	3,479	3,546	7,610	9,475	8,762	8,787	8,844
EPS (SAR)	11.6	11.8	25.4	31.6	29.2	29.3	29.5
P/E (x)	14.7	14.4	16.9	13.6	14.7	14.6	14.5
P/BV (x)	2.5	2.2	4.9	4.4	4.0	3.8	3.6
P/Operating Cash Flow (x)	7.3	6.8	9.3	10.1	10.4	10.1	10.0
EV/EBITDA (x)	6.5	6.2	11.4	9.7	10.3	10.3	10.3
Adjusted EV/EBITDA (x)**	5.3	5.1	9.9	8.6	9.2	9.2	9.3
EV/Sub (SAR)	8,845	6,027	11,745	10,196	9,457	8,874	8,408
DPS (SAR)	3.73	2.50	16.00	20.00	21.00	22.00	23.00
Dividend yield	2.2%	1.5%	3.7%	4.7%	4.9%	5.1%	5.4%

Source: STC, BMG estimates. * P/E, P/BV, P/OCF, EV/EBITDA, EV/Sub and dividend yield are based in 2001a and 2002a on the IPO price of SAR170/share, and on current market thereafter. ** Refer to comparison-based valuation.

Contents

Summary

The most liquid Saudi stock

STC is the most liquid and largest company in the Saudi stock market: since it listing in January 2003 STC generated 20.0% of the market's total turnover and currently represents 21.4% of the market's capitalization. At the current market price of SAR428.50, STC stock has appreciated by 152.1% since its IPO in January 2003 at SAR170/share.

An impressive track record

Behind this strong price performance and market posture, was an equally impressive financial track record. With a monopoly in the wireline and wireless markets in the KSA, STC managed to report a CAGR of 18% and 24% in revenues and EBITDA[1] over the last three years. The company's bottom line came under pressure over the last two years due to non-recurring expenses and an increase in commercial provisioning charges. However, when the bottom line is adjusted to exclude these non-recurring expenses and exceptionally high charges, net income CAGR would be a staggering 36%. The company's balance sheet is equally strong with total debt amounting to a low SAR1,233 million (debt to equity ratio of 0.05x) which will be fully paid back by 2005.

… and more growth potential ahead in the coming two years

The wireless market will remain STC's growth engine over our forecast period. In our opinion the wireline market is showing early signs of maturity at a penetration rate of 14.4% of the population and we forecast it will improve marginally to reach 16.3% in 2007. We expect wireline revenues to remain almost flat at around SAR9 billion. However, there is strong growth potential in the wireless market: as of 2002 wireless penetration reached 21.7% of the population while we estimate the addressable market at 56.8% of the population. In our opinion STC's performance over the coming five years will go through two phases, driven by the growth pattern in STC's wireless operations. We expect a gradual decline in ARPU from the current US$75 to reach US$40 in 2007. This will be a product of an increase in prepaid subs relative to total wireless subs and a decline in wireless calling rates with the advent of competition. During 2003 and 2004 the increase in net adds will offset the drop in ARPU resulting in growth in wireless revenues of 29% and 17% respectively. Accordingly, STC will report impressive growth in bottom line of 115%[2] and 24%, respectively. This period will be followed by a phase of stability and flat earnings after the liberalization of wireless services in 4Q04, where net adds will be almost halved and the expected drop in blended ARPU will offset the increase in wireless subs leaving revenues flat. An expected rise in marketing and advertising expenses in 2005 will put some pressure on the company's margins: EBITDA margin will ease down to 44.2% in 2005 from 46.0% a year earlier causing net income to inch down by an estimated 8%, where it will remain more or less stable thereafter at SAR8.8 billion.

Yet, it is a bit overpriced

We valued STC using two approaches: DCF and a comparison-based valuation relative to European operators on the basis of 2003e and 2004e P/E multiples. In the DCF valuation we arrived at a fair value per share of SAR399.12/share while the comparison-based valuation generated a fair value of SAR423.95/share. To arrive at a target price per share we calculated the mean of the two fair values which came in at SAR411.53, a downside potential of 4.0% compared to STC current market price of SAR428.50. Accordingly, we assigned STC a "Reduce" recommendation.

[1] Earnings Before Other Income and Expenses, Zakat, Depreciation and Amortization (EBOZDA) at STC is the equivalent of Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA).
[2] If we restate 2002 net income to exclude non-recurring expenses and calculate commercial provisioning charges at the current rate of 20% (instead of the 27% that prevailed in 2002) 2003e net income growth would be 25%.

Valuation

Discounted Cash Flow Valuation

Using the DCF approach, we arrived at a fair value per share of SAR399.12, which is 6.9% lower than the current market price. The valuation is based on the following assumptions:

A Risk Free Rate (RFR) of 5.6%: This rate is equivalent to the yield on the 10-year Government Development Bonds. There is a high correlation between interest rates in the US and Saudi Arabia due to the peg of the Saudi riyal to the US$. Accordingly, we believe present yields on the Saudi Development Bonds will be on the rise during our forecast horizon in line with the expected increase in interest rates in the US. We expect the RFR to increase gradually to reach 7.0% in 2005.

A risk premium of 7.3%: Since the beginning of 1992, the Saudi stock market averaged a CAGR of 12.9%, while the average RFR over the same period was 5.6%[3] translating to a market risk premium of 7.3%. A beta could not be calculated for STC due to its short trading history (trading started in January 2003). However, we assign STC an average risk rating, translating to a cost of equity of 12.9% in 2003, which will increase in line with the aforementioned expected increase in RFR to reach 14.3% in 2005.

A perpetual growth rate of 4.0%: We have developed individual FCF estimates for the coming five years. After these five years we believe STC will reach a stage of stability where we have assumed it will grow at a perpetual growth rate of 4.0%.

An equity-dominated capital structure: STC's outstanding debt amounts to a low SAR1,233 million which is scheduled to be fully paid back by 2005. STC's operations are 98% financed by equity (based on market value) and 2% by debt. We do not expect STC to take in new debt since its cash balance is expanding rapidly in line with its growing sales and declining need for capital expenditure. It is worth mentioning that the company's very low gearing is driving up the Weighted Average Cost of Capital (WACC) and limiting the DCF value. Considering the low interest rate environment in KSA, if the company's management increases financial leverage, shareholders value will be affected positively and materially.

Figure 1 | DCF valuation

SAR000 unless stated otherwise	2003e	2004e	F2005e	2006e	2007e
FCF	9,655,857	9,696,111	9,503,769	10,007,228	10,325,363
WACC	12.76%	13.71%	14.26%	14.28%	14.28%
PV of FCF (FY03-FY06)	30,823,701				
Plus: PV of terminal value (FY07 onwards)	87,903,637				
Enterprise value	118,727,338				
Minus: outstanding debt	1,233,333				
Plus: cash and marketable securities	1,359,306				
Plus: non-core investments	881,724				
Equity value	119,735,035				
Equity value (SAR/share)	**399.12**				

Source: BMG estimates

[3] The average RFR refers to the average 12-month interbank rate.

Figure 2 | DCF value sensitivity analysis

	Perpetual Growth Rate				
	2%	3%	4%	5%	6%
WACC - 2%	SAR 407.45	SAR 439.59	SAR 479.49	SAR 530.37	SAR 597.44
WACC - 1%	SAR 377.03	**SAR 403.23**	**SAR 435.09**	**SAR 474.65**	SAR 525.07
WACC	SAR 351.39	**SAR 373.14**	**SAR 399.12**	**SAR 430.70**	SAR 469.90
WACC + 1%	SAR 329.46	**SAR 347.78**	**SAR 369.33**	**SAR 395.09**	SAR 426.39
WACC + 2%	SAR 310.48	SAR 326.09	SAR 344.24	SAR 365.62	SAR 391.15

Source: BMG estimates

Comparison-Based Valuation

We have used two peer groups in our comparable-based valuation: European operators and MENA operators. There are several European operators that share STC's size and scope of operation (wireline and wireless), while few MENA operators fit with STC's profile. Our European sample is comprised mostly of incumbent operators which were formerly government-owned companies operating as the state service providers with virtually no competition and in many cases the government is still a significant shareholder. As for the MENA operators, two of them are incumbent operators (Batelco and Q-Tel) while the remaining three are wireless operators.

STC is trading at a multiple of 16.9x based on 2003e P/E and a multiple of 11.4x based on 2003e EV/EBITDA. However, STC's EBITDA is understated compared to other telecom operators: most operators pay license fees at the start of operations, and amortize it over its term to expiry, thus license fees appear as an amortization expense below the EBITDA line. However, STC pays annual government charges that appear as an operating expense above the EBITDA line. To enhance comparability, we restated STC's EBITDA to exclude government charges, resulting in a lower adjusted EV/EBITDA multiple of 9.9x in 2003.

STC vs. European operators

Compared to the European mean, STC is valued at SAR408.95/share on the basis of 2003e P/E multiple. But STC appears to be significantly less valued at SAR239.28 on the basis of 2003e EV/EBITDA. The same observation is apparent in 2004e multiples. We attribute this discrepancy between valuations based on P/E vs. EV/EBITDA multiples to the fact that STC's EBITDA margin is close to the mean of our sample whereas net profit margin is higher: STC's financial leverage is low and declining, and the zakat rate is low at 2.5% compared to tax rates in Europe. Valuing STC based on a P/E basis aptly rewards the company for its strong balance sheet and favorable tax environment, while valuing it based solely on operating profits (EBITDA) disregards these two favorable aspects of the company's operations and penalizes the company. Accordingly, we have decided not to include EV/EBITDA in our comparison-based fair value calculation.

Figure 3 | Comparison-based valuation vs. European operators

		P/E (x)		EV/EBITDA (x)	
Operator	Country*	2003e	2004e	2003e	2004e
STC		16.9	13.6	11.4	9.7
STC-Adjusted EV/EBITDA		**16.9**	**13.6**	**9.9**	**8.6**
Central and East European Operators					
MATAV	Hungary	13.9	13.4	4.8	4.6
Cesky Telecom	Czech Republic	32.8	17.2	6	4.2
Eesti Telecom	Estonia	14.1	14.1	6.3	6
Lietuvos Telekomas	Lithuania	21.5	18.9	4.5	5
Rostelecom	Russia	16.8	14.3	3.7	3.6
Mean		**19.8**	**15.6**	**5.1**	**4.7**
West European Operators					
TeliaSonera	Nordic & Baltic regions	19.0	16.0	5.9	5.4
Telenor	Norway	14.7	12.6	4.5	3.9
KPN	Netherlands	18.5	15.1	5.5	4.8
Portugal Telecom	Portugal	14.8	12.5	5.2	4.6
Swisscom	Switzerland	14.3	13.6	5.6	5.5
Tele Danmrak	Denmark	14.5	13.0	5.0	4.8
BT	UK	12.6	11.9	4.6	4.3
Deutsche Telekom	Germany	22.0	14.9	6.2	5.4
France Telecom	France	7.2	14.8	6.2	5.6
OTE	Greece	11.3	9.6	5.3	4.6
Telefonica	Spain	17.3	15.3	6.2	5.7
Telecom Italia	Italy	10.2	9.8	7.6	7.4
Mean		**14.7**	**13.3**	**5.7**	**5.2**
European mean		16.1	13.9	5.5	5.0
Corresponding valuation for STC**		**408.95**	**439.13**	**239.28**	**250.48**
Premium/discount on STC		-5%	2%	-44%	-42%

Source: BMG estimates, Auerbach Grayson. * Many of these companies have operations in more than one country. ** Based on adjusted EV/EBITDA.

Based on an average of 2003e and 2004e P/E multiples, we valued STC at SAR424.04, which is a slim 1.0% lower than the current market price of SAR428.50.

STC vs. MENA operators

We will rely on 2003e P/E multiples in our comparison-based valuation vs. operators in the MENA region and we are showing MENA operators' 2003e EV/EBITDA for illustrative purposes (for same reasons referred to above). We have arrived at a P/E based fair value of SAR423.86/share.

Figure 4 | Comparison-based valuation vs. MENA operators

Operator	P/E (x) 2003e	EV/EBITDA (x) 2003e
STC	16.9	11.4
STC-Adjusted EV/EBITDA	**16.9**	**9.9**
MENA Operators		
MobiNil	8.8	4.8
Batelco	10.1	4.8
MTC-Vodafone	16.3	10.5
NMTC-Wataniya	33.6	17.7
Q-Tel	14.8	11.5
Mean	16.7	9.9
Corresponding valuation for STC*	**423.9**	**428.2**
Premium/discount on STC	-1%	0%

Source: EFG Hermes, BMG estimates. * Based on adjusted EV/EBITDA.

By taking an average of the two fair values arrived at using our European and MENA peer groups we arrived at a comparison-based average valuation of SAR423.95/share, very close to the current market price per share of SAR428.50.

STC vs. Saudi stock market

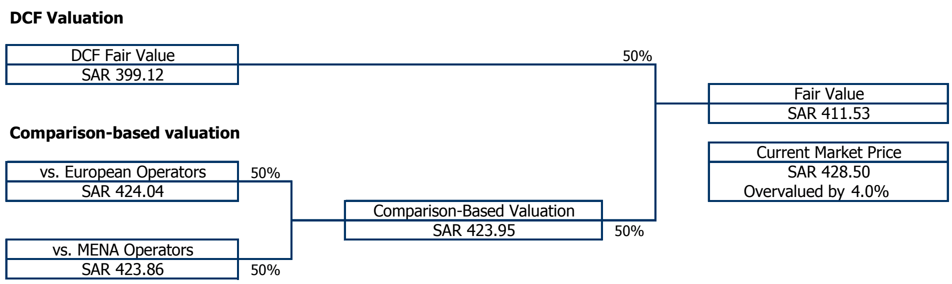
Due to the rally that has taken place since the beginning of the year in the Saudi stock market (Tadawul All Share Index recorded YTD performance of 81%) we believe there a risk of overvaluing STC if a comparison-based valuation using local valuation multiples is applied. We believe the DCF approach and comparison-based valuation vs. similar telcos are more accurate indicators of the fair value of STC. However, for illustrative purposes, we compared STC to local shares on the basis of 2003e P/E[4] to gauge how expensive STC is in a local context. The capitalization-weighted average 2003e P/E for the market is 19.2x. Accordingly, at 2003e P/E of 16.9x STC has an upside potential of 13.9%.

[4] 2003e P/E multiples are based on annualized interim financial results sourced from Bakheet Financial Advisors' "Saudi Stock Market Weekly Report". Our calculated P/E for the market is the capitalization-weighted average of P/E multiples in the range of 0x-100x.

Valuation Summary

We calculated an arithmetic mean of the two fair values arrived at using the two valuation methodologies referred to above, namely the comparison-based and DCF valuations. We arrived at a fair price per share of SAR411.53, implying that STC's share is overvalued by 4.0% based on the current market price of SAR428.50. Accordingly, we assign STC a "Reduce" recommendation.

Figure 5 | Valuation summary



Source: BMG estimates

STC: An Overview

The formation of STC

From 1925 till 1998, all telecommunication services in the KSA were provided directly by the government then since 1975 through the Ministry of Post, Telegraph and Telephones (MoPTT). The establishment of STC in April 1998 was a result of a decision by the Council of Ministers to transfer the telecommunications division of MoPTT to a joint stock company to be formed in the name of Saudi Telecommunication Company. This resulted in the transfer of all rights and assets used by the government in relation to the provision of telecommunication services in the KSA to STC, including fixed, mobile and public telephony, paging and data transmission. Regulatory authority in the telecommunication sector remained a role of MoPTT which formed the Saudi Communication Commission (SCC) later in 2001 to act as the telecommunication regulatory authority. STC is currently under the management of a select team of executive officers with remarkable experience in the private sector. STC's management has embarked on an extensive restructuring program in preparation for its planned IPO, whereby it transformed its operations from a typical over-staffed bureaucratic government-run entity to a relatively dynamic market-driven corporation.

Partial sale of the government's stake

The government, represented by the Public Investment Fund (PIF), was the sole owner of STC till it offered 30% of the company for sale in December 2002. 20% of the company was offered to Saudi Arabian nationals and the remaining 10% were equally split between the General Organization for Social Insurance and the Public Pension Fund. At a selling price of SAR170/share the initial public offering was very successful (oversubscribed at a reported 3.7x) adding some SAR51 billion to the market capitalization and became the largest company in terms of capitalization, currently representing 21.4% of the market's total.

The sole provider of telephony in KSA

The services offered by STC can be categorized into four groups: wireline, wireless, data and internet.

Figure 6 | Highlights of STC services

Wireline services	Local, national and international telephony Public payphones and calling cabins Telegram and telex
Wireless services	Prepaid wireless services Postpaid wireless services Paging
Data services	Leased circuits and other data transmission services
Internet services	Dial-up access to the internet Internet leased lines and other internet-related services

Source: STC

STC has so far enjoyed exclusive rights to provide wireline, wireless and data transmission services in the KSA, and is one of several internet service providers. However, STC's monopoly in the wireless market will soon end as competition will be introduced in the fourth quarter of 2004, while the wireline market will be liberalized later in 2008. Almost all of the services currently offered by STC were introduced prior to its incorporation (wireline in the early 1930s, postpaid wireless and paging in 1995, and internet in 1996), with the exception of prepaid wireless services which were launched in April 2002.

Wireless operations: the growth engine

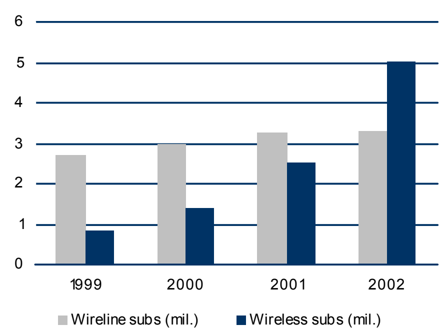
STC has seen significant growth over the last four years and a quick transformation in its revenue structure and subscriber base. Wireless services' contribution to total revenues (including paging) increased from 29% in 1999 to 55% in 2002. The growth in subscriber figures exhibited a similar trend: wireless penetration soared from 4.0% in 1999 to 21.7% in 2002, while wireline penetration increased by a slim 1.5% from 12.9% to 14.4% over the same period. This was a result of a series of reductions in wireless connection fees and tariffs and the introduction of prepaid wireless services in April 2002.

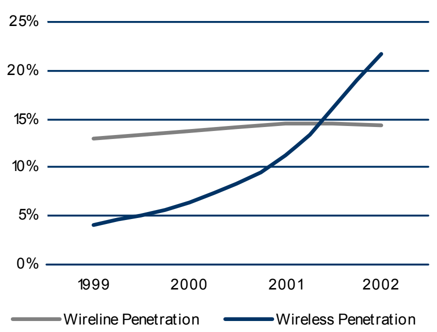
Figure 7 | Financial and operational highlights

	1999	2000	2001	2002
Wireline revenues (SAR mil.)	10,255	11,855	11,792	10,607
Wireless revenues (SAR mil.)	4,182	5,075	7,990	12,940
Total revenues (SAR mil.)	14,437	16,930	19,781	23,547
EBITDA (SAR mil.)	4,224	6,257	7,809	8,053
Net income before non-recurring items and zakat	2,498	4,051	4,972	4,708
Net income (SAR mil.)	2,417	3,953	3,479	3,546
Wireline subs (000)	2,706	2,965	3,233	3,318
Wireless subs (000)	837	1,376	2,529	5,008

Source: International Telecommunication Union (ITU), STC

Figure 8 | Development in subscriber base and penetration rate





Source: ITU, STC

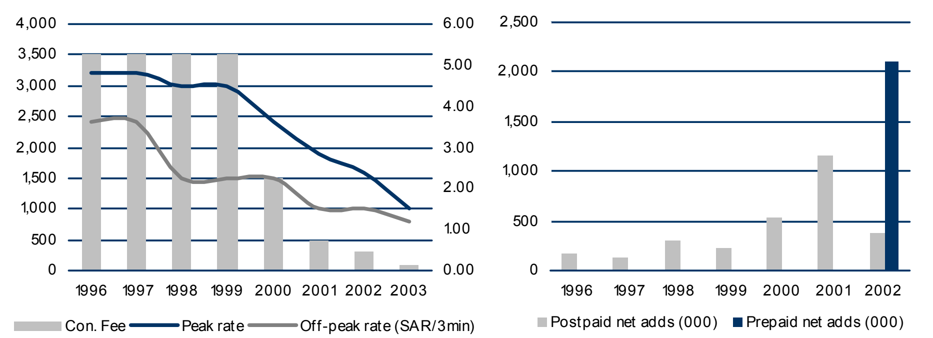
Market Analysis

Wireless Operations

A series of cuts in postpaid connection fees and tariffs helped expand the market

When postpaid wireless services were first introduced in 1995 under the name "Al Jawal", a hefty connection fee of SAR3,500 kept the mobile market relatively dormant. Four years after the launch of the new service, STC's wireless subscribers stood at a meager 837K. The first connection fee cut in 2000 by 57% to SAR1,500 gave a much needed boost to the wireless market, resulting in a 64% increase in net adds. Two further reductions followed in 2001, bringing connection fees to a low SAR500, and pushing net adds during 2001 up to a healthy 1,153k subs, to reach total subs of 2,529k. More reductions were effected in March 2002 and January 2003, bringing connection fees as low as SAR100, yet their effect on net adds was less material than previous ones as postpaid services were introduced in late April 2003 and started fulfilling the pent-up demand among expatriates and the lower end of the market. Tariffs were also slashed from peak/off-peak rates of SAR1.6/1.2 per minute in 1996 to SAR0.5/0.4 in 2003 (for the basic product with the lowest subscription fee and no free bundled minutes), making wireless services more affordable and attractive. SMS and variations from the basic postpaid line were introduced in 2002, with higher subscription fees, lower tariffs and free bundled minutes to appeal to subscribers with various calling habits.

Figure 9 | Postpaid connection fee, tariffs and net adds



Source: ITU, STC, BMG estimates

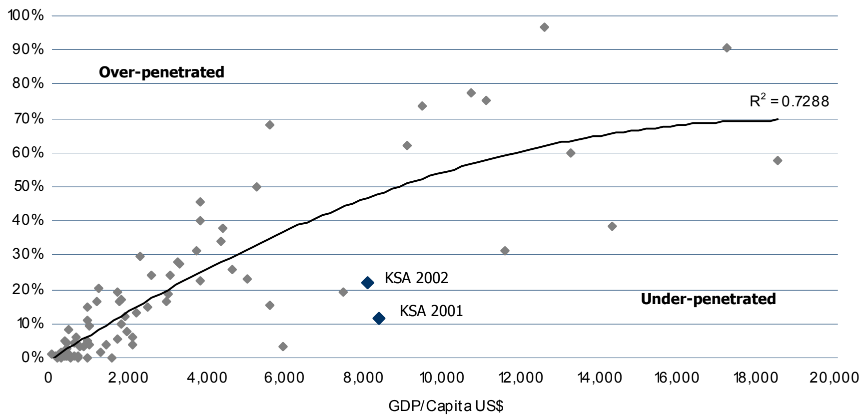
Yet the introduction of prepaid wireless services unleashed the market's potential

Obtaining a postpaid line was cumbersome to expatriates due to the necessity of being sponsored by their employers, then sponsorship was abandoned to be replaced by a refundable deposit that must be paid before acquiring the postpaid line, which reached as high as SAR5,000. Prepaid lines saved expatriates this hassle and catered for a market that constitutes 25.2% of the country's population. Additionally, with no monthly subscription, the prepaid line appealed to low-budget consumers. In the 8 months following the introduction of prepaid services in late April 2002, 2,106K lines were sold while postpaid sales came in at an estimated 100K. This trend continued in 1H03: average prepaid monthly sales amounted to an estimated 150k lines while monthly postpaid sales were estimated at 50K lines.

The market remains under-penetrated

As of the end of 2002 wireless penetration in the KSA stood at 21.7%, significantly higher than the 11.3% recorded a year earlier. However, the Saudi market is still under-penetrated by international standards: based on the correlation between GDP/capita and wireless penetration for 89 countries with GDP/capita less than US$20,000, countries with penetration rates in the vicinity of 21% of the population tend to have a GDP/Capita of around US$3,000. The Saudi market (GDP/capita of US$8,037 in 2002), should have an addressable wireless market close to 50% of the population (refer to figure 10).

Figure 10 | Correlation between GDP/Capita and wireless penetration as of 2001



Source: ITU, STC, BMG estimates

Wireless addressable market estimated at 57% of the population

To arrive at an estimate of the wireless addressable market we calculated the percentage of the population that is 15+ years old (59% of the population[5]) and excluded the illiterate population within that group (23%[6]). The remaining 45.4% of the population were increased using a multiplier of 1.25x to account for the high GDP/capita in the KSA and subscribers having more than one wireless line for business use[7]. We arrived at an addressable market of 56.8% of the population. We forecast that about 90% of the addressable market will be connected by 2007: a forecast penetration rate of 51% of the population. Yet this will depend to a significant extent on the number of competitors to be introduced in the wireless market.

Figure 11 | Forecast wireless penetration and STC market share

All figures in 000s unless stated otherwise	Forecast assumptions	2002A	2003F	2004F	2005F	2006F	2007F
Forecast wireless market subscriber							
Population	Growing at 3.3%, declining to 2.8%	23,060	23,798	24,536	25,272	26,005	26,733
15+ years old population	59% of population	13,605	14,041	14,476	14,910	15,343	15,772
Literate, 15+ years old population	77% of 15+ yrs old population	10,476	10,811	11,147	11,481	11,814	12,145
Addressable market	1.25x literate 15+yrs old population	13,095	13,514	13,933	14,351	14,767	15,181
Penetration rate (% of entire population)		21.7%	31.0%	37.0%	43.5%	48.0%	51.0%
Penetration rate (% of addressable market)		38.2%	54.6%	65.2%	76.6%	84.5%	89.8%
Wireless subs		5,008	7,377	9,078	10,993	12,482	13,634
Wireless net adds		2,479	2,369	1,701	1,915	1,489	1,151
Forecast STC wireless subscriber							
STC share of net adds	Entry of one competitor in 4Q04	100%	100%	85%	40%	45%	50%
STC wireless net adds		2,479	2,369	1,446	766	670	576
STC wireless subs		5,008	7,377	8,823	9,589	10,259	10,835
STC wireless market share		100.0%	100.0%	97.2%	87.2%	82.2%	79.5%

Source: ITU, World Bank, Saudi Ministry of Planning, STC, BMG estimates

The UAE is the most highly penetrated market in the region at 75.9% in 2002, and is often considered a benchmark to estimate the growth potential in the Saudi market. We do not believe the Saudi market will grow to reach a penetration rate as high as the UAE: some 41% of the Saudi population is 14 years old or less, compared to 26.1% in the UAE.

[5] Source: Saudi Ministry of planning.
[6] Source: World Bank.
[7] The current penetration rate of 75.9% in the UAE translates to a multiplier of 1.33x

Can the market accommodate two more wireless operators?

The Saudi government will open up the wireless market to competition in 4Q04, but no official statement has been made yet as to how many new operators will enter the market. It has been suggested that two more competitors will be allowed to operate in the wireless market: the first one in 4Q04 and the second in 2005. We forecast that 65% and 77% of the addressable market will have been met by the end of 2004 and 2005, respectively. According to our estimates if a third operator enters the market by the end of 2005 it will compete with the two other operators for the remaining unaddressed 23% of the addressable market, or 13% of the population. We believe introducing a third operator under these market conditions is rather unlikely and we have assumed only one competitor to STC in our forecast.

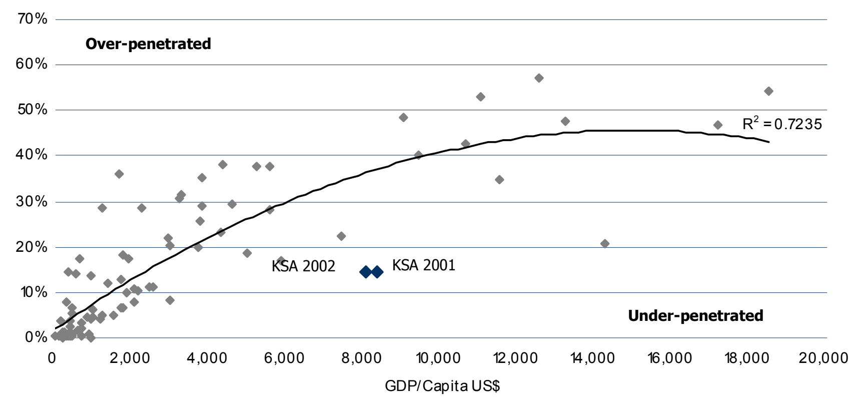
We expect a relatively high churn rate for STC with the introduction of competition in line with what has happened in other markets that were previously liberalized. We forecast that at the launch of the second operator STC market share of net adds will be 40% which will recover to 45% in 2005 and 50% in 2006 onwards (refer to figure 11).

Wireline Operations

An under-penetrated market by international standards

Upon comparing the Saudi wireline market with 89 other countries the market seems to have strong growth potential. Wireline penetration in the KSA in 2002 was 14.4% while a correlation between GDP/capita and wireline penetration based on our sample suggests that the Saudi market can attain penetration rates in the mid thirties.

Figure 12 | Correlation between GDP/Capita and wireline penetration as of 2001

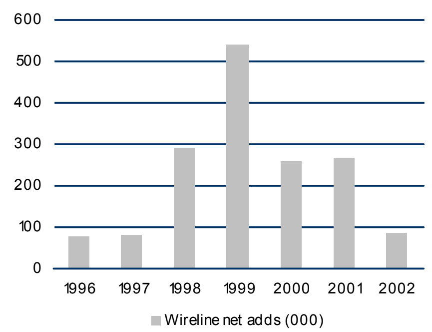


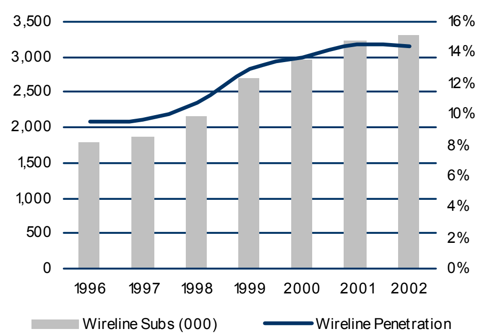
Source: ITU, STC, BMG estimates

Early signs of maturity

In spite of the current low wireline penetration rate of 14.4%, the Saudi wireline market has shown early signs of maturity: over the last five years net adds have averaged 288k subs, adding on average 1% to wireline penetration per year. In 2002, wireline subs growth was even less than population growth (2.6% vs. 3.3%, respectively) resulting in a small drop in penetration from 14.5% to 14.4%.

Figure 13 | Growth in wireline market



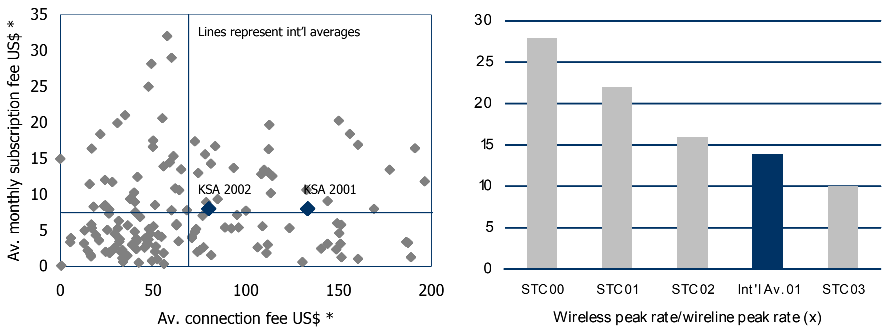


Source: ITU, STC, BMG estimates

… despite favorable calling rates, connection and subscription fee

We compared wireline calling rates, connection and subscription fees with international averages to investigate whether the current low wireline penetration is a result of an unfavorable tariff structure. STC's calling rates are low by international standards, although they were increased by 163% since 1999. Currently, the peak rate for a 3 minute call is US$0.040 compared to an international average of US$0.074. On the other hand, wireline connection fees were high in 2001 at US$133, compared to an international average of US$69. Connection fees were reduced in 2002 and currently stand at US$80, slightly higher than the international average, yet there was no improvement in wireline net adds in 2002, which were actually less than half 2001 net adds. As for the monthly subscription fee, it has not changed for the last 5 years at US$8, very close to the international average of USD$7.7. Accordingly, we think local calling rates, connection fees and subscription fees were not a hurdle against growth in wireline penetration. Neither was wireless calling rates which were 22.1x as expensive as wireline rates in 2001, compared to an international average of 13.9x. This ratio was even higher in 2000 at 27.9x. However, the recent reductions of wireless rates in 2003 brought the ratio down to 10.0x, lower than the international average. Accordingly, until 2003 wireless services were relatively very expensive by international standards compared to wireline and could not have been the cause of low penetration rates in the wireline market.

Figure 14 | Connection, subscription fees and peak calling rates: wireline vs. wireless (2001)



Source: ITU, STC, BMG estimates. *Average of residential and business fees.

We forecast limited growth potential in the wireline market

We believe the wireline market will witness a CAGR of 5.6% over the coming five years to reach 4.4 million subs in 2007, representing a penetration rate of 16.3%.

Figure 15 | Forecast wireline penetration

All figures in 000s unless stated otherwise	Forecast assumptions	2002A	2003F	2004F	2005F	2006F	2007F
Population	Growing at 3.3%, declining to 2.8%	23,060	23,798	24,536	25,272	26,005	26,733
STC wireline subscribers	Growing at CAGR of 5.6%	3,318	3,498	3,705	3,917	4,135	4,357
Net adds		85	181	207	212	218	223
Penetration rate (%)		14.4%	14.7%	15.1%	15.5%	15.9%	16.3%

Source: ITU, World Bank, Saudi Ministry of Planning, STC, BMG estimates

Other services under the umbrella of wireline operations

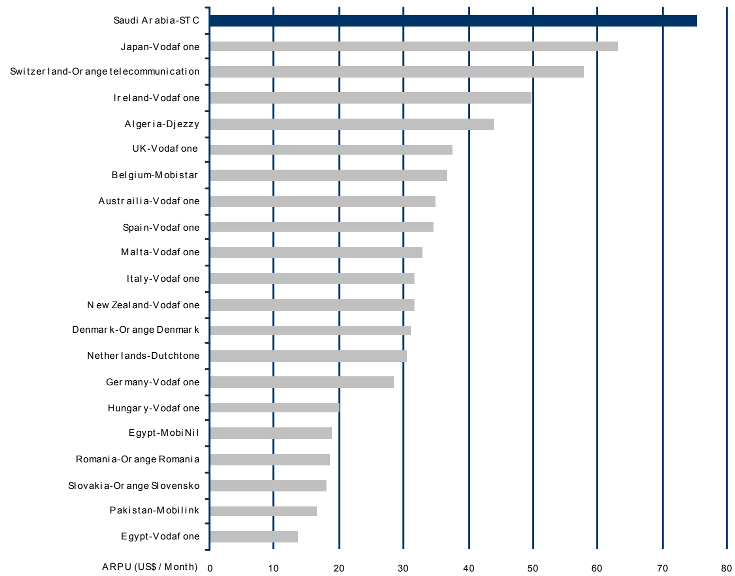
Apart from telephony services, STC provides internet and data communication services but their contribution to total revenues is limited, with internet services representing 0.1% of total revenues in 2001 and data communication services representing 4.1%.

Financial Analysis and Projections

Wireless revenues

We estimate STC wireless blended ARPU in 2002 at US$75, which is the highest ARPU in a sample of 20 operators worldwide, and compares to an average of US$32.5.

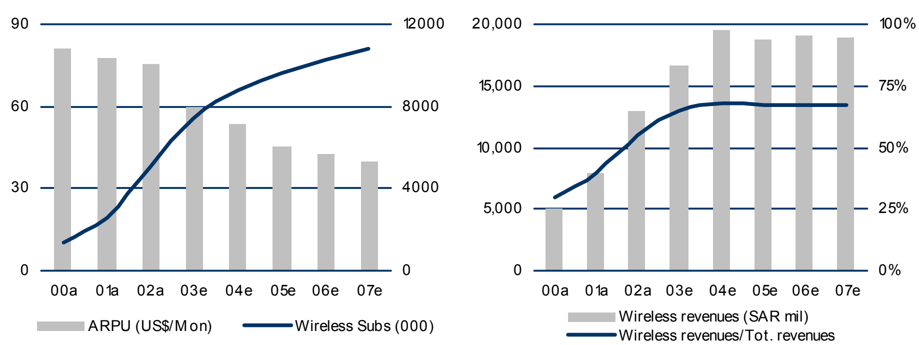
Figure 16 | Blended wireless ARPU: STC vs. other operators (2002)



Source: Vodafone, Orange, Orascom telecom, BMG estimates

This was expected considering the fact that prepaid services were recently introduced in April 2002. Prepaid ARPU is usually significantly lower than postpaid ARPU: the average postpaid ARPU for 10 of the countries referred to in Figure 16 was 4.6x the average prepaid ARPU. Prepaid subs constituted 42% of STC wireless subs in 2002 and we expect it to reach 60% in 2007. Also, the introduction in competition in 4Q04 will inevitably result in lower tariffs, putting more pressure on ARPU. Accordingly, we expect blended ARPU to decline gradually to reach an estimated US$40 in 2007.

Figure 17 | Wireless forecast ARPU and revenues



Source: ITU, STC, BMG estimates

We expect the growth in STC's wireless subs to outpace the decline in ARPU leading to growth in wireless revenues, which will reach its peak in 2004 at SAR19,489 million. With the advent of competition in 4Q04 subscribers net adds will ease down and will be fully offset by the drop in ARPU resulting in more or less stable wireless revenues, hovering around USD19 billion, representing about 67% of total revenues.

Paging revenues, which are classified by STC as part of wireless revenues, will remain negligible at 0.1% of wireless revenues.

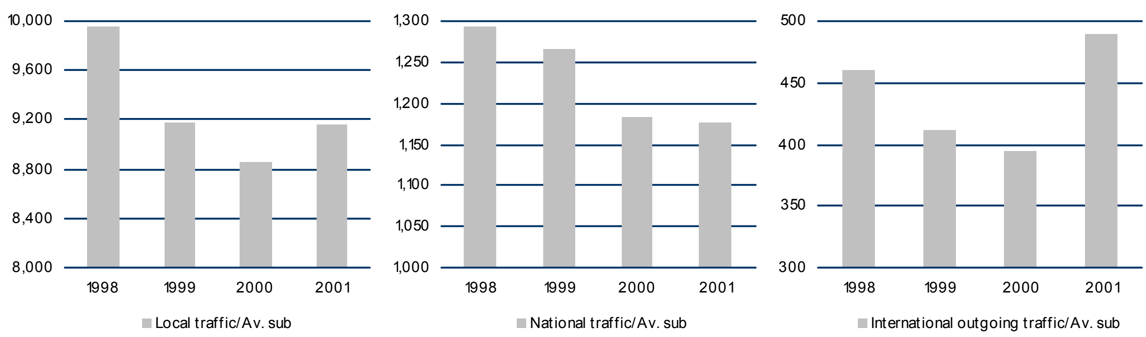
Wireline revenues

We expect local traffic per sub to ease down as some traffic will shift from wireline to wireless. This effect will get more material as wireless penetration increases. However, we expect the increase in internet-related traffic will offset the drop in local telephony. Local tariffs were low by international standards and were increased twice in 2000 and 2002 and are currently 46% lower than the international average. We do not think STC will increase its local tariffs any further in the near future and it has not shown any intentions to increase it so far. We expect revenues from local traffic to be stable over our forecast period.

National traffic per sub has also been dropping due to a shift in traffic from wireline to wireless. The current national peak/off-peak calling rates per minute of SAR0.50/0.25 for 200+Km and SAR0.20/0.10 for less than 200km are close to the basic wireless product calling rates of SAR0.50/0.40. We expect the shift of national traffic to wireless to continue leading to a drop in revenues from national dialing.

International tariffs have been significantly reduced since the company's incorporation, driven mostly by negotiating better settlement rates with international operators: in September 2002 STC reduced international calling rates by some 63% on average. We believe the growth in wireline subscribers and traffic/sub will not fully offset the drop in tariffs, causing a drop in international revenues. Moreover, the same international tariffs apply to wireline and wireless, accordingly a portion of international traffic is bound to shift to wireless in line with the growth in wireless penetration.

Figure 18 | Local, national and international outgoing traffic per average wireline subs



Source: ITU, BMG estimates

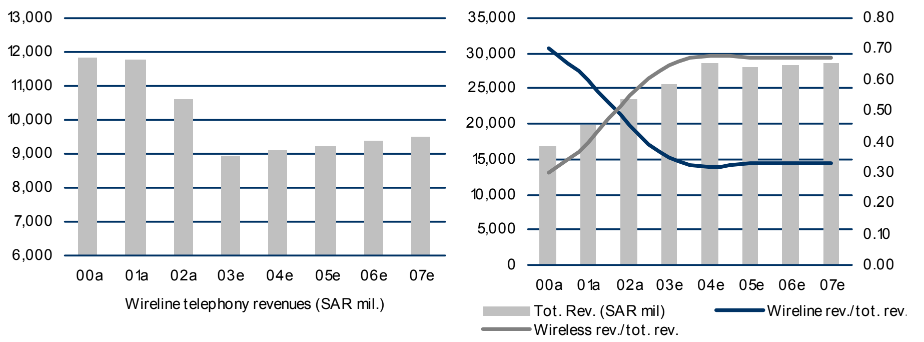
We do not expect any major changes in connection and subscription fees over our forecast period since they are in line with international averages. We expect data, internet and telex/telegraph services to grow at a combined CAGR of 3.8% over the coming five years and represent 3.9% of total revenues by 2007.

Apart from the negative effects of the introduction of competition in the wireless market in 4Q04, STC wireline revenues should benefit indirectly from wireless market liberalization: being the sole wireline operator STC should charge the second/third wireless operator interconnection fees to route their traffic to landlines and to other operators outside the KSA (in case its competitors will not have an international gateway). It is not clear yet what interconnection rates will be applied, however, we expect interconnection revenues to be relatively immaterial and we have not included them in our forecast.

Total operating revenues

We estimate total revenues at SAR25,595 million in 2003, recording a YoY growth of 8.7%. Starting 2004, revenues will stabilize at around SAR28.5 billion till the end of our forecast period.

Figure 19 | Forecast revenues



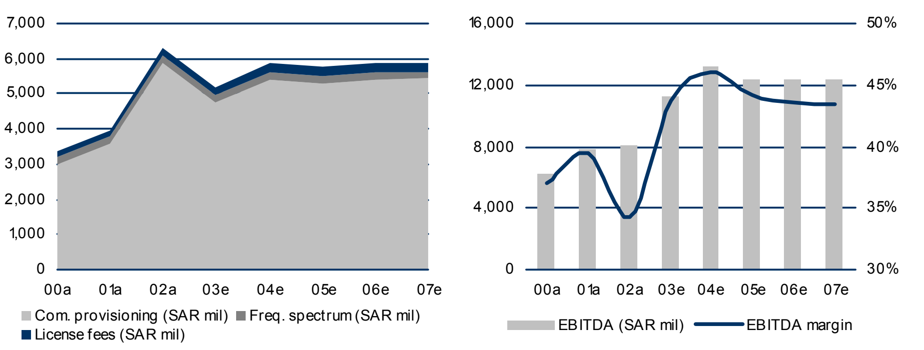
Source: STC, BMG estimates

EBITDA

STC reported a drop in EBITDA margin in 2002 to 34.2%, down from 39.5% in 2001. This was mainly due to an increase in government charges paid by STC for the right to operate as the incumbent operator. Government charges are comprised mostly of commercial provisioning charges which were set in 1999-2001 at 20% of net revenues[8]. In 2002 government charges were increased to 27% and reduced back again to 20% starting 2003. Further reductions in commercial provisioning charges in the future cannot be ruled out yet we have assumed that they will be maintained at 20% during our forecast period. Other annual government charges include license fees at 1% of net revenues and spectrum fees of SAR200 million.

We expect EBITDA margin to rebound in 2003 to reach 43.7% in line with the reduction in commercial provisioning charges. EBITDA margin will reach its peak in 2004 as the growth in the company's operations will result in higher economies of scale that will push EBITDA margin to an estimated 46.0%. After the liberalization of the wireless market in 4Q04 marketing and advertising expenses will increase and EBITDA margins will ease down to 44.2% in 2005 and 43.6% in 2006 and will remain in that range thereafter.

Figure 20 | Forecast government charges, EBITDA and EBITDA margin



Source: STC, BMG estimates

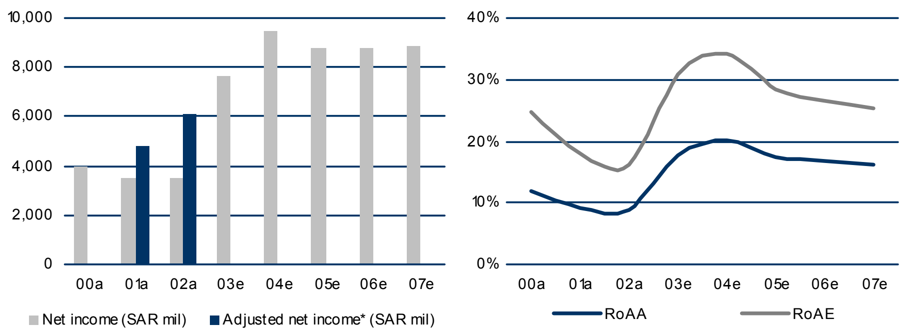
[8] Net revenues equal operating revenues minus access charges paid to connect to foreign operators' networks.

Net income

STC's net income was understated in 2001 and 2002 due to non-recurring expenses: seconded employees' entitlements (SAR794 million in 2001) and the cost of early retirement program (SAR600 million and SAR1,070 million in 2001 and 2002 respectively). These non-recurring expenses, together with the increase in commercial provisioning rate in 2002, resulted in marginal growth in net income of 1.9%, while 2001 showed a 12.0% drop in net income. If we restate 2001 and 2002 to exclude the extraordinary expenses and recalculate commercial provisioning charges at 20%, STC would post growth in net income of 22.3% and 25.7% in 2001 and 2002 respectively.

We expect STC to report net income of SAR7,610 million in 2003, a YoY growth of 114.6%, or 25.3% based on restated 2002 net income. 2004 will be a continuation of the 2003 growth pattern, and then net income will drop in 2005 in line with the aforementioned drop in EBITDA to stabilize around SAR8.8 billion in 2005 onwards.

Figure 21 | Forecast net income, RoAA and RoAE



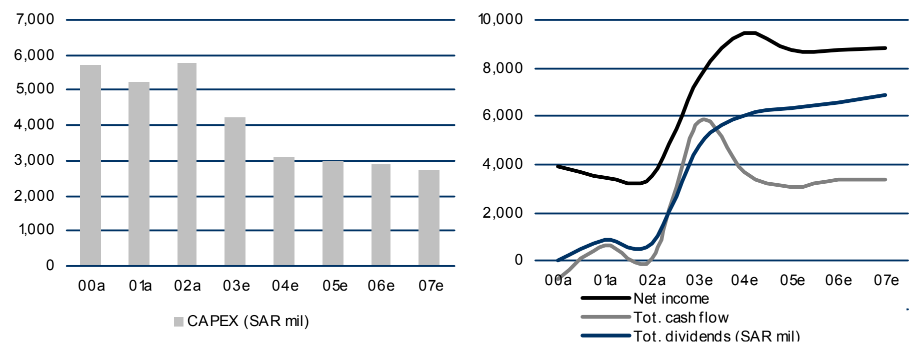
Source: STC, BMG estimates *Excluding non-recurring expenses & considering commercial charges at 20% of net revenues in 2002 instead of 27%.

Financial leverage, CAPEX, cash flows and dividends

As of 2002, the company's outstanding debt amounted to a low SAR1,233 which will be fully paid back by 2005. It is worth mentioning that STC adopts an accounting policy whereby all its interest expense is capitalized. We are of the opinion that capitalization of interest should be limited to debt used in financing capital work in progress and interest capitalization should end once capital work in progress in transferred to fixed assets and its testing phase is completed. However, STC's capitalized interest is immaterial and declining (SAR164.6 million and SAR56.4 million in 2001 and 2002 respectively) and would not have had a major impact on net income should it have been expensed.

Our estimates for wireline and wireless subscriber base growth indicate that the company's CAPEX over our forecast period will be lower than historical figures. Net cash flow will be growing at exponential rates and the company will be building tremendous amounts of cash that it has already starting paying out in dividends: in 1H03 STC declared and distributed interim dividends worth SAR2.4 billion in total (SAR8/share), representing a payout ratio of 58%. We forecast an increase in payout ratio to reach 78% by 2007. STC will still manage to accumulate an estimated SAR21,280 million in cash and cash equivalents by 2007 which we think part of it will inevitably be channeled in regional expansion plans.

Figure 22 | Forecast CAPEX, cash flows and dividends



Source: STC, BMG estimates

1H03 results in brief

STC reported a 6.0% drop in revenues QoQ with 2Q03 total revenues coming in at SAR6,302 million. Wireline revenues eased down by 8.6% while wireless revenues upward trend reversed and the company reported a 4.6% drop due to the cut in postpaid calling rates that was effected on 1 April 2003: peak/off-peak calling rate per minute for the basic postpaid product were reduced from SAR0.80/0.50 to SAR0.50/0.40 and similar reduction were applied to the other postpaid products. Operating expenses were almost flat leading to a drop in EBITDA margin from 33.6% to 30.0%. This led to a 10.9% drop in EBITDA and 16.4% drop in net income QoQ. Compared to last year, 1H03 results were much more impressive, with net income growing by 217.7%. This was a product of a 15.6% improvement in sales (driven by the growth in wireless operations), a drop in commercial provisioning charges (20% of net revenues instead of 27%) and the absence of last year SAR1,070 million non-recurring cost of the early retirement program.

Figure 23 | Interim income statement

All figures in SAR 000s unless stated otherwise	1H02	1H03	YoYΔ	1Q03	2Q03	QoQΔ
Wireline Revenues	5,854,689	4,607,496	-21.3%	2,407,049	2,200,447	-8.6%
Wireless Revenues	5,396,084	8,400,850	55.7%	4,298,461	4,102,389	-4.6%
Total Operating Revenues	11,250,773	13,008,346	15.6%	6,705,510	6,302,836	-6.0%
Total Operating Expenses	8,892,834	8,864,597	-0.3%	4,452,470	4,412,127	-0.9%
Operating Income	2,357,939	4,143,749	75.7%	2,253,040	1,890,709	-16.1%
EBITDA	3,956,987	5,915,182	49.5%	3,127,736	2,787,446	-10.9%
EBITDA margin	35.2%	45.5%	10.3%	46.6%	44.2%	-2.4%
Net Inc. before Non-Op. Items & Zakat	2,408,392	4,251,664	76.5%	2,312,125	1,939,539	-16.1%
Net Income before Zakat	1,338,392	4,251,664	217.7%	2,312,125	1,939,539	-16.1%
Net Income	1,305,631	4,147,911	217.7%	2,259,151	1,888,760	-16.4%

Source: STC, BMG estimates

Financial Statements

Balance Sheet

All figures in SAR 000s unless stated otherwise	2001a	2002a	2003e	2004e	2005e	2006e	2007e
Cash and cash equivalents	1,802,349	1,941,866	7,756,080	11,461,919	14,491,654	17,888,320	21,280,446
Accounts receivable, net	6,076,230	5,447,908	3,199,328	3,572,444	3,505,346	3,556,706	3,564,185
Inventories, net	447,544	410,655	398,843	427,027	436,616	449,928	455,824
Prepayments and other current assets	97,318	126,380	115,441	124,726	130,045	136,328	141,177
Total current assets	**8,423,441**	**7,926,809**	**11,469,691**	**15,586,116**	**18,563,662**	**22,031,282**	**25,441,631**
Property, plant and equipment, net	29,870,474	32,018,244	32,721,145	32,075,359	31,093,960	29,794,828	28,170,080
Investments in associates	667,151	769,634	877,944	1,001,549	1,142,249	1,302,812	1,486,049
Other investments	136,565	112,090	98,399	98,399	98,399	98,399	98,399
Other non-current assets	71,914	86,066	93,550	104,460	102,498	104,000	104,219
Total non-current assets	**30,746,104**	**32,986,034**	**33,791,039**	**33,279,767**	**32,437,107**	**31,300,039**	**29,858,747**
Total assets	**39,169,545**	**40,912,843**	**45,260,730**	**48,865,884**	**51,000,768**	**53,331,321**	**55,300,378**
Accounts payable	7,305,415	6,932,435	6,487,134	6,107,883	6,023,999	5,955,835	5,876,390
Accrued expenses and other payables	4,776,095	4,091,111	4,312,383	4,179,302	4,057,009	4,023,300	3,954,126
Deferred revenue-current	1,217,124	1,582,984	2,132,885	2,381,629	2,336,897	2,371,137	2,376,123
Short-term borrowings	1,216,667	583,333	466,667	183,333	0	0	0
Dividends payable	0	750,000	2,400,000	3,000,000	3,150,000	3,300,000	3,450,000
Total current liabilities	**14,515,301**	**13,939,863**	**15,799,070**	**15,852,148**	**15,567,905**	**15,650,272**	**15,656,639**
Deferred revenue	2,068,280	1,681,080	1,827,260	2,040,361	2,002,039	2,031,373	2,035,644
Long-term borrowings	683,333	650,000	183,333	0	0	0	0
Employees' end of service benefits	1,428,345	1,382,570	1,382,130	1,428,998	1,424,593	1,456,848	1,471,317
Total non-current liabilities	**4,179,958**	**3,713,650**	**3,392,723**	**3,469,359**	**3,426,632**	**3,488,220**	**3,506,961**
Paid-in capital	12,000,000	15,000,000	15,000,000	15,000,000	15,000,000	15,000,000	15,000,000
Legal reserve	1,155,340	1,509,923	2,270,884	3,218,428	4,094,613	4,973,273	5,857,668
Retained earnings	7,321,154	6,762,405	8,811,051	11,338,947	12,924,616	14,232,554	15,292,109
Unrealized gains (loss) on other inv.	-2,208	-12,998	-12,998	-12,998	-12,998	-12,998	-12,998
Total shareholders' equity	**20,474,286**	**23,259,330**	**26,068,937**	**29,544,377**	**32,006,232**	**34,192,829**	**36,136,779**
Total liab. and shareholders' equity	**39,169,545**	**40,912,843**	**45,260,730**	**48,865,884**	**51,000,768**	**53,331,321**	**55,300,378**

Source: STC, BMG estimates

Income Statement

All figures in SAR 000s unless stated otherwise	2001a	2002a	2003e	2004e	2005e	2006e	2007e
Wireline revenues	11,791,851	10,607,248	8,947,962	9,090,103	9,241,292	9,380,639	9,512,359
Wireless revenues	7,989,517	12,939,817	16,646,662	19,489,449	18,801,475	19,073,011	19,001,120
Total revenues	**19,781,368**	**23,547,065**	**25,594,624**	**28,579,552**	**28,042,767**	**28,453,649**	**28,513,479**
Government charges	3,963,678	6,299,389	5,209,449	5,859,693	5,776,988	5,872,995	5,900,696
Access charges	1,859,091	1,763,532	1,740,104	1,628,634	1,485,681	1,439,386	1,367,307
Employee costs	3,261,987	3,456,375	3,455,274	3,572,444	3,561,431	3,642,067	3,678,239
Depreciation	2,800,611	3,265,293	3,548,116	3,779,651	3,989,896	4,187,917	4,375,701
General and administrative expense	1,768,550	2,569,454	2,431,489	2,715,057	3,084,704	3,272,170	3,279,050
Repairs and maintenance	1,119,243	1,405,318	1,563,489	1,660,734	1,749,037	1,832,206	1,911,075
Total operating expenses	14,773,160	18,759,361	17,947,921	19,216,213	19,647,738	20,246,740	20,512,068
Operating income	5,008,208	4,787,704	7,646,703	9,363,339	8,395,029	8,206,909	8,001,411
EBITDA	**7,808,819**	**8,052,997**	**11,194,818**	**13,142,990**	**12,384,925**	**12,394,826**	**12,377,112**
EBITDA margin	39.5%	34.2%	43.7%	46.0%	44.2%	43.6%	43.4%
Commission income	59,374	30,548	33,983	213,486	429,897	620,576	858,849
Other income and expenses	-95,194	-110,168	124,040	141,574	161,592	184,409	210,458
Income before non-recurring items & zakat	4,972,388	4,708,084	7,804,725	9,718,400	8,986,518	9,011,894	9,070,718
Non-recurring items	-1,394,473	-1,070,000	0	0	0	0	0
Income before zakat	3,577,915	3,638,084	7,804,725	9,718,400	8,986,518	9,011,894	9,070,718
Zakat	99,190	92,250	195,118	242,960	224,663	225,297	226,768
Net income	**3,478,725**	**3,545,834**	**7,609,607**	**9,475,440**	**8,761,855**	**8,786,597**	**8,843,950**

Source: STC, BMG estimates

Cash Flow Statement

All figures in SAR 000s unless stated otherwise	2001a	2002a	2003e	2004e	2005e	2006e	2007e
Net income	3,478,725	3,545,834	7,609,607	9,475,440	8,761,855	8,786,597	8,843,950
Adj. to reconcile to net cash from op. act.	4,623,499	5,256,017	3,439,805	3,656,047	3,849,196	4,027,354	4,192,464
Changes in assets and liabilities	-1,161,903	-1,333,083	2,735,460	-425,115	-239,485	-78,501	-143,335
Net cash flow from operating activities	6,970,318	7,468,768	13,784,873	12,706,371	12,371,565	12,735,450	12,893,079
Net cash flow from investing activities	-5,244,934	-5,766,470	-4,237,326	-3,133,865	-3,008,497	-2,888,785	-2,750,953
Net cash flow from financing activities	-1,056,250	-1,562,781	-3,733,333	-5,866,667	-6,333,333	-6,450,000	-6,750,000
Net change in cash & cash equivalents	**669,134**	**139,517**	**5,814,214**	**3,705,839**	**3,029,735**	**3,396,665**	**3,392,126**
BOP cash and cash equivalents	1,133,215	1,802,349	1,941,866	7,756,080	11,461,919	14,491,654	17,888,320
EOP cash and cash equivalents	**1,802,349**	**1,941,866**	**7,756,080**	**11,461,919**	**14,491,654**	**17,888,320**	**21,280,446**

Source: STC, BMG estimates

Financial Ratios

	2001a	2002a	2003e	2004e	2005e	2006e	2007e
Growth							
Revenues	16.8%	19.0%	8.7%	11.7%	-1.9%	1.5%	0.2%
Operating profit	29.8%	-4.4%	59.7%	22.4%	-10.3%	-2.2%	-2.5%
EBITDA	24.8%	3.1%	39.0%	17.4%	-5.8%	0.1%	-0.1%
Net profit	-12.0%	1.9%	114.6%	24.5%	-7.5%	0.3%	0.7%
Profitability							
Operating profit margin	25.3%	20.3%	29.9%	32.8%	29.9%	28.8%	28.1%
EBITDA margin	39.5%	34.2%	43.7%	46.0%	44.2%	43.6%	43.4%
Net profit margin	17.6%	15.1%	29.7%	33.2%	31.2%	30.9%	31.0%
EPS	11.6	11.8	25.4	31.6	29.2	29.3	29.5
RoAA	9.3%	8.9%	17.7%	20.1%	17.5%	16.8%	16.3%
RoAE	18.1%	16.2%	30.9%	34.1%	28.5%	26.5%	25.2%
Leverage							
Total debt/Total assets	4.9%	3.0%	1.4%	0.4%	0.0%	0.0%	0.0%
Total debt/Equity	9.3%	5.3%	2.5%	0.6%	0.0%	0.0%	0.0%
Net debt/Equity	0.5%	-3.0%	-27.3%	-38.2%	-45.3%	-52.3%	-58.9%

Source: STC, BMG estimates

Disclaimer

Inv. Rating

Upside

Buy
Significantly over-weight vs. the index

25%

Add
Over-weight vs. the index

0%

Reduce
Under-weight vs. the index

-25%

Sell
Do not hold the stock

Downside