



EFG - Hermes

Etisalat

Saudi Arabia Starts To Deliver Growth

30 November 2005

United Arab Emirates | Telecom

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ST Rec. : Buy
LT Rec. : Accumulate

Current Price*: AED 29.5
LT Fair Value : AED 38.4

• We raise our LT FV for Etisalat to AED38.4 implying an upside potential of 30% to the current market price and 34% to our last FV for the company. We revise our ST/LT recommendation from Accumulate/Neutral to Buy/Accumulate.

• The upgrade is mostly due to the stronger than forecast performance for Etisalat in the UAE market in 2005 in addition to Mobily exceeding our estimates in the Saudi Market. We upgrade our UAE mobile subscribers estimate to 4.5 million at the end of 2005, versus our old forecast of 4.1 million. We also revise Mobily subscribers to 2.5 million subscribers, up from our previous 1.6 million estimate.

• 3Q2005 results came in strong, with net revenues and profits rising by 21% and 23% versus 3Q2004 to AED3.2 billion and AED1.1 billion, respectively. We are forecasting 2005 to be a good year with net revenues and profits rising by 20% and 23% to AED12.6 billion and 4.2 billion, respectively.

• The Etisalat consortium won a 26% stake in PTCL last June but the deal has not yet been finalized. We consolidate Etisalat's share of net profit in PTCL through the equity method. Etisalat's share in PTCL accounts for 3% of Etisalat's valuation, a potential downside risk to our valuation if the deal were not to be concluded. Etisalat recently pre-qualified for a 35% stake in the Tunisian state-owned fixed line operator, Tunisie Telecom and for Telsim, the second mobile operator in Turkey.

• On a peer valuation basis, Etisalat is trading at the high end of the valuation range on a forward P/E. It is trading on 05e and 06e P/Es of 25.5x and 21.2x. The stretched multiples are partially attributable to the payment of the royalty (50% of net profit) below the EBITDA line.

• However, it is interesting to note that if we both exclude Etihad Etisalat's estimated losses for 2005 from Etisalat's earnings and deduct the current market value of Etisalat's stake in Etihad Etisalat (AED6.8 per share) from Etisalat's market capitalization, Etisalat's adjusted 2005 P/E ratio drops to 17.8x.

December year end	2004a	2005e	2006e	2007e
Operating Income (mn)	6,854	8,396	9,204	9,262
Net Income (Attrib.) (mn)	3,418	4,192	5,055	5,859
ROE	25.7%	26.8%	27.8%	28.5%
EPS	0.94	1.15	1.39	1.61
EPS Growth	19.0%	22.6%	20.6%	15.9%
P/E * (Attrib.)	31.3	25.5	21.2	18.3
DPS	0.45	0.50	0.70	0.97
Dividend Yield	1.5%	1.7%	2.4%	3.3%
BVPS	3.7	4.3	5.0	5.7
P/BV*	8.06	6.84	5.89	5.22
CFPS (Operating CF)	1.2	1.7	2.1	2.3
P/CF	23.9	17.8	14.2	12.8
EBITDA (mn)	8,090	9,740	10,643	10,795
EBITDA Margin	62.2%	62.4%	59.9%	55.9%
EV/EBITDA	12.4	10.2	9.0	8.7
EV/Sub (Blended)	20,552	17,291	15,376	14,648
Net Debt (Cash)** (mn)	(6,977)	(7,806)	(11,517)	(12,799)
Net Debt (Cash) / BV**	-53%	-50%	-63%	-62%
Net Debt (Cash) / Mkt Cap**	-7%	-7%	-11%	-12%

**excluding dividends

Fig in AED unless otherwise stated



Estimate Changes		2004a		2005e		2006e	
(AED mn)		Old	New	Old	New	Old	New
Revenues	13,010	14,205	15,611	14,929	17,769		
EBITDA	8,090	9,143	9,740	8,952	10,643		
EBITDA Margin	62.2%	64.4%	62.4%	60.0%	59.9%		
Net Attrib. Inc.	3,418	3,360	4,192	3,476	5,055		

Stock Data:

Last Ex-Div Date	AED0.25 on 10 July 05
Mkt. Val. (mn)	AED107,085
Shares (mn)	3630
Av. Mthly Liqd. (mn)	AED774 mn
52-Week High / Low	AED47.0 / 18.5
Bloomberg / Reuters	ETISALAT UH / ETEL.AD
Est. Free Float	40.0%

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*As at 28 November 2005

KINDLY REFER TO THE IMPORTANT DISCLOSURES AND DISCLAIMER ON PAGE 13.

I. VALUATION

A. DCF Valuation

We revise our LT fair value for Etisalat to AED38.4, 34% above our previous LT fair value and 30% above the current market price of AED29.5 per share. We raise our fair value as a result of the following:

a) Etisalat (stand-alone)

i) We raise Etisalat's mobile subscribers estimate for 2005 to 4.5 million, up from 4.1 million in our previous forecast, to reflect the stronger than expected growth in Etisalat's mobile subscriber base in the first nine months of 2005. This is in addition to the possible delay to the start of operations of the second telecom operator in the UAE from the beginning of 2006 to mid 2006, allowing for more time for Etisalat to add subscribers in a monopoly environment.

ii) We believe Etisalat will continue to deliver strong results in the second half of 2005 (which was partially witnessed in 3Q2005). This goes against our previous assumption that revenues would slow down. We expect 2005 net revenues from domestic operations will grow 20% to AED12.6 billion compared to our old estimate of AED11.6 billion. We also revise Etisalat's top line going forwards, forecasting an annual average growth rate of 3% for revenues compared to 1% in our previous forecast.

iii) The company capitalized some of its assets in 2003 which led to an overstatement of the depreciation charge in 2003 and a decline in the depreciation expense in 2004. Since the company does not expect that this will occur again this year, we have revised our depreciation assumptions for 2005 going forward. This, in addition to the rise in revenues mentioned above, has led to a rise in the estimated 2005 net operating profit (calculated by EFG-Hermes) from our old estimate of AED7.5 billion to AED8.4 billion. In 2010, we now forecast a rise to AED9.6 billion versus our old estimate of AED6.6 billion.

b) Regional Operations

iv) We revise upward our mobile subscribers estimate for the Saudi market due to the strong performance of Etihad Etisalat in the first six months of operation. Etihad Etisalat is commercially known as Mobily and is 35% owned by Etisalat. We have also incorporated into our forecast the likely entrance of a third mobile operator by 2007. Accordingly, we forecast a rise in the penetration rate to 100% in 2010 versus our old estimates of 70%. We forecast that Mobily will end 2005 with 2.5 million subscribers versus the 1.6 million previously forecast.

v) We reduce the cost of equity for Etihad Etisalat from 12.2% to 11.2%. The risk of a third operator entering the market is already factored into our forecasts, thus eliminating the need for a higher risk premium to reflect that risk.

vi) We consolidate Etisalat's share of the net profit in Pakistan Telecom (PTCL) through the equity method. We discuss the Pakistani telecom market and Pakistan Telecom briefly in section III C. We believe that the Pakistani operations account for approximately 3% of Etisalat's valuation. We include the Pakistani operations in our forecast despite the possibility of the deal being called off with the Pakistani Privatization Commission (PC). We expect a 50-50% chance that the deal be finalized towards the end of 2005. We are highlighting that in case of failure to conclude the deal, we will revise our FV downwards by 3% to reflect the exclusion of Etisalat's share of earnings in Pakistan Telecom.

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We did not include Atlantique Telecom in our valuation since we believe that the value of its operations today is immaterial to Etisalat's valuation. We also continue to believe that despite the potential for growth in the Sudanese telecom market, the value of Etisalat's stake in Kanartel (the consortium that won the second fixed line license in Sudan in November 2004) is still insignificant relative to Etisalat as a whole. We upgrade our ST recommendation on Etisalat from Accumulate to Buy.

Its worth noting that the market capitalization of Etihad Etisalat currently amounts to AED70.6 million (as at 27 November 2005, Tadawul), which implies a 60% premium to our estimated equity value of AED44.1 billion.

Table 1.1: Etisalat's Sum-of-The-Parts DCF valuation

AED (mn)	2005e	2006e	2007e	2008e	2009e	2010e	2011e	2012e
Etisalat (incl Pakistan Operations)								
COPAT	5,932	6,948	7,530	8,186	8,801	8,926	9,197	9,477
Capex & Chg. In WI	(567)	(163)	(200)	(509)	(471)	(492)	(514)	(483)
FCF	5,365	6,785	7,330	7,677	8,330	8,434	8,683	8,995
WACC	9.4%							
Terminal Growth	3.5%							
EV	123,119							
Net Debt (Cash)	(831)							
Equity Value	123,950							
Equity Value per share	34.1							
Etihad Etisalat								
COPAT		237	1,136	2,754	3,927	5,038	5,042	5,068
Capex & Chg. In WI		(1,146)	(403)	(542)	(682)	(871)	(782)	(605)
FCF		(909)	733	2,212	3,245	4,167	3,937	4,136
WACC	9.8%							
Terminal Growth	4.5%							
EV	52,565							
Net Debt (Cash)	8,427							
Equity Value	44,138							
Etisalat Equity Stake (35%)	15,448							
Equity Value per share	4.3							
Long Term Fair Value	38.4							

Source: EFG-Hermes Estimates

Downside Risks to Our Valuation

On the Domestic Front: As we mentioned in our previous note, "Regional Ambitions with Resources to Match" dated March 5 2005, the market share that the UAE second operator is expected to gain depends heavily on the regulatory environment in the UAE at the time of its entrance. Should the telecom authority allow more freedom to the new entrant and it pursues a more aggressive strategy than we anticipate, then we see Etisalat losing more than our estimated 10% market share for the fixed line market and 15% for the mobile market by 2010.

On the Regional Front: The degree of market deregulation would affect how a potential third operator behaves in the Saudi market. If the regulatory authority allowed for favorable market conditions such as Mobile Number Portability (MNP) to attract entrants into the market, this would be in favor of the new entrant. MNP is currently under study by the regulatory authority with a probability of being implemented next year.

Etisalat has announced that it is encountering problems in finalizing the deal with Pakistan Telecom. Etisalat is currently discussing certain requests with the privatization commission, however, the time frame to conclude the deal has not yet been set. Since the share of Etisalat in Pakistan Telecom accounts for an estimated 3% of our valuation for Etisalat, the downward risk to our valuation is limited should Etisalat fail to conclude the deal successfully. The net profit of Etisalat would also come under our expectations by 8%.

B. Comparable Valuation

Etisalat is trading at the high end of the valuation range on a forward P/E. The stretched P/E multiples are partially attributable to the payment of the royalty (50% of net profit) below the EBITDA line. However, it is interesting to note that if we exclude Etihad Etisalat's estimated losses for 2005, Etisalat's adjusted 2005 P/E ratio drops from 25.5x to 23.1x. If we also deduct the current market value of Etisalat's stake in Etihad Etisalat (AED6.8 per share) from Etisalat's market capitalization, Etisalat's adjusted 2005 P/E ratio drops further to 17.8x.

It is worth noting that 2005 is expected to be a good year for Etisalat, with total company earnings growing 23%. However, Etisalat is expected to face competition in its local market by 2006 with pressure on company margins and earnings likely to rise from 2007, depending on the aggressiveness of the new entrant and its strategy for gaining market share. This, in addition to the start-up nature of Etihad Etisalat in Saudi Arabia, is putting slight downward pressure on the company's earnings in the early stages of operation. However, we forecast earnings will be sustained beyond 2005 both by an expected decline in the royalty payment paid by Etisalat to the UAE government due to the loss of its monopoly and growth in the Saudi operations.

Table 1.2: Comparable Valuation of Etisalat with Peers in the EMEA Region¹

Operator	Country	Price	Mkt Cap	EV/Revenue			EV/EBITDA			P/E			Div. Yld
		LC*	(USD mn)	05e	06e	07e	05e	06e	07e	05e	06e	07e	04
Middle East & Africa													
Jordan Telecom(JOD)	Jordan	5.530	1,953	3.7	3.7	3.6	7.9	8.5	8.5	19.0	21.3	22.6	3.3%
Sudatel (AED)	Sudan	129.2	2,322	3.6	2.6	2.2	5.4	4.0	3.4	8.5	6.8	5.7	7.8%
Batelco (BHD)	Bahrain	1.185	3,143	4.9	5.0	5.0	8.7	9.1	9.3	14.1	15.4	16.3	3.4%
Qtel (QAR)	Qatar	223.9	6,145	7.3	6.0	5.3	12.2	10.4	9.7	19.7	17.9	13.8	3.8%
Maroc Telecom (MAD)	Morocco	101.0	9,410	4.0	3.7	3.5	7.1	6.5	6.2	15.1	13.9	12.9	5.0%
Telkom (ZAR)	Sth Africa	137.0	11,305	2.0	2.0	1.9	4.8	4.7	4.6	9.9	9.7	9.4	6.6%
Etisalat(AED)	UAE	29.50	29,147	6.1	5.3	4.9	9.7	8.9	8.8	25.5	21.2	18.3	1.5%
Etisalat (excl. Etihad Etisalat)**		29.50	22,442	4.8	4.2	3.9	7.7	7.1	7.0	17.8	15.2	13.8	2.0%
Europe													
Magyar (HUF)	Hungary	969.0	4,828	2.3	2.3	2.2	5.6	5.6	5.6	14.0	13.2	12.5	7.2%
Cesky (CZK)	Czech	496.8	7,157	3.0	3.0	3.0	6.7	6.8	6.8	25.5	20.6	19.0	7.2%
OTE (EUR)	Greece	17.58	10,417	1.9	1.8	1.8	8.9	4.6	4.3	N/R	15.7	12.8	0.0%
TPSA (PLN)	Poland	24.00	11,205	2.5	2.5	2.5	5.4	5.7	5.6	17.9	17.0	15.9	1.4%

*Local Currency, Prices for Middle East operators are as at 28 November 2005, prices for the remaining companies are as at 25 November 2005

**Multiples adjusted for the exclusion of Etisalat share in Etihad Etisalat at market value

Figures are in USD million unless otherwise stated

Sources: RKIM and EFG-Hermes Estimates

It is worth noting that Etisalat's earnings include its share of earnings in Pakistan Telecom. If we were to exclude the earnings from PTCL, Etisalat would be trading at a P/E of 27.6x, 22.1x, and 19.0x for 2005, 2006 and 2007 respectively. On the other hand, on an EV/EBITDA basis, Etisalat would be trading at a discount if we were to exclude the Pakistani operation, since the net cash position improves as a result of not including the debt that will arise in buying the 26% stake in PTCL. On a forward EV/EBITDA, Etisalat (excluding PTCL's related debt) would be trading at 10.0x, 8.8x and 8.4x for 2005, 2006 and 2007 respectively.

Currently, Etisalat's dividend yield is 1.5% which is very low compared to peers in the Middle East and Africa. We forecast Etisalat's dividend yield will rise to 6.5% by 2010. We forecast Etisalat will have a net cash position (excluding dividends) of 7% and 11% of market capitalization in 2005 and 2006 respectively. The company mentioned its intention to continue expansions in the region with particular interest in Egypt, Tunisia, Turkey, Iraq and Lebanon. Etisalat recently pre-qualified in the bid to acquire the 35% stake in Tunisie Telecom that is being privatized by the government. Etisalat also pre-qualified in the bid for Telsim, the second mobile operator in Turkey.

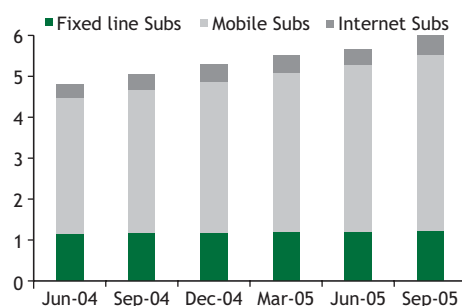
We upgrade our LT recommendation from Neutral to Accumulate to reflect potential growth opportunities that Etisalat is seeking in the region in the near future, the improvement in its Free Cash Flow (FCF) as a result of the anticipated decline in the royalty paid by Etisalat to the UAE government and the maturing of the Saudi operation. FCF yield is expected to rise from 3% in 2004 to 9% in 2010.

II. FINANCIAL RESULTS

Etisalat 9M2005 Results

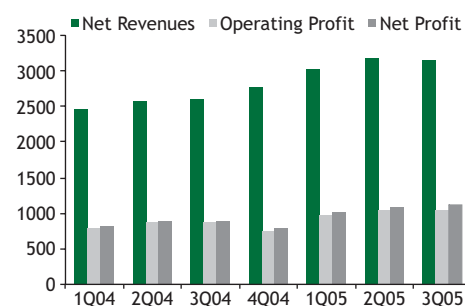
Etisalat continued its strong performance of the first six months of 2005 into the third quarter. In 3Q2005 Etisalat recorded 21% growth in net revenues to AED3.2 billion versus AED2.6 billion in the same quarter last year. Year on year, fixed line subscribers rose 4% to 1.2 million, mobile subscribers rose 23% to 4.3 million and internet subscribers rose 20% to 0.470 million in 9M2005 compared to the same period in 2004.

Figure 2.1: Etisalat Quarterly Subscriber Mix (mn)



Source: Etisalat Financial Statements

Figure 2.2: Etisalat's Revenues, Operating Profit and Net Profit (AED mn)



Etisalat's operating profits increased 20% to AED1.0 billion in 3Q2005, up from AED875 million in 3Q2004. The company recorded a 23% rise in net profit to AED1.1 billion compared to AED906 million in 3Q2004. The Board of Directors announced on July 4th 2005 the distribution of a semi-annual dividend for 2005 of AED0.25 per share, representing a 1.7% dividend yield (annualized). The ex-dividend date was on 10 July 2005.

III. FORECASTS

A. UAE Operations (Etisalat)

Etisalat Monopoly to end this year

Etisalat no Longer a Monopoly in 2006...

In May 2005, the Telecom Regulatory Authority (TRA) in the UAE announced its approval for the establishment of a new company to provide telecom services (national & international voice telephony, internet and data) in the country. This announcement ended the exclusivity that Etisalat has enjoyed over telecom services. The new entrant will be a local venture, with the state pension and social security fund holding 40%, the Authority of Dubai Technology, E-Commerce, and Media Free Zone (Tecom) holding 40% stake with the remainder being floated to UAE citizens. The company will be headquartered in Dubai with a capital of AED4 billion (US\$1.1 billion) and is expected to start operations by mid 2006.

Change in Etisalat Forecast

Our previous forecast assumed the entry of the second telecom operator at the beginning of 2006. However, since there has been no indication as to the status of the new company's network or the starting date for operations, we have shifted the entry of competition to mid 2006.

Fixed line Subscribers

The incumbent fixed line operator usually retains a dominant market share...

Our previous set of projections already incorporated the entrance of competition in the international, mobile and internet market. However, our previous forecasts did not include competition in the fixed line segment. Our new projections incorporate competition in the fixed line market. We do not believe Etisalat will lose much market share in the fixed line market due to the huge investments the competition will have to deploy to provide fixed line services. We believe the impact on Etisalat will be minor at least in the early stages of competition. Given that the new entrant is also partially government owned, we believe that the regulatory authority in the UAE will try to facilitate its entrance without there being a significant reduction in prices. At the moment it is very difficult to draw a picture as to how both operators will operate in the market until further information regarding the regulatory aspects, national roaming and interconnection agreements are clarified. However, looking at other emerging market experiences such as in Korea and Eastern Europe, the incumbent fixed line operator usually retains a majority market share while the alternative fixed line operator retains only 6-7% market share. Given that the second entrant in the UAE will be backed by the government, we do not exclude the probability that the new company will have the financial means to invest heavily in infrastructure building its own backbone network, benefiting from the ongoing and expected construction and economic booms in the UAE over the coming period.

Impact of competition would be mostly felt starting 2007

Since we assume the entry of the second operator by mid 2006, we do not expect its impact on the market will be very significant in 2006. We also believe that the new company might be roaming on Etisalat's network for the first few months, until it establishes its own network. We believe that Etisalat's fixed line market share would decline to 90% by 2010 with its share of net additions declining to 60%. Should the regulatory environment change over the coming period, we might need to revise our forecasts downwards to reflect the possible change in market dynamics and market shares.

Table 3.1: UAE Fixed line Market Indicators

	2002	2003	2004	2005e	2006e	2007e	2008e	2009e	2010e
Population (mn)	3.8	4.0	4.3	4.6	4.9	5.2	5.5	5.8	6.1
Teledensity	28.8%	28.4%	27.8%	27.2%	26.7%	26.4%	26.0%	25.8%	25.7%
Fixed Line Subscriber Additions (mn)	0.04	0.04	0.05	0.06	0.05	0.05	0.04	0.04	0.04
Total Fixed Line Subscribers (mn)	1.1	1.1	1.2	1.2	1.3	1.3	1.3	1.4	1.4
Etisalat Share of Net Additions	100%	100%	100%	100%	80%	75%	65%	65%	60%
Etisalat Fixed line Subscribers (mn)	1.09	1.14	1.19	1.24	1.28	1.32	1.35	1.38	1.41
Market Share of Etisalat	100%	100%	100%	100%	99%	97%	94%	92%	90%
2nd Operator Share of Net Additions	0%	0%	0%	0%	20%	25%	35%	35%	40%
Market Share of 2nd Operator				0%	1%	3%	6%	8%	10%

Sources: UAE Ministry of Planning, Etisalat and EFG-Hermes Estimates

Mobile Subscribers

Mobile Subscribers' forecast revised slightly upwards

With the market close to saturation, we had previously expected subscriber additions to slow down by end 2005 and 2006. However, with the announcement of the introduction of competition over the next year, Etisalat has continued to gain subscribers at the same high pace, beating our expectation for the year. We revise our mobile subscriber figure in 2005 upwards, forecasting that the company will close the year with 4.5 million mobile subscribers versus our previous estimate of 4.1 million. Since by the time competition enters, the mobile market will be fully saturated, we believe that subscribers would be mostly gained through churn and market segmentation. We forecast that beyond 2006, subscribers would grow at the same rate as population growth. We also believe that the penetration rate in the UAE might exceed the 100% level, similar to European and Asian countries such as Sweden, Portugal, the UK and Hong Kong as mobile users in high per capita countries tend to own two mobile lines, for business as well as personal use. We expect that we will be seeing the full impact of competition by 2007 with Etisalat losing a market share of 6% to the new entrant, rising to 15% by 2010.

Table 3.2: UAE Mobile Market Indicators

	2002	2003	2004	2005e	2006e	2007e	2008e	2009e	2010e
Population (mn)	3.8	4.0	4.3	4.6	4.9	5.2	5.5	5.8	6.1
Total Mobile Subscribers (mn)	2.4	3.0	3.7	4.5	5.0	5.4	5.8	6.2	6.5
Growth in Mobile Subscribers	27%	22%	24%	22%	12%	8%	7%	6%	5%
Mobile Subscriber Additions (mn)	0.5	0.5	0.7	0.8	0.5	0.4	0.4	0.3	0.3
Penetration Rate (pop)	64%	74%	86%	98%	103%	105%	106%	106%	106%
Etisalat Mobile Subscribers (mn)	2.4	3.0	3.7	4.5	4.9	5.1	5.3	5.4	5.5
Etisalat Share of Net Additions	100%	100%	100%	100%	80%	47%	36%	33%	32%
Market Share of Etisalat	100%	100%	100%	100%	98%	94%	90%	87%	85%
2nd Operator Mobile Subscribers (mn)	-	-	-	-	0.11	0.32	0.56	0.79	0.99
2nd Operator Share of Net Additions	0%	0%	0%	0%	20%	53%	64%	67%	68%
Market Share of Second Operator	0%	0%	0%	0%	2%	6%	10%	13%	15%

Sources: UAE Ministry of Planning, Etisalat and EFG-Hermes Estimates

Etisalat's impressive revenue performance is expected to continue in 4Q2005

Revenues, EBITDA and Net Operating Profit

In our previous forecasts, we also expected a slight slowdown in mobile revenues in 2005 due to projected market saturation. However, Etisalat continued with its impressive performance in the first nine months of 2005 and we expect that it will continue to grow at this pace over the rest of 2005, exceeding our old estimates. We, therefore, forecast that in 2005 the company net revenues will rise 21% to AED12.6 billion versus our old estimate of AED11.6 billion. We are forecasting that the full impact of competition is expected to hit by 2007, with growth in net revenues expected to slow down to 4.6%. Going forward, we project that net revenues will grow at an annual growth rate of 3% versus our old estimate of 1% annually.

A change in our depreciation assumptions partially led to a rise in Net Operating Profit

When we first initiated coverage of Etisalat, the company had only released its preliminary 2004 results. Our top and bottom line figures were in line with the company's results. After the company published its full financial statements and breakdowns, the EBITDA margin came in lower than our 2004 estimate by 1%. We therefore lower our EBITDA margin estimate for 2005 to 62.4% compared to 63.4% in our previous forecast. The depreciation expense also came below our expectations for the year by 20% and 14% below the 2003 depreciation expense. This is the result of capitalizing some of the assets in 2003 which led to overstating the depreciation expense in the same year and a decline in the depreciation expense in 2004 to AED1.2 billion versus our estimate of AED1.5 billion and AED1.4 billion in 2003. Accordingly, our estimate of the net operating profit (calculated by EFG-Hermes) came 3% below 2004 net operating profit to reach AED6.8 billion versus our previous estimate of AED6.6 billion in 2004. Since the company does not expect that this would occur this year, we have revised our depreciation assumptions for 2005 going forwards. This, in addition to the rise in revenues mentioned above, has led to a rise in our 2005 net operating profit forecast from AED7.5 billion to AED8.4 billion, and from AED6.6 billion to AED9.6 billion for 2010.

Profits from Domestic Operations

We forecast that profits from Etisalat operations in the UAE will grow 23% to AED4.2 billion in 2005, up from AED3.8 billion in our old estimates. The upward revision is mostly a result of the expected rise in revenues in the second half of 2005. In 2006 and 2007, we forecast a decline in the growth rate of net profit, as a result of the impact of competition kicking in by mid 2006. However, this is expected to be partially offset by the projected decline in the royalty payment that we are foreseeing as a result of Etisalat losing its monopoly over the telecom market. As per our initiation of coverage note in March 2005, we forecast a gradual decline in the royalty payment by Etisalat from the current 50% of net profits to 30% by 2009 and onwards.

B. Saudi Operations (Etihad Etisalat)

Mobily gains 2.2 million subscribers since starting operations

Etihad Etisalat launched its operations at the end of May 2005, under the commercial name "Mobily". According to Mobily, the company gained 2.2 million subscribers in nearly 6 months since it began operations. The company also reported a net loss of SAR386 million for the three months ending June 2005. Given the current rate of subscriber additions at Mobily, we believe that Mobily will significantly exceed our expectation of 1.6 million subscribers by the end of 2005. We revised our forecasts for the Saudi market to reflect: i) the expected increase of Mobily subscribers in 2005 and ii) to incorporate the entrance of a third mobile operator anticipated in mid 2007. The regulatory authority, the Communication and Information Technology Commission (CITC), has recently announced its intention to allow a third mobile operator into the market and a couple of international operators have expressed interest.

The entrance of a third mobile operator will accelerate subscribers growth

The entrance of a third operator is expected to push the penetration rate above our previous expectations of 64% in 2007 to 85%. Both operators will try to aggressively gain subscribers and market share before the entry of the third operator to raise the barriers to entry. We project mobile subscribers will reach 27.3 million in 2010 versus our old estimate of 21.3 million.

CITC has granted STC a 3G license for SAR754 million. Along with Mobily (which already has a 3G license), both operators are expected to provide 3G enabled services by early 2006, a source of revenue that is yet to be tapped.

Table 3.3: Saudi Arabia Mobile Market Indicators (assuming a 3 operator scenario)

	2003a	2004a	2005e	2006e	2007e	2008e	2009e	2010e
Population (mn)	23.3	23.9	24.4	25.0	25.6	26.2	26.8	27.3
Total Mobile Subscribers (mn)	7.5	9.2	12.9	17.4	21.9	25.1	26.7	27.3
Growth in Subscribers	51%	23%	39%	35%	26%	15%	6%	3%
Net Additions (mn)	2.5	1.7	3.6	4.5	4.5	3.3	1.5	0.7
Penetration Rate (pop)	32%	39%	53%	69%	85%	96%	99%	100%
Mobily Net Subscribers (mn)	0.00	0.00	2.50	4.99	7.34	8.69	9.29	9.57
Mobily Share of Net Additions	0%	0%	69%	55%	52%	41%	40%	40%
Market Share of Mobily	0%	0%	19%	29%	34%	35%	35%	35%
STC Net Subscribers (mn)	7.5	9.2	10.3	12.4	14.3	15.3	15.8	16.0
STC Share of Net Additions	100%	100%	31%	45%	42%	32%	30%	30%
Market Share of STC	100%	100%	81%	71%	65%	61%	59%	58%
3rd Operator Net Subscribers (mn)	0.0	0.0	0.0	0.0	0.3	1.1	1.6	1.8
3rd Operator Share of Net Additions	0%	0%	0%	0%	6%	27%	30%	30%
Market Share of 3rd Operator	0%	0%	0%	0%	1%	5%	6%	7%

Sources: STC, EIU and EFG-Hermes Estimates

Mobily gaining the majority of additions in 2005...

We are forecasting that Mobily will close the year with 2.5 million subscribers with a share of net additions of 69-70%, with prepaid subscribers accounting for the majority of subscribers. We believe Mobily will try to increase its postpaid to prepaid subscriber mix in the coming period to attract high-end customers and to maintain a healthy ARPU level. We forecast that Mobily would more than double its subscribers by next year while its market share would exceed 30% within two years from the start of operations.

Given that the latest number of mobile subscribers for STC is not available, we made a crude assumption that STC will add 1.1 million subscribers based on their average monthly additions. We forecast that STC will close the year at 10.3 million subscribers. We expect STC will try to increase its share of net additions in 2006 by lowering its tariffs, which are currently on average higher than Mobily's tariffs, and to try to offer more competitive packages in order to compensate for the slowdown in additions in 2005.

We project that STC will maintain its market leadership with a market share projected to reach 58% in 2010 while Mobily is expected to achieve a market share of 35% by the end of 2010.

The role of the regulatory authority is crucial in the coming period

We conservatively forecast that the third operator will gain a market share of 7% by 2010. However, if the two existing players decided to reap the benefit of a duopoly and jointly agree not to reduce tariffs much over the period before the 3rd operator enters, this would give the 3rd operator leeway to enter the market with very low prices to attract new subscribers as well as to induce churn from the existing two operators. Another factor that would support the third entrant is the implementation of MNP.

We do not exclude the idea that the two operators would lobby to extend the exclusivity period beyond September 2006. However, until there is further clarification from the regulatory authority, we prefer to stick to our three operator scenario.

Table 3.4: Etihad Etisalat Financial Indicators

Figures in AED unless otherwise stated	2005e	2006e	2007e	2008e	2009e	2010e
Mobily Subscribers (mn)	2.50	4.99	7.34	8.69	9.29	9.57
ARPU (AED)	125.5	106.7	93.9	88.2	84.7	82.2
ARPU (USD)	34.2	29.0	25.6	24.0	23.1	22.4
Gross Revenues (mn)	1,217	4,842	7,612	9,179	9,810	10,068
EBITDA (mn)	(99)	237	1,136	2,754	3,927	5,037
EBITDA Margin (%)			15%	30%	40%	50%

Source: EFG-Hermes Estimates

Given the strong subscriber additions in the first few months of operation and the upward revision of our subscriber forecast going forward, we believe that Etihad Etisalat's financial performance might surprise on the upside and its EBITDA might turn positive sooner than expected.

C. Pakistan Operations

Telecom Market

Pakistan Telecommunication Company Ltd (PTCL) is the fixed line operator in Pakistan. The company is 88% owned by the government with the remainder accounted for by free float. PTCL provides mobile services through Pakistan Telecommunication Mobile Limited (PTML), a 100% owned subsidiary. PTCL also provides internet services through Paknet, the largest ISP in Pakistan.

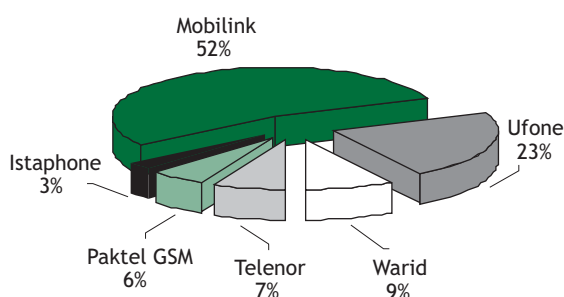
PTCL lost its monopoly over fixed line in 2003

PTCL is the leading telecommunication service provider in Pakistan with fixed line subscribers currently reaching 5.2 million, implying a penetration rate of 3.4% (source: Pakistan Telecommunication Authority (PTA)). After seven years of exclusivity for PTCL, the company lost its monopoly, as the market was liberalized in 2003 and several Long Distance and International (LDI) and Local Loop (LL) operators have shown interest in the fixed line market. 12 LDI and 38 LL licenses were granted after the operators met all the requirements. Still, we expect PTCL will play a dominant role in the fixed line market as the new entrants have to rely on PTCL infrastructure until they build their own.

Six players sharing the mobile market in Pakistan

There are six mobile operators in Pakistan. The operators are PTML, (under the brand name: Ufone), the mobile subsidiary of Pakistan Telecom, Mobilink, the 88% subsidiary of Orascom Telecom, Telenor, Paktel, Instaphone and Warid Telecom. As at September 2005, total mobile subscribers reached 16.9 million, implying a penetration rate of 10.9% (Source: PTA).

Figure 3.5: Market Share of the Mobile Operators in Pakistan (September 2005)



Source: Pakistan Telecommunication Authority

In the FY ending June 2005, PTCL's revenues grew 7.4% to PKR84.1 billion (USD1.4 billion). Operating profits declined by 12% to PKR38.1 billion with the operating profit margin falling by almost 10% to 45.4%. Net profit declined by 8% to PKR27 billion.

Etisalat Consortium the winner of the government stake in PTCL

Privatization of Pakistan Telecom

In line with liberalizing the telecom market, the Pakistani government put a 26% stake in PTCL up for sale to a strategic investor along with management control. In June 2005, an Etisalat-led consortium offered the highest bid at USD2.6 billion (AED9.5 billion), followed by China Mobile (Hong Kong) Ltd. at USD1.4 billion and Singapore Telecommunications at USD1.2 billion. The Etisalat consortium includes Dubai Islamic bank which holds a 10% stake in the consortium and will provide 10% of both the equity and the debt in the transaction.

In August 2005, Etisalat announced that it had appointed seven banks as mandated lead arrangers to finance a USD2.1 billion loan. This is expected to cover 90% of the purchase price. The seven banks are HSBC Amanah, Barclays Capital, Calyon, Citigroup, Deutsche Bank, National Bank of Abu Dhabi, and National Bank of Dubai. The 18-month Islamic bridge facility will be used to finance Etisalat's share of the final payment that was expected to be paid by the end of August 2005. The consortium had paid 10% of the transaction value earlier in June. Etisalat announced encountering difficulty with the Pakistani Privatization Commission in finalizing the deal with the final payment not having yet been made. Etisalat is pushing to reduce the initial price that it initially offered (USD2.6 billion) to USD1.4 billion, the price that the second highest bidder, China Mobile, offered back in June. In addition, Etisalat has other requests including asking the government to make certain changes in the top management of PTCL and to reduce the amount that the government is planning on paying PTCL employees from PKR5 billion to PKR1 billion. Currently, the parties involved are trying to resolve the issues at hand, with no set date to finalize the deal.

D. Africa Operations

In April 2005, Etisalat acquired 50% stake in Atlantique Telecom² and a 10-year management contract to manage the company's mobile operations in West Africa. The operations are in the following countries: Côte d'Ivoire, Benin, Burkina Faso, Gabon, Niger and Togo. The deal was valued at EUR100 million (USD124 million). No further information is currently available regarding the acquisition.

The above-mentioned six countries have an estimated population of 58 million (Worldfactbook, July 2005 estimate) with GDP/Capita ranging from USD260 (Niger) to USD850 (Côte d'Ivoire), with the exception of Gabon, which has the highest GDP/Capita at USD5,470. Its worth noting that these countries have young populations (around 40-50% of the population is between 0-14 years of age) and a large percentage of the population is below the poverty line. Fixed line and mobile penetration rates in these countries range from less than 1% (Niger) to 9% (Côte d'Ivoire). Gabon is the only country that has a high fixed line and mobile penetration rate of 25%, yet it is the smallest in terms of population (1.4 million).

Poor infrastructure and a low telecoms penetration rate present an opportunity for growth in the mobile market given an encouraging economic and political environment. Since we do not have further information regarding the telecom market and the regulatory environment in these countries and we believe the overall impact on Etisalat's value to be low, we did not include Atlantique Telecom in our forecasts until further clarifications from the company.

Other Possible Operations

Etisalat recent pre-qualified for a 35% stake in Tunisie Telecom, the fixed line operator in Tunisia. Etisalat was among 13 short listed bidders from the Middle East and Europe including Batelco of Bahrain, Saudi Oger, Saudi Telecom Company, Telefonica of Spain, France Telecom, Telecom Italia, Vivendi Universal of France and Portugal Telecom. The Ministry of Technology and Communications in Tunisia announced early this year its intention to privatize Tunisie Telecom and the winner is expected to be announced early 2006. Tunisie Telecom is the sole fixed line operator in the country and provides mobile services (35% market share) along with Tunisiana, the mobile operator owned by Orascom Telecom and Wataniya of Kuwait. Currently, the fixed line and mobile subscribers in Tunisia stand at 1.2 million and 4.5 million, implying penetration rates of 11% and 40% respectively.

Etisalat also prequalified among 12 other international operators for Telsim, the second mobile operator in Turkey. The winner is expected to be announced by early December 2005.

Etisalat announced in August its intention to expand its operations in Egypt through applying for the third mobile license. Among other known contenders is MTC of Kuwait. The pre-qualified applicants are expected to be announced in the coming few months with operations expected to start by 2007.

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Financial Statements (December year end)

(AED mn)	2003a	9M04	2004a	9M05	2005e	2006e	2007e	2008e
Balance Sheet								
Cash & Liquid Assets	7,917	8,846	7,802	7,656	8,714	12,781	14,557	15,840
Accounts Receivable & Prepayment	769	896	1,576	2,091	2,206	2,647	3,177	3,812
Due from Telecom Administrations	103	158	141	208	195	238	285	332
Net Accounts Receivables	872	1,053	1,717	2,299	2,401	2,885	3,461	4,144
Inventory	94	89	86	75	90	104	116	119
Total Current Assets	8,883	9,988	9,605	10,030	11,205	15,770	18,134	20,103
Net Plant	8,669	8,689	8,605	8,526	8,362	8,023	7,589	6,968
Investments	316	363	2,173	3,472	11,481	11,581	11,892	12,507
Total Assets	17,868	19,040	20,384	22,028	31,048	35,374	37,616	39,578
Bank Overdrafts	-	-	-	-	0	0	(0)	0
Accounts Payable	3,617	4,246	4,096	4,871	5,067	6,128	7,195	8,116
Due to Other Telecom Admin.	887	1,112	1,042	1,135	1,239	1,544	1,867	2,056
Total Payables	4,503	5,358	5,137	6,005	6,307	7,672	9,062	10,172
Dividends Payable	750	-	825	-	908	1,264	1,758	2,492
Accrued Expenses and Provisions	728	-	734	-	785	855	953	1,019
Total Current Liabilities	5,981	5,358	6,696	6,005	8,000	11,883	13,865	15,776
Loans	-	-	-	-	6,975	4,883	2,790	698
Employees' end of Service Benefits	369	364	403	414	411	419	427	436
Total Liabilities & Provisions	6,350	5,722	7,098	6,419	15,386	17,184	17,082	16,909
Net Worth	11,518	13,318	13,285	15,609	15,662	18,189	20,533	22,669
Income Statement								
Gross Revenues*	11,528	-	13,010	-	15,611	17,769	19,328	20,482
Net Revenues	9,226	7,651	10,434	9,362	12,568	14,191	14,993	15,616
Cost of Services	(3,718)	-	(4,164)	-	(4,954)	(5,991)	(7,033)	(7,520)
SG and A	(654)	-	(756)	-	(917)	(1,135)	(1,499)	(1,874)
EBITDA	7,156	-	8,090	-	9,740	10,643	10,795	11,087
EBITDA Margin	62%	-	62%	-	62%	60%	56%	54%
Depreciation and Amortization	(1,424)	-	(1,236)	-	(1,344)	(1,439)	(1,533)	(1,621)
Net Operating Profit	5,732	5,100	6,854	6,316	8,396	9,204	9,262	9,466
<i>NOP (EBIT) Margin</i>	50%	67%	53%	67%	54%	52%	48%	46%
Net Interest Income (Expense)	72	75	120	185	131	153	146	158
Investment Income	(86)	-	14	-	15	16	16	17
Earnings before Taxes	5,718	5,175	6,988	6,501	8,542	9,374	9,424	9,642
Royalty fees	(2,873)	(2,625)	(3,418)	(3,231)	(4,220)	(4,099)	(3,687)	(3,342)
Net Profit from Domestic Operations	2,873	2,625	3,418	3,231	4,220	5,010	5,531	6,206
Income from Etihad Etisalat	-	-	-	-	(441)	(358)	(94)	473
Income from PTCL	-	-	-	-	412	403	422	440
NPAUI	2,873	2,625	3,418	3,231	4,192	5,055	5,859	7,120
Cash Flow Statement								
Cash Operating Profit after Tax	4,283	-	4,672	-	5,491	6,590	7,436	8,660
<i>Change Working Investment</i>	608	-	(198)	-	533	937	900	491
Cash Flow Post Chg in WI	4,891	-	4,474	-	6,025	7,527	8,336	9,150
Capital Expenditure	(997)	-	(1,172)	-	(1,100)	(1,100)	(1,100)	(1,000)
Free Cash Flow	3,894	-	3,302	-	4,925	6,427	7,236	8,150
Non-operating Cash Flow	99	-	(1,876)	-	(9,089)	152	(57)	(342)
Cash Flow before Financing	3,993	-	1,427	-	(4,165)	6,579	7,179	7,808
Net Financing	(1,547)	-	(1,542)	-	5,076	(2,512)	(5,403)	(6,525)
Change in Cash	2,446	-	(115)	-	912	4,067	1,776	1,283

*Revenues include inpayments to other telecom administrations, discounts and rebates and are EFG-Hermes Estimates
Sources: Etisalat and EFG-Hermes Estimates