

### Summary:

## Saudi Telecom Co.

**Primary Credit Analyst:**

Michael O'Brien, London (44) 20-7176-3561; michael\_obrien@standardandpoors.com

**Secondary Credit Analyst:**

Alexander Griaznov, Moscow (7) 495-783-4109; alexander\_griaznov@standardandpoors.com

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### Foreign Currency

**Credit Rating:** A+/Stable/A-1

## Rationale

The rating on Saudi Telecom Co. (STC), the incumbent fixed-line and leading mobile telecommunications operator in the Kingdom of Saudi Arabia (AA-/Stable/A-1+), is based on the company's stand-alone credit profile, which Standard & Poor's Ratings Services assesses at 'A', as well as on our opinion that there is a "high" likelihood that the Saudi government would provide timely and sufficient extraordinary support to STC in the event of financial distress.

In accordance with our criteria for government-related entities (GREs), our view of a "high" likelihood of extraordinary government support is based on our assessment of STC's:

- "Important" role for the government as the largest telecoms operator in the Kingdom and a provider of key communications infrastructure, and its position as a flagship national company. STC's role is also instrumental in the rollout of telecoms technologies necessary for further industrialization and the technological development of the Saudi Arabian economy.
- "Very strong" link with the government, considering the latter's 70% shareholding in the company (with other Saudi GREs owning a further stake of about 13%), appointment of board members, and role in the oversight of decision-making processes. The government's strategic oversight is particularly relevant for decisions related to potential investments outside the Kingdom.

The rating on STC is supported by its leading market position in the liberalized Saudi telecoms market, with a difficult-to-replicate national network, implicit state support, high operating profitability margins in its domestic market, and underlying strong cash flows. STC's financial policy remains conservative, as the company only recently used debt to partially fund its initial overseas investments.

The rating is constrained, however, by potential further regulatory changes that may adversely affect the company's competitive position and market shares, for example, resulting in higher competition in the Saudi mobile market. In addition, revenue growth in STC's domestic fixed-line business is low due to fixed-to-mobile traffic substitution and stagnation in household penetration of about 67%. Furthermore, the company's fixed broadband Internet penetration via digital subscriber line is still low, although it is improving incrementally. On a consolidated basis, investment needs for the company remain substantial, notably to expand the third-generation (3G) mobile network capabilities, as well as to develop overseas subsidiaries.

### Key business and profitability developments

Revenue for the 12 months ended March 31, 2010, increased by 2.2% compared with the same period last year, driven primarily by data and Internet growth. However, revenue in the first quarter of 2010 declined by 3.9% versus the fourth quarter of 2009. This was primarily due to pressure on wireless revenue, which fell by about 5.7% compared with the fourth quarter of 2009. Adjusted EBITDA in the first quarter of 2010 was 17.5% lower than a

year ago and adjusted EBITDA for the 12 months ended March 31, 2010, declined by 5.0% compared with full-year 2009. This indicates the effect of foreign-exchange volatility for the overseas assets that STC consolidates and increased mobile competition and lower prices in STC's domestic market. As a result of these elements--and also taking into account the consolidation of Oger Telecom Ltd. and start-up costs in new operations outside Saudi Arabia--the company's consolidated adjusted EBITDA margin for the 12 months ended March 31, 2010, fell to 37.0% from 43.7% a year earlier.

### **Key cash flow and capital-structure developments**

Primarily due to STC's relatively low leverage, the company retains some flexibility within the limits of its financial policy to undertake inorganic growth activities abroad, although the potential credit impact of such actions could reduce ratings headroom. Following the purchase of a 35% stake in Oger Telecom for Saudi Arabian riyal (SAR) 9.8 billion (\$2.6 billion) in 2008, STC's adjusted debt was SAR27.0 billion on March 31, 2010. (SAR17.3 billion of this amount relates to debt in STC's investee companies with no recourse to STC, indicating low leverage at the parent company level). As a result, the company's consolidated adjusted debt to EBITDA was 1.4x for the 12 months ended March 31, 2010: this ratio has been broadly stable over the last eight quarters. Over the same period, funds from operations (FFO) to debt improved to 72.3%, compared with 70.9% for full-year 2009.

The company's ratio of free operating cash flow (FOCF) to debt was negative 1.0% in 2009, compared with 11.4% in 2008, primarily as a result of unfavorable working capital changes and higher capital expenditures (capex). However, FOCF to debt in the 12 months to March 31, 2010, improved to 10.4% owing to lower capex during the first quarter of 2010. In general, domestic capex should moderate over time, reflecting the substantial network investments that have already been made across the portfolio, contributing to free cash flow growth in 2010. Discretionary cash flow, however, has remained negative due to the payment of substantial dividends.

### **Liquidity**

The 'A-1' short-term rating is supported by STC's ample liquidity and good financial flexibility for its needs, in our view. On March 31, 2010, the company's liquidity resources included consolidated cash and cash equivalents of SAR7.3 billion. In addition, the parent company had available undrawn facilities with local banks totaling SAR1.5 billion.

On March 31, 2010, debt maturities within one year amounted to SAR5.9 billion. Other cash payments following the first quarter of 2010 include interim dividends of SAR1.5 billion.

We believe that the company's underlying strong FOCF generation will continue over the next few years and remain a support for the financing of any significant investments. In 2008, FOCF proved insufficient to cover large acquisitions such as the Oger Telecom stake. STC continues to pay substantial dividends, contributing to negative discretionary cash flow (FOCF after dividends).

We foresee STC funding its requirements with new debt issuance, within the limits of its financial policy. The company's liquidity policy stipulates that it will have sufficient cash available to meet projected business needs with minimum cash coverage on a rolling 12-month basis.

## **Outlook**

The stable outlook reflects our view that STC will remain committed to a conservative financial policy and that the Saudi Arabian government will retain its controlling stake in the company.

We anticipate that STC's ratio of FFO to debt should remain more than 50% on average and that the ratio of adjusted debt to EBITDA should remain between 1x and 2x. These ratios assume that the company maintains its strong domestic competitive position and strong profitability and cash flow generation, while the overseas assets continue to post demonstrable growth. Any deviation toward higher leverage of more than 2x would need to be temporary--and not linked to shareholder distributions or an unforeseen weakening of operating performance--to avoid pressure on the rating. STC's key credit protection ratios have moved slowly toward the long-term thresholds typical for the rating level, given the incremental increase in debt since 2008. Nevertheless, the company retains financial flexibility for its investment plans within the boundaries of its financial policy and has the potential to adjust dividends, as was the case in 2009 compared with 2008.

The rating could come under pressure from a more accelerated debt-funded growth path accompanied by a more aggressive financial policy. Equally, a noticeable weakening of operating performance as a result, for example, of a substantial adverse effect of regulatory decisions or intense competition could pressure the rating. Upside for the rating is limited at this stage, given the risks and dynamics associated with the telecoms industry.

A significant reduction in the state's shareholding in STC and consequent reappraisal of our GRE assessment could also lead to a one-notch downgrade.

**Additional Contact:**

Industrial Ratings Europe; CorporateFinanceEurope@standardandpoors.com

**Additional Contact:**

Industrial Ratings Europe; CorporateFinanceEurope@standardandpoors.com

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