

13 October 2005

Recommendation

Sell*

Upside/Downside

-27.5%

Fair Value

SAR685.3

Current Price

SAR945.0*



Saudi Telecommunication Co.

Telecom sector | Saudi Arabia

1H05 update report

Reuters Code

7010.SE

Market Cap

SAR283,500 mil.

Enterprise Value

SAR281,765 mil.

Number of Shares Outstanding

300 mil.

Average Weekly turnover

SAR3,921 mil.

52-Week high/low

SAR995/498 (28Aug05/10Oct04)

Absolute Performance

-1%/6%/85% (1M /3M/YTD)

Performance Relative to TASI

-5%/-15%/-45% (1M /3M/YTD)

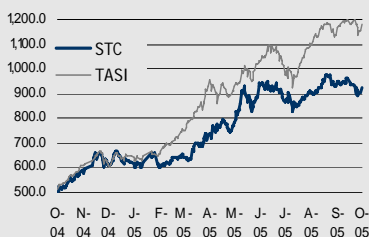
Shareholders' Structure

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 13 October 2005.

1H05 results indicate slower growth

STC reported a net income of SAR5,914 million in 1H05, 15.1% higher than the SAR5,141 million recorded in 1H04. Due to competition, the company added only 554,000 wireless subscribers in the first five months of 2005 compared to 1.7 million in FY04. Wireline subscribers grew from 3.70 million by the end of 2004 to 3.75 million by May 2005. STC's wireless revenues grew 14.8% to SAR11,521 million in 1H05 from SAR10,033 million in 1H04, while wireline revenues declined 8.6% to SAR4,436 million in 1H05 from SAR4,853 million a year earlier. As a result, the 1H05 revenues grew at a disappointing rate of 7.2% to SAR15,957 million as opposed to 1H04 revenues of SAR14,886 million.

Increasing competition

With stiff competition from the new operator, Mobily, STC is likely to capture only 40% of net additions in 2005 as Mobily has already acquired over one million subscribers within the first three months of operations. In addition, the government intends to allow a third mobile operator by the end of 2007. These developments are likely to cause an increase in STC's churn rate going forward as well as growing mobile telephony rapidly. We expect penetration levels to rise from 36% to 64% during 2004–2007. However, we forecast STC's market share of net additions in the wireless segment to fall to 30% by 2008. The government has announced plans to end STC's monopoly over fixed line operations by the end of 2007. Hence, we estimate that STC's fixed line market share would fall to 95% by 2009.

We downgrade our recommendation for STC from "Add" to "Sell"

We valued STC using DCF and a comparison based valuation vs. international peers on the basis of 2005e and 2006e PE multiples. Our DCF valuation yielded a 12-month fair value of SAR540.5 per share, whereas the comparison-based valuation generated a fair value of SAR830.1 per share. By taking an average of the two figures we arrived at a fair value of SAR685.3 per share for STC, about 27.5% below the current market price of SAR945.0 per share. Accordingly, we downgrade our recommendation for STC from "Add" to "Sell".

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Indicator	2003a	2004a	2005e	2006e	2007e	2008e	2009e
Revenues (SAR mil.)	27,292	30,499	32,473	33,892	35,109	36,185	37,221
EBITDA (SAR mil.)	13,013	14,741	16,295	17,177	17,969	18,881	19,794
EBITDA margin	47.7%	48.3%	50.2%	50.7%	51.2%	52.2%	53.2%
Net income (SAR mil.)	8,525	9,314	12,170	12,915	13,574	14,605	15,615
EPS (SAR)	28.4	31.0	40.6	43.0	45.2	48.7	52.0
P/E (x)	33.1	30.3	23.2	21.8	20.8	19.3	18.1
P/BV (x)	9.6	9.1	8.6	8.1	7.7	7.3	6.8
P/Operating Cash Flow (x)	26.1	23.4	16.7	16.3	15.6	14.9	14.2
EV/EBITDA (x)	21.5	19.0	17.2	16.3	15.6	14.9	14.2
EV/Sub (SAR)	25,650	21,788	19,507	17,868	16,573	15,515	14,530
DPS (SAR)	22.0	26.0	34.5	36.6	38.5	41.4	44.2
Payout Ratio (%)	77%	84%	85%	85%	85%	85%	85%

Source: STC, BMG estimates.

1H05 results in brief

Subscriber base

STC added 554,000 subscribers in the wireless business in the first five months of 2005, taking its total wireless subscriber base to 9.7 million. We believe that STC's subscriber base increased by another 110,000 in June¹, in line with the first five months. As a result, the company's subscriber base grew by around 660,000 during the first half of 2005, compared to 1.7 million new subscribers in FY04, thus indicating a slower growth rate. In 1H05, the prepaid segment was the main contributor to the increase in subscriber base, accounting for 74% of net additions compared to 60% in all of 2004. As of May 2005, prepaid subscribers formed 54.3% of STC's total subscriber base, while postpaid users accounted for the remaining 45.7%. We do not perceive any change in STC's prepaid-postpaid mix at the end of 1H05.

A significant development in recent months is the progress made by STC's competitor, Mobily, in the wireless segment. Launched in May 2005, Mobily surpassed the one million subscriber mark on August 21, 2005, well ahead of its end-2005 estimate. With this development, Mobily's market share has reached approximately 9% of the estimated total 11 million wireless subscribers in the market. This indicates strong subscriber response to the new operator's services and aggressive tariffs and is likely to lead to sharp erosion in STC's market share going forward.

In the wireline business, STC's subscriber base grew from 3,695,000 at the end of 2004 to 3,752,000 in the first five months of 2005. We expect an overall 5% growth in wireline subscribers in 2005, mainly driven by low teledensity (around 15% in FY04) in the country.

Revenues

In 1H05, STC's wireless operations acted as the primary growth driver, while fixed line revenues experienced a drop. This is evident from the fact that wireless revenues formed 72.2% of the total revenues in 1H05 as compared to 67.3% in 1H04. The company's wireless revenues rose 14.8% over 1H04 to SAR11,521 million. Wireline revenues showed negative growth due to slow growth in subscribers and falling tariffs, which declined 8.6% over 1H04 to SAR4,436 million. STC's total revenues increased by a disappointing 7.2% to SAR15,957 million, as compared to 13.1% for the full year 2004.

In 2Q05, wireless revenues were SAR5,864 million, 15.1% higher than the same quarter last year while wireline revenues declined to SAR2,174 million, 12% lower than 2Q04. Overall revenues in 2Q05 stood at SAR8,038 million, up by 6.3% over 2Q04.

Examined sequentially, in 2Q05, wireless revenues grew 3.7% over 1Q05 while wireline revenues dropped by 3.8%, leading to a sequential growth of 1.5% in total operating revenues.

Figure 1 | STC quarterly income statements

All figures in SAR 000s unless stated otherwise	1Q04	2Q04	6M04	1Q05	2Q05	6M05
Wireline Revenues	2,383,599	2,468,928	4,852,527	2,261,430	2,174,374	4,435,804
Wireless Revenues	4,937,444	5,096,035	10,033,479	5,656,803	5,863,893	11,520,696
Total Operating Revenues	7,321,043	7,564,963	14,886,006	7,918,233	8,038,267	15,956,500
Total Operating Expenses	4,771,068	4,885,664	9,656,732	4,605,797	5,115,826	9,721,623
Operating Income	2,549,975	2,679,299	5,229,274	3,312,436	2,922,441	6,234,877
EBITDA	3,637,047	3,715,018	7,352,065	4,251,011	3,958,839	8,209,850
EBITDA margin	49.7%	49.1%	49.4%	53.7%	49.3%	51.5%
Net Income before Non-Op items & Zakat	2,535,144	2,617,434	5,152,578	3,233,005	2,858,808	6,091,812
Net Income before Zakat	2,544,406	2,712,638	5,257,044	3,080,803	2,971,179	6,051,982
Net Income	2,502,634	2,638,304	5,140,938	3,010,952	2,903,138	5,914,090

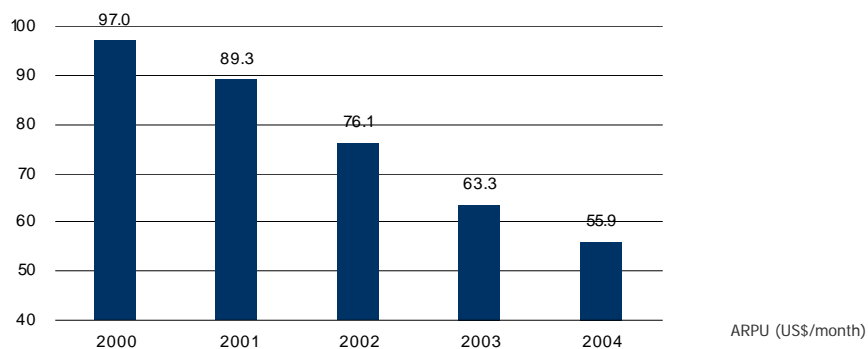
Source: STC

¹ BMG estimates, extrapolated from the first 5 months; since STC has provided only 5 months subs data

ARPU

STC did not release any data on average revenue per user (ARPU) for 1H05. However, our analysis of wireless revenues and the wireless subscriber base at the end of June 2005 leads us to believe that STC's blended ARPU is around SAR200 in 1H05. STC's ARPU for FY2004 was SAR210. Increasing competition due to the entry of Mobily coupled with its aggressive tariff schemes is likely to result in further ARPU declines in 2H05.

Figure 2 | Historical trends in STC's Wireless ARPU



Source: STC, BMG estimates

Net income

STC's EBITDA margins expanded to 51.5% in 1H05, from 49.4% in 1H04 primarily due to lower government charges. However, EBITDA margins in 2Q05 decreased to 49.3% from 53.7% in 1Q05, primarily due to a 40.4% rise in marketing expenditure to counter competition. The company's net income for 1H05 jumped 15.0% to SAR5,914 million over 1H04. Net income in 2Q05, at SAR2,903 million was 10.0% higher than the 2Q04 figure.

Entry of a new wireless operator

Etiyah Etisalat received the second operator license in August 2004, and started offering wireless services from May 25, 2005. The company operates under the brand "Mobily" across 32 cities and offers post paid services, including voicemail, news and data downloads from the Mobily portal. In the prepaid segment, the company is offering two different packages — *Anees* provides services at cheaper rates based on peak and off peak call timing, while the other *Wafeer*, provides services under which the more a user talks the greater the reduction in rates. Mobily is reported to have garnered one million subscribers in the first three months post-launch. We expect the company to end 2005 with nearly two million subscribers as STC's share of net additions declines to 40%. The government has also announced plans to allow a third mobile operator in 2007 and a second fixed line operator from 2007. We expect STC to lose further market share to these new entrants.

Number portability

The Saudi Arabian telecom regulator has introduced number portability in mid-August 2005. This has already led to the easy movement of mobile subscribers from one operator to the other. Going forward, this could pose challenges to STC considering the fact that Mobily's services have already been well received by the masses. STC's churn rate is likely to increase in the near future unless the company takes appropriate corrective measures such as aggressive promotions, improved customer service, and low tariff plans.

3G License

STC obtained a 3G license on May 7, 2005, for a one-time fee of SAR753.7 million. We expect STC to start offering 3G-based services like video streaming and music downloads from early 2007. We believe that these value-added services are likely to bring some stability to the total ARPU levels. However, considering the increased competition in the market after the possible entry of a third wireless operator in 2007, we estimate a reasonable drop in ARPU from 2007 onwards.

Forecast update

Subscribers

In the wireless business, we expect subscribers to grow at a fast pace, driven by the fall in tariffs and more competitive offerings. We expect penetration levels to reach 80% by 2009 from 36% in 2004, with the total wireless base in the country crossing 24 million by the end of 2009. Considering the rapid subscriber additions by Mobily, we expect STC to end 2005 with a 40% market share in net additions. Starting 2006, we assume that STC will try to bring some stability to its net additions. We expect STC would attempt to retain its existing subscribers with improved service levels and aggressive tariff plans. Therefore, we maintain our assumption of 40% market share in net additions for STC in 2006. Given the likely impact of the entry of a third wireless operator in 2007, we project a lower share of net additions from 2007 onwards.

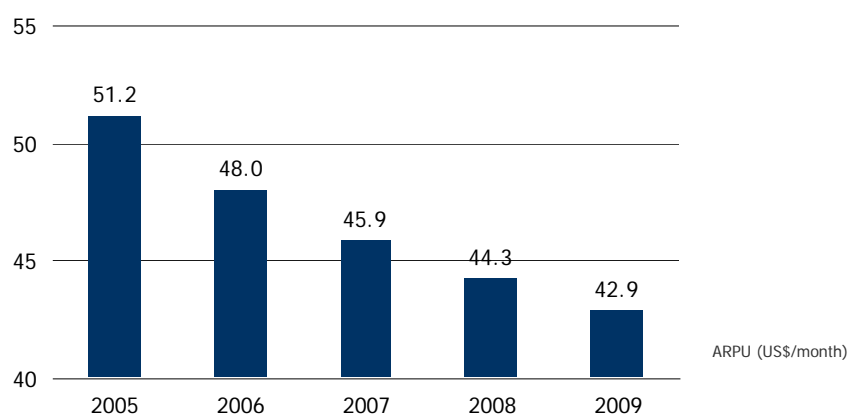
We think that the growth in wireline subscribers is likely to follow the past trend (growth of around 5%). Although the company has suffered from a drop in wireline revenues for 1H05 over 1H04, we expect a rebound in the wireline revenues in 2H05. We believe that STC will try to retain fixed line subscribers with lower tariffs and better offerings. The wireline penetration level in the country was low at the end of 2004 (around 15.0%), which leaves scope for further growth. We also incorporated the impact of a possible loss of STC's wireline monopoly from 2007 in our calculations.

ARPU

Reduction in tariffs due to intensifying competition and substantial growth in the lower income-generating segment of prepaid subscribers are likely to result in a further fall in ARPU levels in 2H05. Moreover, the new entrant, Mobily, has substantially grown its subscriber base in its first 3 months of operation through lower tariffs. We expect wireless tariffs to fall further as observed in other emerging markets in Latin America and Central Europe.

We expect the introduction of 3G services in 2007, which are likely to provide added revenue streams through increased usage of value-added services by wireless subscribers. However, the possible entry of the third operator in 2007 could apply more pressure on the ARPU. With a mix of forces in operation, we expect blended ARPU to drop to SAR161 by 2009.

Figure 3 | ARPU forecasts for the Wireless segment



Source: STC, BMG estimates

Valuation update

One-Year DCF Fair value per share of SAR540.5

We used the yields on the 10-year government bond as the risk free rate (4.62%). We have arrived at a market premium of 8.85% for STC using market return data for the past 15 years. We arrived at a beta of 0.88 using the share price and index (TASI) data. This gives us a cost of equity of 12.4% for the company. STC is a debt free company, and hence, its cost of equity becomes the cost of capital. Therefore, we arrived at a one-year DCF value of SAR540.5 per share, which reflects a 42.8% downside from the current price of SAR945.0.

Comparison-based fair value per share of SAR830.1

For this analysis, we used Latin American and CEEMEA operators with comparable penetration levels. In comparison to Latin American operators on the basis on 2005e and 2006e P/E multiples, STC is valued at SAR681.7, while compared to CEEMEA operators on the basis on 2005e and 2006e P/E multiples, we arrived at a fair value of SAR701.8. Considering the higher per capita income of Saudi Arabia, we applied a premium of 20% on the average fair value, SAR691.7, thereby arriving at a comparison-based fair value of SAR830.1, reflecting a downside of 12.2% from the current market price.

Figure 4 | Comparative valuation on price to earnings multiple

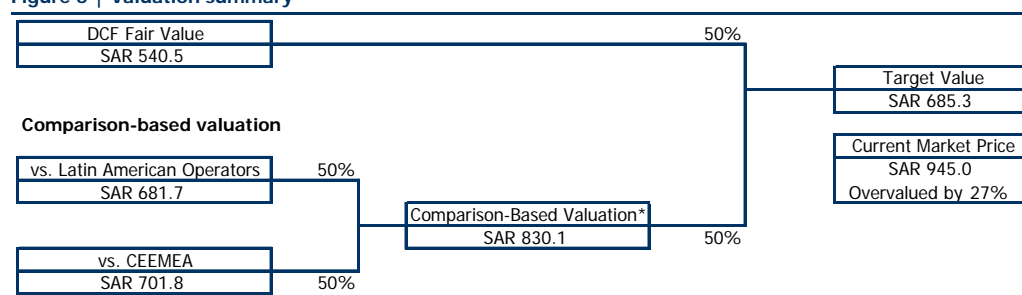
Operator	Geography	PE 05E	PE 06E
Brasil Telecom Participacoes SA	Latin America	17.31	10.71
Entel	Latin America	16.98	14.54
America Moviles	Latin America	22.09	16.63
Mean		18.79	13.96
Corresponding valuation for STC		762.4	601.0
Average STC value		SAR681.7	
Cesky Telecom AS	CEEMEA	27.85	22.04
Magyar Telecom	CEEMEA	13.66	12.96
Vimpelcom	CEEMEA	13.70	10.78
Mean		18.40	15.26
Corresponding valuation for STC		746.6	656.9
Average STC value		SAR701.8	

Source: Reuters estimates, BMG estimates; Multiples as of 9th October 2005

Target value per share of SAR685.3

We determined a target value of SAR685.3 by taking an average of the two fair values arrived at using the two valuation methods, namely the DCF and the comparison-based valuation. Our target value reflects a downside of 27.5% from the current market price of SAR945.0. Accordingly, we downgrade STC from "Add" to "Sell".

Figure 5 | Valuation summary



Source: BMG estimates; *Comparison-based valuation has been arrived at by incorporating an adjustment factor of 20%

Financial Statements

Balance Sheet

All figures in SAR million unless stated otherwise	2003a	2004a	2005e	2006e	2007e	2008e	2009e
Cash and cash equivalents	5,388.1	6,748.7	7,319.3	8,595.5	11,650.4	14,589.6	17,530.7
Accounts receivable, net	3,015.1	3,133.6	3,271.6	3,277.1	3,324.4	3,484.2	3,643.5
Inventories, net	303.8	217.7	162.4	169.5	175.5	180.9	186.1
Prepayments and other current assets	176.6	196.6	209.3	218.4	226.3	233.2	239.9
Total current assets	8,883.6	10,296.5	10,962.6	12,260.6	15,376.6	18,487.9	21,600.2
Property, plant and equipment, net	31,906.7	30,781.6	31,938.7	33,168.9	32,677.9	32,353.7	32,172.2
Intangibles	0.0	0.0	603.0	452.2	301.5	150.7	0.0
Investments in associates	879.4	957.7	957.7	957.7	957.7	957.7	957.7
Other non-current assets	102.5	82.0	82.0	82.0	82.0	82.0	82.0
Total non-current assets	32,888.6	31,821.4	33,581.3	34,660.9	34,019.1	33,544.1	33,211.9
Total assets	41,772.2	42,117.8	44,543.9	46,921.4	49,395.7	52,032.0	54,812.1
Accounts payable	2,943.4	2,728.6	2,917.7	2,999.8	3,116.6	3,266.4	3,415.8
Other current liabilities	6,479.0	5,830.6	6,142.1	6,400.2	6,621.7	6,817.5	7,006.0
Total current liabilities	9,422.4	8,559.2	9,059.8	9,400.1	9,738.3	10,083.9	10,421.8
Deferred revenue	1,379.3	1,006.6	1,006.6	1,006.6	1,006.6	1,006.6	1,006.6
Employees' end of service benefits	1,576.0	1,643.4	1,743.4	1,843.4	1,943.4	2,043.4	2,143.4
Total non-current liabilities	2,955.2	2,650.0	2,750.0	2,850.0	2,950.0	3,050.0	3,150.0
Total shareholders' equity	29,394.6	30,908.6	32,734.1	34,671.3	36,707.4	38,898.1	41,240.3
Total liab. and shareholders' equity	41,772.2	42,117.8	44,543.9	46,921.4	49,395.7	52,032.0	54,812.1

Source: STC, BMG estimates

Income Statement

All figures in SAR million unless stated otherwise	2003a	2004a	2005e	2006e	2007e	2008e	2009e
Wireline revenues	9,548.1	9,586.7	9,809.1	9,963.9	10,028.3	10,105.9	10,139.6
Wireless revenues	17,743.9	20,912.0	22,663.8	23,927.9	25,080.5	26,079.0	27,081.4
Total revenues	27,292.0	30,498.7	32,472.9	33,891.8	35,108.8	36,184.9	37,220.9
Cost of Goods Sold	12,607.1	13,669.3	13,904.7	14,173.4	14,331.2	14,408.6	14,449.0
Selling, Gen & Admin Expenses	1,672.0	2,088.2	2,273.1	2,541.9	2,808.7	2,894.8	2,977.7
Depreciation Expense	3,813.0	4,261.4	3,713.9	3,853.5	4,001.9	3,942.7	3,903.6
Total operating expenses	18,092.0	20,018.9	19,891.7	20,568.8	21,141.9	21,246.1	21,330.2
Operating income	9,200.0	10,479.7	12,581.2	13,323.1	13,966.9	14,938.8	15,890.7
Intangible Amortization	0.0	0.0	-150.7	-150.7	-150.7	-150.7	-150.7
EBIT	9,200.0	10,479.7	12,430.4	13,172.3	13,816.2	14,788.0	15,740.0
Other Income	51.9	31.2	0.0	0.0	0.0	0.0	0.0
Commission income	43.6	63.4	52.1	73.5	105.4	191.5	274.9
Special Items	-544.2	-1,007.2	0.0	0.0	0.0	0.0	0.0
Income before Zakat	8,751.4	9,567.1	12,482.5	13,245.8	13,921.5	14,979.5	16,014.8
Zakat	226.2	252.8	312.1	331.1	348.0	374.5	400.4
Net Income	8,525.3	9,314.3	12,170.4	12,914.6	13,573.5	14,605.1	15,614.5
Common dividends	6,600.0	7,800.0	10,344.9	10,977.4	11,537.5	12,414.3	13,272.3
Retained Income	1,925.3	1,514.3	1,825.6	1,937.2	2,036.0	2,190.8	2,342.2

Source: STC, BMG estimates

Cash Flow Statement

All figures in SAR million unless stated otherwise	2003a	2004a	2005e	2006e	2007e	2008e	2009e
Net income	8,525	9,314	12,170	12,915	13,573	14,605	15,614
Adj. to reconcile to net cash from op. act.	4,591	5,171	3,159	4,031	4,147	4,002	3,879
Changes in assets and liabilities	-1,515	-2,445	596	106	94	12	11
Net cash flow from operating activities	11,601	12,040	15,925	17,051	17,815	18,619	19,505
Net cash flow from investing activities	-5,181	-4,705	-4,871	-5,084	-3,511	-3,618	-3,722
Net cash flow from financing activities	-4,312	-7,706	-10,341	-10,904	-11,432	-12,223	-12,997
Net change in cash	2,107	-372	713	1,063	2,872	2,778	2,786
BOP cash	0	2,107	1,735	2,448	3,512	6,384	9,162
EOP cash	2,107	1,735	2,448	3,512	6,384	9,162	11,948

Source: STC, BMG estimates

Financial Ratios

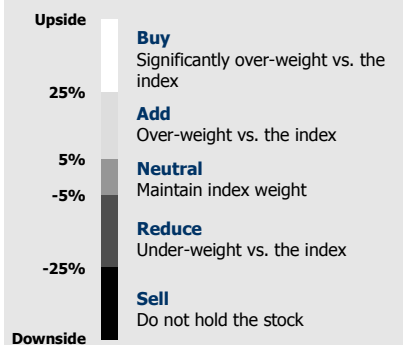
	2003a	2004a	2005e	2006e	2007e	2008e	2009e
Growth							
Revenues	15.9%	11.7%	6.5%	4.4%	3.6%	3.1%	2.9%
Operating profit	92.2%	13.9%	18.6%	6.0%	4.9%	7.0%	6.4%
EBITDA	61.6%	13.3%	10.5%	5.4%	4.6%	5.1%	4.8%
Net profit	140.4%	9.3%	30.7%	6.1%	5.1%	7.6%	6.9%
Profitability							
EBITDA margin	47.7%	48.3%	50.2%	50.7%	51.2%	52.2%	53.2%
Operating profit margin	33.7%	34.4%	38.3%	38.9%	39.4%	40.9%	42.3%
Net profit margin	31.2%	30.5%	37.5%	38.1%	38.7%	40.4%	42.0%
EPS (SAR)	28.4	31.0	40.6	43.0	45.2	48.7	52.0
ROAIC	33.5%	35.4%	40.3%	41.0%	42.6%	46.2%	49.6%
ROAE	31.9%	30.9%	38.2%	38.3%	38.0%	38.6%	39.0%

Source: STC, BMG estimates

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Inv. Rating*



* We have added a new rating, "Neutral", in the mid-range of the continuum, between -5% and 5%.