

December 16, 2010

KEY DATA

Fair Value per Share (BHD)	0.660
Closing Price (BHD)*	0.490
52-week High / Low (BHD)	0.625 / 0.490
YTD / 12-month Return	-16.06% / -15.44%
Trailing P/E	7.7
Market Cap (BHD Millions)	706
Shares Outstanding (Millions)	1,440
Free Float	23%
Reuters / Bloomberg	BTEL.BH / BATELCO BI

*As of December 15, 2010. Sources: Bloomberg, Zawyia, and NBK Capital

KEY METRICS

	2009A	2010F	2011F	2012F
EPS (BHD)	0.07	0.07	0.07	0.06
EPS Growth	1%	-5%	-5%	-4%
P/E	6.7	7.1	7.5	7.7
Dividend Yield	10.2%	10.3%	10.1%	10.3%
EV/ EBITDA	4.4	4.5	4.6	4.7
Revenue (BHD Millions)	347	341	340	340
Revenue Growth	9%	-2%	0%	0%
EBITDA (BHD Millions)	150	147	143	141
EBITDA Growth	5%	-2%	-3%	-1%
EBITDA Margin	43.3%	43.0%	42.0%	41.5%

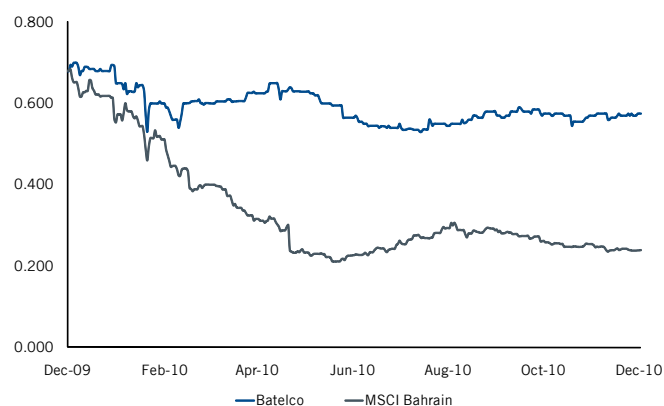
Sources: Company financial statements and NBK Capital

FORECASTS

(BHD Millions)	3Q2009A	2Q2010A	3Q2010F	4Q2010F
Revenue	86	85	85	85
EBITDA	37	36	36	36

Source: NBK Capital

REBASED PERFORMANCE



Sources: MSCI, Reuters, and NBK Capital

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HIGHLIGHTS

12-Month Fair Value: BHD 0.660

Recommendation: Buy – Risk Level: 4**

Reason for Report: 9M2010 Update

- A strong dividend play: The company is currently trading at an expected 2010 dividend yield of 10.3 % based on our forecast payout ratio of 73%. This is in line with the company's historical payout ratio of 69% in 2009. Moreover, with a healthy balance sheet, Batelco has the financial means to pay such a dividend. At the end of 9M2010, the company's balance sheet stood debt free. Furthermore, we believe Batelco's excess cash for 2010 represents around 16% of the current value of the stock.
- With increased competition in Bahrain, Batelco's financial performance is under pressure. During 9M2010, total revenues remained flat at BHD 256 million, while EBITDA declined by 1% and reached BHD 111 million. However, net income declined by 17% year-over-year (YoY) to BHD 66 million, mainly due to the increasing share of losses from the start-up operation in India. Batelco reported disappointing operating performance for 3Q2010. The company achieved revenues of BHD 85.3 million and EBITDA of BHD 36.5 million, which were 8% and 10% below our forecast, respectively.
- Batelco's main business is in two mature markets, Bahrain and Jordan, characterized by intense competition and slow subscriber growth.
- We are forecasting declining revenue of 2% for the group for FY2010. Going forward, we expect total revenue growth will remain flat between 2011 and 2014. Although the company is trying to be more cost-efficient, we still believe that EBITDA will be under constant pressure due to competition in Batelco's main markets. Thus, we believe that EBITDA will decline at a compound annual growth rate (CAGR) of 1% between 2009 and 2014 versus our previously forecasted growth rate of 2%.
- With more focus on Batelco as a dividend play, we have added a dividend discount model to our normal valuation methods (DCF and peer-based valuation). Our new 12-month fair value per share estimate is now BHD 0.660. Given that the fair value estimate is 35% higher than Batelco's latest market price, our new recommendation is "Buy."

** Please refer to page 8 for recommendations and risk ratings.

OUTLOOK

Bahrain - Mobile Market Overview and Forecast

We believe that, during 4Q2010, Batelco will witness another drop in the number of active mobile subscribers similar to the decrease in 3Q2010. This decrease is mainly due to regulatory restriction on prepaid subscribers and increased competition (during 3Q2010, Viva Bahrain conducted aggressive promotional activities in the local mobile, broadband, and international direct dial [IDD] markets). As for 2011, drawing on what happened in Kuwait when Viva entered the market as the third operator, we are expecting the storm to calm down. Thus, we assume that the total number of active mobile subscribers will reach 1.48 million in 2011 and will grow at a CAGR of just 3% between 2011 and 2014. Looking at the net additional subscribers split between the operators, we believe that over our forecast horizon Viva Bahrain will continue capturing the highest number of net additional subscribers. As for Batelco's market share, we believe it will decline from the current level of 51% to 46% in 2014.

Batelco's blended average revenue per user (ARPU) declined by 14% to USD 23.3 in 9M2010 from USD 27 in 2009, again due to increased competition over the period and the moderate subscriber growth witnessed by the operator. We forecast continued pressure on Batelco's blended ARPU, and thus expect it to reach USD 17.5 in 2014.

Figure 1 Mobile Market in Bahrain

Key Market Metrics		2009	9M2010	2010f	2011f	2012f	2013f	2014f
Looking at modest market growth	Total Mobile Subscribers*	1,369	1,412	1,435	1,483	1,533	1,584	1,639
	<i>Growth</i>	2%	3%	5%	3%	3%	3%	3%
Market Share:								
	<i>Batelco</i>	52%	51%	49%	48%	47%	46%	46%
	<i>Others</i>	48%	49%	51%	52%	53%	54%	54%
Batelco's Blended ARPU (USD)*		27.0	23.3	23.4	21.1	19.4	18.3	17.5

*based on active subscribers. Sources: Informa and NBK Capital

Jordan - Mobile Market Overview and Forecast

We believe that the growth that the Jordanian market witnessed during 9M2010 (7%) was due to the increased competitive activity in the market; however, it is likely that the market may see a slowdown in overall growth as penetration levels are already high in a market that is dealing with increased levels of consumer taxation. Thus, we forecast the total number of active subscribers will grow at a CAGR of 4% between 2010 and 2014, which will translate into a penetration rate of 112% at the end of 2014. We believe that Umniah will overtake the second market position from Jordan Telecom during the 4Q2010, as the company was able to secure a 44% share of the net additional subscribers during 9M2010. Hence, we are expecting the company's market share to reach 30% in 2014.

Umniah's blended ARPU declined by 2% to USD 12.3 in 9M2010 from USD 12.5 in 2009. We forecast Umniah's blended ARPU will reach USD 11.5 in 2014 due to increased competition.

Figure 2 Mobile Market in Jordan

Key Market Metrics		2009	9M2010	2010f	2011f	2012f	2013f	2014f
Total Mobile Subscribers*		5,886	6,280	6,428	6,815	7,084	7,303	7,530
<i>Growth</i>		10%	7%	9%	6%	4%	3%	3%
Market Share:								
	<i>Umniah</i>	27.6%	28.7%	29.6%	30.0%	30.0%	30.1%	30.3%
	<i>Others</i>	72.4%	71.3%	70.4%	70.0%	70.0%	69.9%	69.7%
Umniah's Blended ARPU (USD)*		12.5	12.3	12.1	11.9	11.8	11.7	11.5

*based on active subscribers. Sources: Informa and NBK Capital

Umniah number two by
4Q2010

Group Level Forecast

Taking all the above into consideration, we reviewed our previous forecast and incorporated the following changes:

- We now forecast total revenue will remain flat between 2009 and 2014 versus our previously forecasted CAGR of 3%. We believe that the mobile segment will remain the highest contributor to total revenues at 49% of the total revenue over our forecasted horizon.
- Although Batelco is trying to be more cost-efficient, we still believe that its EBITDA will be under constant pressure due to competition in the company's main markets. Thus, we believe that Batelco's EBITDA will decline at a CAGR of 1% between 2009 and 2014 versus our previously forecasted growth rate of 2%. This will translate into the EBITDA margin decreasing from its actual level of 43% in 2009 to 41% in 2014.
- According to management guidance, we forecast capital expenditures (CAPEX) will represent around 12% of total sales in 2010, which is around BHD 41 million. Going forward, we believe CAPEX as a percentage of sales will decrease to 10% by 2014.
- Our forecast for Batelco's net income excludes the group's share of results from associates. In our previous report, we forecasted the share of results from associates as it included only Sabafone operations. However, with the acquisition of STel and the limited disclosure on the contribution of each operation, we opted not to include the share of results from associates in our forecasts. For valuation purposes, we use the latest book value of Batelco's investments in associates.

Figure 3 New 2010 Forecast Compared with Previous Forecasts

(BHD Millions)	2009 Actual	2010F		2010 New Forecast Versus	
		Old	New	2009 Actual	Old 2010 F
Revenue	347	358.0	341.1	-1.7%	-4.7%
EBITDA	150	150.3	146.7	-2.4%	-2.4%
EBITDA Margin	43.3%	42.0%	43.0%		

Sources: Company financial statements and NBK Capital

Competitive pressures to
rationalize growth

WHAT'S THE STORY?

In Bahrain

Bahrain's telecommunications market has historically been one of the most competitive in the region. We believe that the active role of the regulator and the small size of the country have helped telecom operators introduce the latest technologies to the market and have contributed to the market's unique evolution. With the introduction of a new operator (Viva Bahrain) to the competitive landscape, we believe that there has been notable progress on both counts.

- **Viva Bahrain Off to an Aggressive Start:** March 3, 2010, witnessed the commercial launch of Viva Bahrain's operations. The operator introduced attractively structured mobile packages offering the following:
 - **Promotions:** For a three-month period, starting from the operator's launch date:
 - Free wireless broadband connectivity (with complimentary dongles)
 - Free on-net calls and international calls to Saudi Telecommunications Company (STC), Viva's parent company, subscribers in Saudi Arabia
 - Up to 90% off on international calls
 - **Subsidized Roaming Rates:** During March 2010, Viva Kuwait offered subsidized roaming rates to its customers roaming on Viva Bahrain's network and significantly reduced tariffs for those making international calls to Bahrain.

Compared to competitors, Viva Bahrain offers some of the most competitive local mobile tariffs with unified on-net and off-net rates (in contrast to its competitors offering different on-net and off-net tariffs). Following the expiration of the launch promotions, in June 2010, the operator introduced additional promotions offering free on-net calls during certain off-peak hours and weekends, calls to STC (Saudi Arabia) at local rates, and up to 90% off on international calls.

Viva Bahrain aims to capture, within the first two years of its operations, a 20% market share in the mobile market and a 30-40% market share in the broadband market.

- **Mobile Number Portability (MNP):** MNP is expected to be introduced in Bahrain within the next six months. However, conclusive deadlines for its implementation remain to be seen. We believe that the implementation of MNP will certainly increase competitive pressures in the mobile market.
- **Local Loop Unbundling in the Cards:** In April 2010, a number of fixed-line and broadband operators started to test Batelco's Local Loop Unbundling (LLU) service. The LLU service effectively grants third-party operators access to Batelco's native fixed-line copper network, enabling them to provide broadband and fixed-line services to residential and corporate consumers connected via Batelco's existing network. As of November 2010, the Telecommunications Regulatory Authority (TRA) has issued a draft order to Batelco to allow other licensed operators to use Batelco's fixed copper network on fair and non-discriminatory terms. Batelco is expected to respond to the draft order in about a month's time since issue, following which the TRA will issue a final order with which Batelco is expected to comply within 14 days from the date of issue. We believe this development will be a vital catalyst in accelerating the competitive evolution of Bahrain's fixed-line and broadband market.
- **Batelco Invests to Improve Mobile Network Technology:** April 2010 saw the launch of Batelco's 21 Mbps mobile broadband services. Subsequently, in May 2010, the operator contracted Ericsson to expand and modernize the mobile network. The agreement will help in increasing the network's high-speed packet access (HSPA) capability, expand the operator's 2G and 3G footprint, as well as prepare the mobile network for an eventual long-term evolution (LTE) transition. We believe this is a natural progression in Batelco's competitive strategy given Viva Bahrain's prior introduction of 21 Mbps mobile broadband speeds in March 2010.

Additionally, during 2Q2010 Batelco completed major enhancements to its BlackBerry platform to deliver connections that are up to 17 times faster over Batelco's global network.

- **Batelco Invests Further in International Cables:** In March 2010, Batelco signed an agreement with Global Bridge International (GBI) to provide GBI with a landing station for the company's new sub-sea cable. The new cable system will provide connectivity between countries in the Gulf region and onwards to Europe and Asia. The cable system is scheduled to launch during 2011, is designed to operate for up to 25 years, and will provide Batelco with increased international bandwidth capacity.
- **TRA Plays an Active Role:** The year 2010 continues to see an increasing participation by the TRA in terms of introducing new regulations and answering market participant grievances, with an underlying theme of fostering increased competition across the industry. The major regulatory developments are summarized as follows:
 - **Regulation of Termination Rates:** In February 2010, the TRA issued a determination declaring Zain Bahrain a dominant operator in Bahrain, leading to the subsequent regulation of termination rates (termination rates relate to the wholesale rates charged by one mobile operator to another, for calls, short message service [SMS], and multimedia messaging service [MMS]) terminating on its own network) charged by Zain Bahrain. As a result, Zain Bahrain and Batelco are now both considered dominant market players whose termination rates are regulated by the TRA. We believe this development will not only normalize the competitive advantage enjoyed by Zain Bahrain but will also be conducive to fostering Viva Bahrain's growth. Furthermore, this development also has the potential to further reduce mobile tariffs in the country, thereby eventually decreasing operators' margins.
 - **Deregulation of Batelco's Retail Tariffs:** Historically, Batelco's retail tariffs have been heavily regulated by the TRA, requiring the operator to obtain pre-introduction regulatory approvals for its new tariffs. However, February 2010 saw the introduction of a new framework for regulating retail tariffs. Under the new framework, Batelco is no longer required to acquire regulatory approvals for its tariffs, providing that the operator's pricing policies do not violate tariff controls (such as margin squeeze, predatory pricing, and excessive pricing) defined to protect consumers and to aid fair competition. We believe this new framework will, in the long-term, help Batelco protect its market share and promote further growth of competition in the market.
 - **TRA Committed to Maintain Fair Competition:** In August 2010, following complaints filed by 10 Bahraini telecom operators, the TRA ordered Batelco to increase its international call tariffs to Bangladesh and India. The complaints described Batelco's pricing margin as anti-competitive and predatory. In light of the new framework, the TRA clearly is looking to make mobile services more affordable for consumers. However, we believe that the TRA's prompt order for the upward revision of international call rates also confirms the telecom regulator's commitment to maintaining fair competition in the Bahraini telecommunications market.
 - **Registration of Prepaid Subscribers:** August 2010 also saw the issuance of the TRA's instructions to prepaid mobile subscribers in Bahrain, requiring them to properly register their lines with their mobile operators. Subscribers unregistered by August 31, 2010, were disconnected from the network. We believe this issue has resulted in pressuring Bahrain's mobile subscriber growth during 3Q2010, with the overall subscriber base declining by 2% QoQ to 1.41 million.
 - **Batelco's Third-party Internet Access Charges under Review:** During August 2010, following a complaint lodged by menatelecom (a local Internet services provider), the TRA ordered Batelco to reduce its rates charged to third-party operators in return for gaining access to Batelco's international Internet facilities. The rate charged by Batelco (to menatelecom) was reduced substantially to USD 25,800 a year from

USD 121,000 a year. We believe this sets a precedent for industry transactions of a similar nature and could result in reducing overall Internet retail tariffs in the country, making the industry more competitive, and thus creating the potential to increase Internet penetration rates.

In Jordan

We believe Jordanian mobile operators are maneuvering through a difficult period, despite the introduction of technological innovations in the market.

- Jordanian mobile consumers now enjoy 3G services—offered exclusively by Jordan Telecom (JTG) until February 2011. Subsequently, Zain also won a 3G license that will enable the company to provide 3G services following the expiration of JTG's exclusivity period. Umniah has yet to acquire a 3G license; however, we believe its acquisition will be the next natural step for the operator's competitive strategy.
- Although we believe these developments are positive stimulants for the mobile markets, mobile subscribers are now facing increased taxes on mobile services. As of August 2010, the Jordanian government increased the special tax applied on mobile calls from 8% to 12%. Hence, the effective tax rate payable by consumers now stands at 29.92%—we believe this high tax rate could hinder overall market growth.
- Competition has intensified significantly since the start of the year, with operators competing aggressively for the regional and local communication needs of consumers—via increasingly customized product offerings. The entry of Friendi mobile (Jordan's new mobile virtual network operator [MVNO]) during 2Q2010 further spurred the competitive pressures in the market. However, the telecom regulator ordered Friendi mobile to halt commercial services in August 2010. Because of limited information on the issue, we do not know the exact reasons for this event. However, we would like to point out that Umniah recently raised concerns over the mobile access and call origination (MACO) agreements between Zain Jordan and Friendi mobile.

In India

During 4Q2009, Batelco's Indian associate, STel, launched commercial operations in three (Bihar, Odisha, and Himachal Pradesh) out of the six category C circles the company was awarded licenses for. This operation launch was followed by STel's commercial launch in two more circles (Assam and the northeastern state) in 3Q2010. Since the operator's initial launch, STel's subscriber base reached approximately 1 million at the end of March 2010 and thereafter grew to 1.64 million by the end of September 2010. We believe the operator has been able to achieve this growth by offering its customers value-efficient tariffs and "Bulk Minutes" promotions, primarily targeting the low-income market segment. In terms of market share, according to the TRA's website, at the end of June 2010 STel maintained a 1.5%, 4.69%, and 2.69% share of the mobile market in Bihar, Himachal Pradesh, and Odisha, respectively. In May 2010, STel won spectrum licenses to provide 3G services in three circles (Bihar, Odisha, and Himachal Pradesh) for USD 76 million. The operator has budgeted for CAPEX of approximately USD 74 million, over the next five years, for its 3G network rollout in the respective circles and expects to launch 3G services during 2Q2011. We believe this rollout is a positive development for STel as the 3G network will enable the operator to service the high-end market segment in the near future.

However, as a caveat, we note that India's Department of Telecommunications (DoT) recently decided to send show cause notices to 85 operators, including STel, seeking responses about why the companies' respective licenses should not be cancelled over violations of eligibility conditions. The DoT's concerns over these show orders relate to non-compliance with eligibility conditions in relation to the memorandum of association, registration norms, and minimum paid-up share capital.

FINANCIAL STATEMENTS

Balance Sheet (BHD Thousands)		Historical		Forecast			
Fiscal Year Ends December	2008	2009	2010	2011	2012	2013	2014
ASSETS							
Cash and Short-Term Investments	153,540	76,400	122,825	159,048	186,617	213,764	254,837
Total Receivables, Net	61,409	49,398	61,397	61,221	61,203	61,187	61,552
Total Inventory	3,115	2,519	3,172	3,214	3,264	3,314	3,355
Prepaid Expenses	8,639	8,686	9,517	9,642	9,793	9,943	10,064
Other Current Assets, Total	2,666	5,136	5,290	5,449	5,612	5,781	5,954
Total Current Assets	229,369	142,139	202,201	238,575	266,489	293,988	335,760
Property/Plant/Equipment, Total - Net	206,686	196,019	185,352	186,679	184,456	177,715	164,068
Intangibles, Net	35,439	31,793	27,006	22,219	17,432	12,645	7,858
Long-Term Investments	117,980	177,996	169,059	169,059	169,059	169,059	169,059
TOTAL ASSETS	714,791	673,076	708,747	741,660	762,565	778,536	801,874
LIABILITIES & EQUITY							
Accounts Payable	57,735	45,990	52,870	53,569	54,403	55,238	55,909
Accrued Expenses	43,719	49,144	47,753	47,617	47,602	47,590	47,873
Current Port. of LT Debt/Capital Leases	74,757	36,569	-	10,000	10,000	10,000	20,000
Other Current Liabilities	31,117	32,012	27,288	27,209	27,201	27,194	27,356
Total Current Liabilities	207,328	163,715	127,911	138,395	139,207	140,022	151,139
Long-Term Debt	38,671	-	10,000	10,000	10,000	10,000	10,000
Deferred Income Tax	5,879	5,307	5,572	5,851	6,144	6,451	6,773
Minority Interest	10,648	10,731	10,731	10,731	10,731	10,731	10,731
Total Liabilities	262,526	179,753	154,214	164,977	166,081	167,204	178,643
Total Equity	452,265	493,323	554,533	576,684	596,484	611,332	623,231
TOTAL LIABILITIES AND EQUITY	714,791	673,076	708,747	741,660	762,565	778,536	801,874
Income Statement (BHD Thousands)		Historical		Forecast			
Fiscal Year Ends December	2008	2009	2010	2011	2012	2013	2014
Total Revenue	319,076	346,940	341,095	340,118	340,018	339,928	341,953
Cost of Revenue	93,013	103,895	105,740	107,137	108,806	110,477	111,819
Gross Profit	226,063	243,045	235,356	232,981	231,212	229,451	230,135
Selling/General/Admin. Expenses	60,728	63,058	59,692	61,221	61,203	61,187	61,552
Depreciation/Amortization	44,292	41,344	44,275	47,132	49,940	52,629	55,023
Operating Income	98,776	108,986	102,396	95,718	91,167	86,741	84,494
Interest Income (Exp), Net Non-Operating	(561)	240	3,887	5,936	7,332	8,700	10,004
Equity Income in Associates*	3,592	1,185	-	-	-	-	-
Other, Net	8,304	1,343	-	-	-	-	-
Net Income before Taxes	110,111	111,754	106,283	101,654	98,499	95,441	94,498
Provision for Income Taxes	2,210	2,936	2,683	2,939	3,074	3,160	3,242
Net Income after Taxes	107,901	108,818	103,600	98,715	95,425	92,281	91,256
Minority Interest	(3,694)	(3,777)	(3,966)	(4,164)	(4,372)	(4,591)	(4,821)
Net Income*	104,207	105,041	99,635	94,551	91,053	87,690	86,436
Cash Flow (BHD Thousands)		Historical		Forecast			
Fiscal Year Ends December	2008	2009	2010	2011	2012	2013	2014
Cash from Operating Activities	146,032	162,207	131,486	140,707	139,040	137,294	137,391
Cash from Investing Activities	(63,033)	(81,699)	(25,122)	(37,338)	(35,074)	(31,943)	(25,806)
Cash from Financing Activities	(143,116)	(157,648)	(59,939)	(67,145)	(76,398)	(78,204)	(70,512)
Net Change in Cash	(60,117)	(77,140)	46,425	36,224	27,569	27,146	41,073

*As explained on page 3, our forecasts for Batelco exclude the group's share of results from associates and any other investment gains or losses. Sources: Company financial statements and NBK Capital

RISK AND RECOMMENDATION GUIDE

RECOMMENDATION			UPSIDE (DOWNSIDE) POTENTIAL	
BUY			MORE THAN 20%	
ACCUMULATE			BETWEEN 5% AND 20%	
HOLD			BETWEEN -10% AND 5%	
REDUCE			BETWEEN -25% AND -10%	
SELL			LESS THAN -25%	
RISK LEVEL				
LOW RISK			HIGH RISK	
1	2	3	4	5

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