RASMALA

Paltel Group

Bellwether of the Palestinian stock market

We initiate coverage on Paltel Group, the largest listed company in Palestine

We initiate coverage on Paltel Group (Paltel) with a Buy recommendation and JOD6.10/share target price, suggesting 25% upside potential. Paltel, the bellwether of the Palestinian stock market, has a strong balance sheet and, in our view, can sustain a healthy dividend pay-out.

Economic backdrop is challenging, severe risk of a further slowdown

In its latest report on the state of the Palestinian economy, the IMF warned that there is a high risk of a slowdown in growth and a rise in unemployment in both the West Bank and Gaza. The IMF looked at two scenarios (baseline and lower growth), both of which depend on the speed of easing of Israeli restrictions on movement and access, the level of donor aid and fiscal retrenchment. Under the former, the IMF projects real GDP growth of 5.6% in 2013F, and under the latter, 3.0%.

One of the fastest-growing telecommunications markets globally

Despite the economic and political constraints, the Palestinian telecoms market offers strong potential for growth, in our view: penetration is low (78% at end-June), GDP/capita should continue to grow under the IMF's baseline scenario and the population is one of the youngest and fastest-growing globally. We forecast mobile subscriber growth (28% CAGR for 2006-11) to remain at double-digit rates for the next five years, especially if 3G can be introduced.

We expect Paltel to lose some market share to new entrant Wataniya Mobile, but to continue to hold a dominant market position and to be well-placed to capitalise on future growth. We forecast a CAGR of 8% for 2011-14F in mobile subscriptions, but assume a cautious outlook for ARPUs (a -6% CAGR for 2011-14F). These assumptions result in low single-digit net income growth for 2011-14F, but continued healthy FCF generation and a strengthening net cash position.

Valuation at low end of peer group, healthy dividend yield of 8.2%

Paltel is currently trading at a 3.9x 2012F EV/EBITDA multiple, with an EV/subscriber of US$277, both at the low end of the peer group range, discounting the competitive and political situation, in our opinion. We value Paltel using comparable multiples and cross-check with a DCF analysis, which yields our target price of JOD6.10/share. Our TP implies a 2013F target EV/EBITDA of 4.5x. One of the main attractions of the stock, in our opinion, is its healthy 2012F dividend yield of 8.2%, which we think should provide a solid floor to the share price, given the strength of the balance sheet.

Key Forecasts & Valuation Metrics

year to Dec	2010	2011	2012F	2013F	2014F
Revenues (JODm)	338.3	370.2	367.7	396.2	409.8
EBITDA (JODm)	143.3	164.2	154.4	162.0	163.1
Fully diluted EPS (JOD)	0.66	0.69	0.62	0.64	0.74
Dividend per share (JOD)	0.40	0.40	0.40	0.40	0.40
Normalised PE	7.46	7.09	7.90	7.61	6.62
EV/EBITDA	4.3	3.7	3.9	3.5	3.3
Dividend yield (%)	8.1%	8.1%	8.2%	8.2%	8.2%

Accounting standard: IFRS — Source: Company data, Rasmala forecasts

Important disclosures can be found in the Disclosures Appendix.

Buy

Target Price JOD6.10

Key data	
Price (close 6 Dec)	JOD4.89
3M high/low	JOD4.99
Market cap	JOD644m / US$908m
Av (12M) turnover	US$0.54m/day
Free float	49.3%
Reuters	PALTEL.PL
Bloomberg	PALTEL PS
Net debt (cash)	(JOD36m)
3yr EPS CAGR 11-14F	2.3%
2012F div yield	8.2%

Source: Bloomberg

Price performance

	(1M)	(3M)	(12M)
Price (JOD)	4.90	4.55	5.20
Absolute (%)	-0.2%	7.5%	-6.0%
Rel to mkt*(%)	-0.4%	0.6%	-3.8%

* Al Quds Gen Index
Source: PEX

Contact details

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Rasmala Equities Forecasts: Paltel Group

Income statement

JODm, year to December	2010	2011	2012F	2013F	2014F
Revenues	338.3	370.2	367.7	396.2	409.8
Cost of sales	-78.9	-82.1	-84.8	-90.1	-93.8
Operating costs	-116.1	-123.9	-128.5	-144.0	-152.9
EBITDA	**143.3**	**164.2**	**154.4**	**162.0**	**163.1**
DDA & Impairment (ex gw)	-31.6	-37.1	-41.1	-48.2	-49.2
EBITA	**111.8**	**127.0**	**113.3**	**113.9**	**113.9**
Goodwill (amort/impaired)	0.0	0.0	0.0	0.0	0.0
EBIT	**111.8**	**127.0**	**113.3**	**113.9**	**113.9**
Net interest	-2.2	-2.1	-1.9	-1.0	-0.5
Associates	-9.1	-13.5	-4.0	-3.0	-3.0
Other pre-tax items	-9.9	-10.4	-3.0	0.0	0.0
Reported PTP	**90.5**	**101.0**	**104.4**	**109.9**	**110.4**
Taxation	-4.2	-10.3	-23.0	-25.3	-13.3
Minority interests	0.0	0.0	0.0	0.0	0.0
Other post-tax items	0.0	0.0	0.0	0.0	0.0
Reported net profit	**86.3**	**90.7**	**81.4**	**84.6**	**97.2**
Normalised EBITDA	**143.3**	**164.2**	154.4	162.0	163.1
Normalised PTP	90.5	101.0	104.4	109.9	110.4
Normalised net profit	**86.3**	**90.7**	**81.4**	**84.6**	**97.2**

Balance Sheet

JODm, year ended December	2010	2011	2012F	2013F	2014F
Cash & market secs (1)	80.3	71.4	62.9	87.7	105.3
Other current assets	133.0	121.2	125.7	135.5	136.0
Tangible fixed assets	190.2	207.5	216.1	215.6	231.2
Intang assets (incl gw)	33.4	29.7	29.7	29.7	29.7
Other non-current assets	114.4	145.0	155.0	153.0	156.6
Total assets	**551.3**	**574.8**	**589.4**	**621.5**	**658.8**
Short term debt (2)	15.6	14.2	14.2	14.2	7.1
Trade & other current liabilities	83.4	84.6	83.7	90.2	89.2
Long term debt (3)	35.5	21.3	7.1	0.0	0.0
Oth non-current liabilities	25.5	26.1	26.9	27.7	28.5
Total liabilities	**159.9**	**146.1**	**131.8**	**132.0**	**124.8**
Total equity (incl min)	391.4	428.7	457.5	489.5	534.0
Total liabilities & S/H equity	**551.3**	**574.8**	**589.4**	**621.5**	**658.8**
Net debt	**-29.2**	**-36.0**	**-41.6**	**-73.6**	**-98.2**

Cash flow statement

JODm, year to December	2010	2011	2012F	2013F	2014F
EBITDA	143.3	164.2	154.4	162.0	163.1
Change in working capital	-14.6	-4.9	-15.4	-8.2	-9.6
Net interest (paid) / rec	-2.2	-2.1	-1.9	-1.0	-0.5
Taxes paid	-0.2	-4.2	-27.4	-25.8	-9.4
Other operating cash items	16.7	14.9	29.3	26.8	9.9
Cash flow from ops (1)	**143.1**	**167.8**	**139.0**	**153.8**	**153.5**
Capex (2)	-51.9	-56.6	-48.0	-46.0	-63.0
Disposals/(acquisitions)	0.7	0.0	0.0	0.0	0.0
Other investing cash flow	-17.0	-49.7	-32.0	-22.5	-12.5
Cash flow from invest (3)	**-68.3**	**-106.3**	**-80.0**	**-68.5**	**-75.5**
Incr / (decr) in equity	0.0	0.0	0.0	0.0	0.0
Incr / (decr) in debt	-20.0	-15.6	-14.2	-7.1	-7.1
Ordinary dividend paid	-45.9	-51.5	-52.7	-52.7	-52.7
Preferred dividends (4)	0.0	0.0	0.0	0.0	0.0
Other financing cash flow	-2.4	-0.7	-0.7	-0.7	-0.7
Cash flow from fin (5)	**-68.3**	**-67.9**	**-67.6**	**-60.5**	**-60.5**
Forex & disc ops (6)	0.0	0.0	0.0	0.0	0.0
Inc/(decr) cash (1+3+5+6)	**6.5**	**-6.3**	**-8.6**	**24.9**	**17.5**
Equity FCF (1+2+4)	91.1	111.2	91.0	107.8	90.5

Source: Company data, Rasmala forecasts

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Investment summary

We initiate coverage on Paltel Group, the largest telecoms operator in Palestine, with a Buy recommendation and a JOD6.10/share TP. Paltel has a dominant position in a fast-growing telecommunications market. We believe its strong balance sheet should provide the company with a strong incentive to continue to pay out healthy dividends.

Paltel Group – largest listed stock in Palestine

Paltel Group is the largest telecoms operator in Palestine and is also the largest listed company on the Palestine Exchange, representing about 41% of the market cap of the Al Quds index and 33% of the market cap of the overall market. Paltel offers fixed, mobile, internet and data services throughout Palestine, as well as value-added and next-generation services. The firm is currently the only provider of fixed-line services in Palestine and, for now, the only operator in Gaza, but new competitor Wataniya Mobile (Wataniya PS, US$1.22, Not Rated) aims to launch there in the near future.

We view Paltel Group as an attractive investment opportunity for a number of reasons:

1) It gives investors exposure to a market that is outside mainstream emerging markets, but that has what we think are compelling fundamentals;

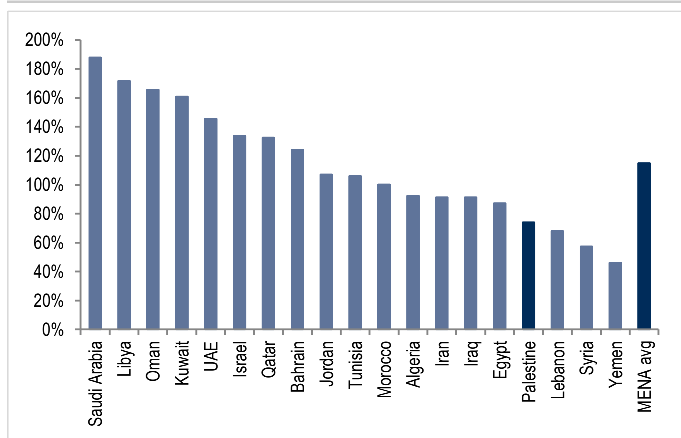
2) We see demographics as a key driver for growth and as a major attraction for investors: the population in Palestine is relatively small (about 4.2m people), but is also very young and is growing fast (+3.1% on average for the past 10 years); in addition, levels of disposable income have been improving;

3) Paltel Group has a dominant position in a fast-growing and underpenetrated (78% at end June 2012) telecommunications market;

4) Our forecasts for Paltel Group are relatively modest, but could get a boost if Israel were to allow 3G in Palestine;

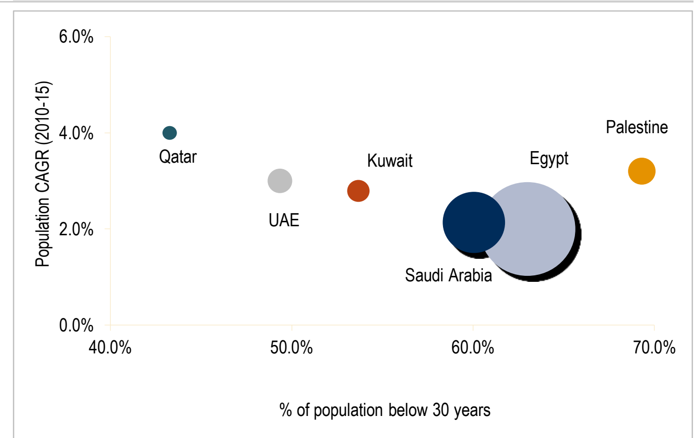
5) The stock trades at low multiples, and one of the main attractions is a healthy dividend yield of 8.2%, supported by a strong balance sheet.

Chart 1 : Mobile penetration rates – MENA region 2011



Source: Bloomberg, Rasmala

Chart 2 : Demographic statistics in GCC, Egypt and Palestine



Size of bubble represents population size
Source: US Census Bureau, IMF, Rasmala

Outlook for Paltel

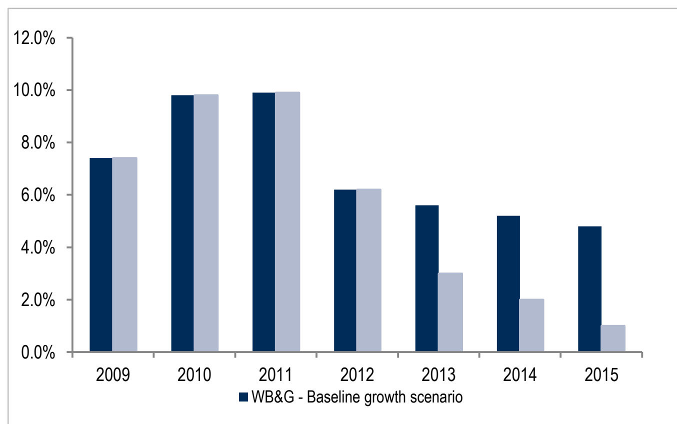
Palestinian economy highly correlated to political situation

One must consider the company's performance within a difficult economic and political context: Israeli restrictions on movement make logistics and imports/exports difficult to manage; Israel dominates vital resources and infrastructure; and the developing nature of the Palestinian economy presents a range of obstacles. At the end of November 2012, the UN General Assembly voted to grant Palestine non-member observer State status, while expressing the urgent need for the resumption of negotiations between Israel and the Palestinians leading to a permanent two-state solution. While a major step forward for Palestine, this may not lead to immediate changes to the day-to-day situation on the ground, in our view.

Unlike other countries, the rate of economic growth in Palestine is driven by three main factors that are hard to control by the Palestinian public or the private sector: 1) the speed of easing of Israeli restrictions on movement and access; 2) shortfalls in donor aid; and 3) economic growth in Israel, which accounts for two-thirds of Palestine's exports. In other ways, however, correlation with the global economy is relatively limited.

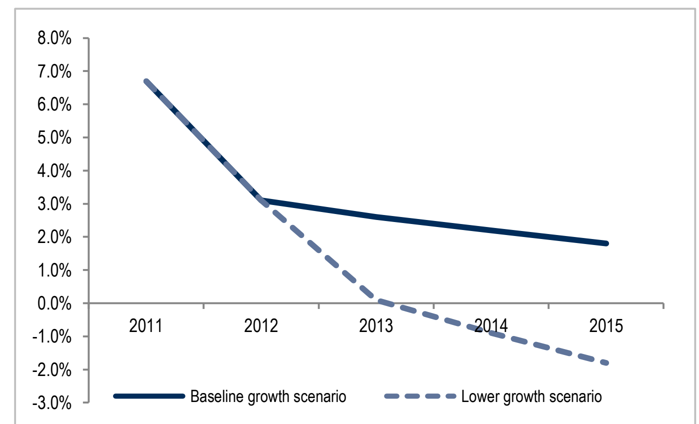
Worryingly, growth in the West Bank has been slowing over the past few years, as the result of the above factors, combined with the uncertainty caused by the Palestinian Authority's (PA) fiscal crisis and the global economic crisis. The slowdown of growth continued into 2012, even in Gaza, and in its latest report on the state of the Palestinian economy, the IMF warned that there is a high risk of a continued slowdown in growth and a rise in unemployment in both the West Bank and Gaza over the next three years. The IMF looked at two scenarios (baseline and lower growth). Under the former, the IMF projects real GDP growth of 5-6% for 2013-15F, which is still reasonable, in our view, compared with growth in other countries in the region, or indeed globally. Under the latter, however, growth would steadily slow down over 2013-15F, and GDP per capita would drop by 1% in 2014 and about 2% in 2015F.

Chart 3: Palestine – GDP growth (%)



Source: IMF September 2012

Chart 4: GDP per capita (% change)



Source: IMF September 2012

Paltel - effects of higher tax rates and a weakening economy

Growth of 28% annually, on average, in the Palestinian telecommunications market over 2006-11 was amongst the highest in the MENA region, coming from a low base perhaps, but achieved despite all the political challenges the industry was facing. Israeli restrictions have been a problem for the telecommunications sector, which relies on imports of equipment and faces restrictions on the development of networks. Mobile penetration rates are still low and at the lower end of the range for the

region, or elsewhere globally, where penetration rates are above the 100% level, despite the strong growth over the past five years.

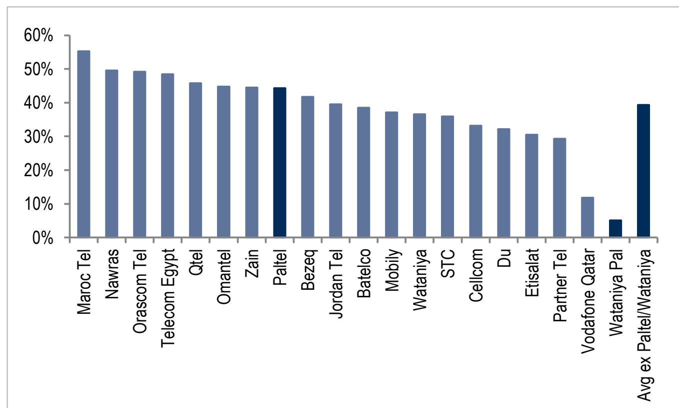
We forecast mobile subscriber growth to remain at double-digit rates for the next five years, especially if 3G can be introduced. Paltel is facing increased competition in the Palestinian telecommunications market from new entrant Wataniya Mobile. We forecast an 8% CAGR in mobile subscribers for Paltel for 2011-14F, but think that the increased competition will continue to put pressure on ARPUs (a -6% CAGR for 2011-14F).

In addition, Paltel Group voluntarily elected to waive its right to a partial exemption to pay an income tax rate of 50% of the nominal tax rate for a period of two years, which increases its tax rate from about 10% in 2011 to our forecast of 22% for 2012F. This year, the devaluation of the Israeli Shekel (collection currency) versus the Jordanian Dinar (reporting currency) has also negatively affected revenues and operating results. Hence, it should be no surprise that we expect 2012 to be a difficult year, with prospects for flat revenues and a 10% drop in net income, but 3% growth in pretax profits.

EBITDA margins have been in line with the average in the MENA telecoms sector – at around 44% in 2011 (up from 42% in 2010) and 42.7% in the first three quarters of 2012. We expect these to remain around the 40% level over our forecast period, despite the lower ARPUs and higher operating costs.

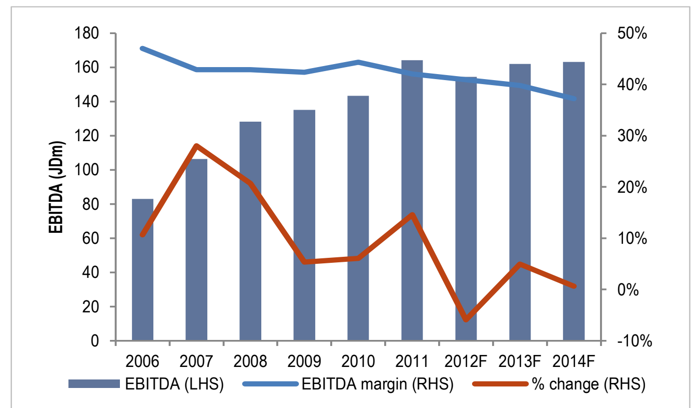
All in all, we believe that Paltel Group will continue to hold a dominant position in the Palestinian telecommunications market and that it is well-positioned to capitalise on future growth in the data segment. We see upside to our forecasts, in particular if Israel allows the introduction of a 3G network.

Chart 5 : Peer group EBITDA margins 2011



Source: Company reports, Bloomberg

Chart 6 : Paltel EBITDA (JODm) and EBITDA margins



Source: Company reports, Rasmala forecasts

Valuation at the lower end of the peer group

We value Paltel using comparable multiples. Paltel is currently trading at a 3.9x 2012F EV/EBITDA multiple, with an EV/subscriber of US$277, both at the low end of the peer group range. The 2012F dividend yield is a healthy 8.2%, which we think should provide a solid floor to the share price, given the strength of the balance sheet (net cash). We set a target price of JOD6.10/share.

Risks to our investment case

- The single biggest risk to investing in Palestine remains the political situation.
- At the moment, Wataniya is the only competitor in the Palestinian market and only in the West Bank and in the mobile segment. Potential new competitors and a sooner-than-expected entry of Wataniya Mobile into Gaza could have a worse-than-expected impact on our forecasts.
- Prepaid customers currently represent about 90% of Jawwal's (Paltel's mobile operator) subscribers and could easily switch to other mobile service providers. A worse-than-expected churn rate could materially affect Jawwal's operations.
- Palestine does not have its own national currency, and therefore the PNA does not have the ability to set monetary policy. Paltel's main operations are denominated in Israeli Shekels, whereas its reporting currency is in Jordanian Dinar. Hence, any currency movements could lead to a change in forecasts.
- Another general concern is the ability of the PA to resolve its fiscal crisis, which could lead to higher taxes and levies, which, in turn, could have an adverse impact on our bottom-line forecasts.
- Israel maintains control over the Palestinian telecoms market and has not yet allowed 3G. Any further delays could hamper future growth opportunities for Paltel.
- Israel also controls imports of equipment.
- Paltel has a substantial investment portfolio in listed securities (US$50m at end-2011), which does not relate to the operations of the company and which may lead to financial gains or losses on the P&L. We have not factored such gains or losses into our forecasts.
- Paltel Group has a 25% stake in Dubai-based VTel Holding, which has been a loss-making entity (reported under the 'Associates' in the P&L) and for which Paltel has taken provisions. Any further deterioration could lead to a change in our bottom-line forecasts.

Valuation

We value Paltel using DCF analysis and comparable multiples. Paltel is currently trading at a 2012F EV/EBITDA multiple of 3.9x, at the low end of the peer group range; the dividend yield is a healthy 8.2%. We set a target price of JOD6.10/share.

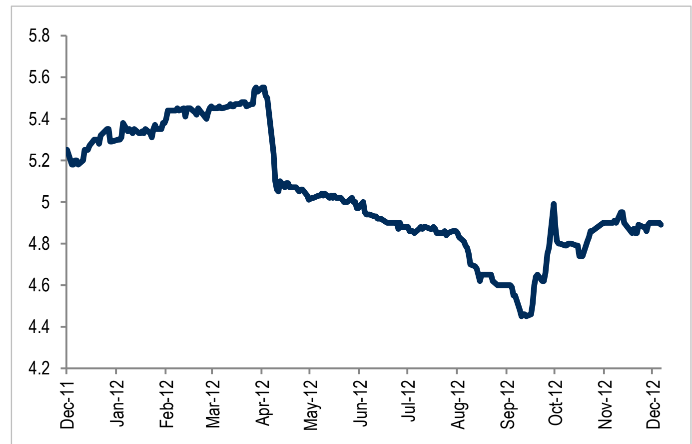
Paltel – share price performance

Paltel's shares have significantly underperformed the market this year and are down 8% YTD. Its recent performance has been better, however, with the shares up 10% from its low reached in the middle of September. Catalysts for outperformance, in our view, will have to come mainly from strong operational results and positive news flow on the Palestinian economy.

Chart 7 : Paltel 5-year share price performance

Source: Palestine Exchange

Chart 8 : Paltel 12-month share price performance



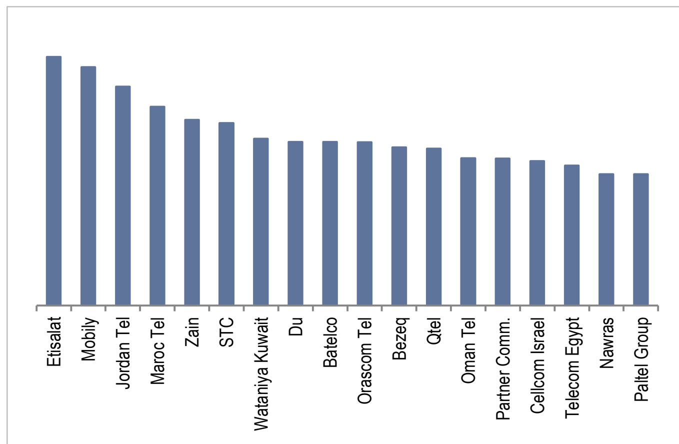
Source: Palestine Exchange

Paltel Group – valuation multiples

Because the Palestinian market is not covered by any international and very few regional investment firms, no consensus is available, hence, we cannot cross-check our forecasts or multiples.

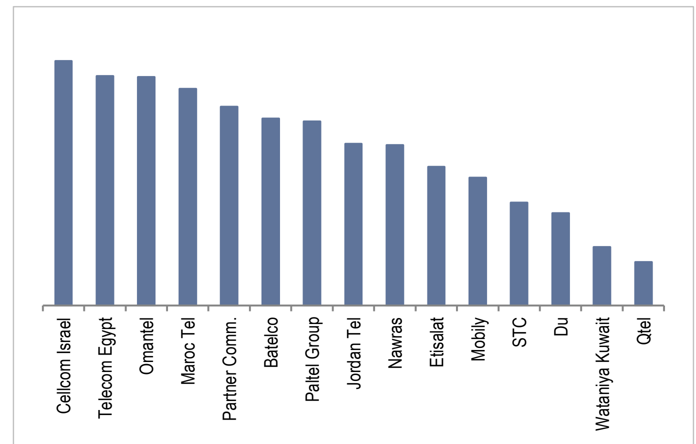
We use sector relative valuation multiples for 2013F as the basis for our valuations, and use DCF as a sensitivity check. To derive our target price for Paltel Group, we assume a 12-month forward 2013F multiple of 4.5x EV/EBITDA, about a 10% discount to the average for the regional peer group, implying a fair value of JOD6.10/share. This suggests upside potential of 25% for the shares.

Chart 9 : Regional telecoms – EV/EBITDA (x) 2012F



Prices as of close of 6 December 2012
Source: Bloomberg, Rasmala

Chart 10 : Regional telecoms – dividend yield 2012F



Prices as of close of 6 December 2012
Source: Bloomberg, Rasmala

A DCF analysis, in which we assume a WACC of 12.6% (Rf=2%, risk premium 11.4%), a long-term EBITDA margin of 35% and a terminal growth rate of 1.5%, suggests a higher value of JOD6.75 per share, noting that this valuation is highly sensitive to the capex requirements.

All in all, with a 2012F EV/EBITDA of 3.9x, an EV/subscriber of US$277 and a dividend yield of 8.2%, we believe that Paltel is an attractive proposition in the wider MENA region. However, we see the dividend yield as one of the main attractions in the shorter term, or at least until operational performance starts to improve, thus providing a floor for any potential falls in the share price.

Paltel Group – company background

Paltel is the largest telecoms operator in Palestine and is also the largest listed company on the Palestine Exchange, representing about 41% of the market cap of the index. Despite the loss of market share to new operator Wataniya, we believe Paltel is well-positioned to capitalise on future growth.

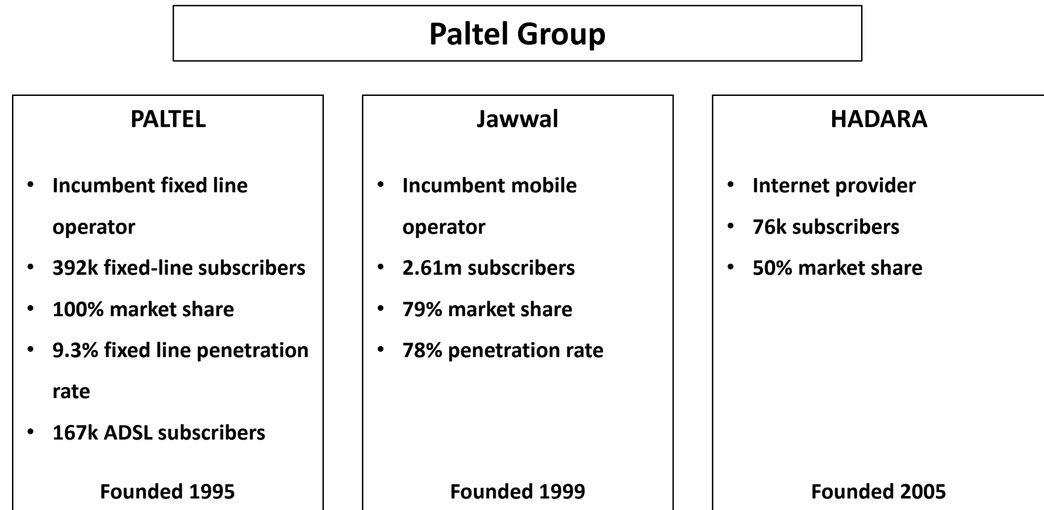
Paltel Group – company snapshot

Palestine Telecommunications Company (Paltel), headquartered in Ramallah in the West Bank, is the largest telecom operator in Palestine. It was established in 1995, when the Palestinian National Authority granted an exclusive licence to develop the telecoms sector in the West Bank and Gaza.

Paltel offers fixed, mobile, internet and data services throughout Palestine – for now it is the only operator in Gaza, but new competitor Wataniya Mobile is planning to launch there in the near future. Paltel also offers value-added and next generation services. The firm is the only provider of fixed-line services in Palestine, although this may change with liberalisation of the sector.

Paltel Group is an integrated operator, with Paltel as the fixed line operator, Jawwal the mobile operator, Hadara the data services provider, Hulul the IT arm of the group, Palmedia the multimedia services provider and Reach the first call center in Palestine. Paltel also owns equity in VTel Holdings, a Dubai-based telecommunications firm.

Chart 11 : Paltel group – main operating companies



Data as of end-June 2012
Source: Company reports

Until recently, Paltel was the only operator in the country, except for some presence by Israeli operators. However, with the launch of Wataniya's operations in the West Bank in 2009, and with the regulator set to allow competition in the fixed-line business, Paltel's major challenge, as we see it, will be to defend market share in this growing market, while maintaining margins at healthy levels. Growing competition could put pressure on ARPUs, but these are still relatively high on a regional basis.

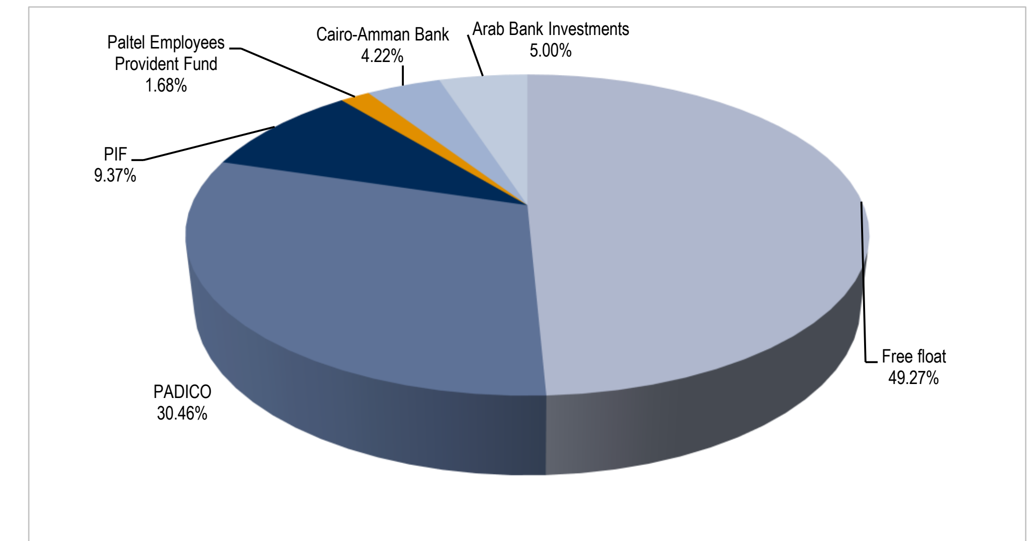
Shareholder structure

Paltel is the largest listed firm on the Palestine Exchange, with a market cap of about US$908m and representing about 33% of the Palestine Exchange's total market cap and 41% of the Al Quds Index. In

2005, it listed on the Abu Dhabi Securities exchange, but trading volumes were low and it delisted in 2010. Paltel is the most liquid stock on the Palestine Exchange, trading, on average, US$0.54m per day (during H1 2012).

As of end-September 2012, Paltel had a free float of 49.3%. PADICO owns 30.5%, PIF (Palestine Investment Fund) 9.4%, and Arab Bank and Cairo Amman Bank had a stake of 5%.

Chart 12 : Paltel Group – shareholder structure

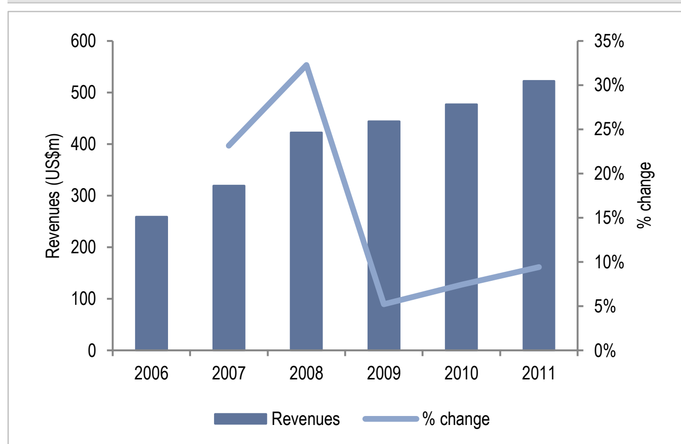


Data as of 30 September 2012
Source: Company reports

Operational performance

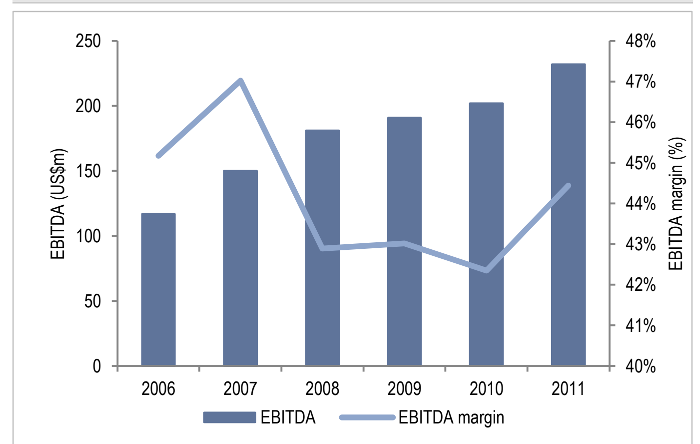
Paltel's financial performance was robust in 2011. Revenues improved by 9% to US$522m from US$477m reported in 2010. EBITDA improved by 15% to US$232m in 2011, resulting in an EBITDA margin of 44% (vs 42% in 2010). The latter fluctuated between 42% and 47% during the 2006-11 period.

Chart 13 : Paltel revenues 2006 –11 (US$m)



Source: Company reports

Chart 14 : Paltel EBITDA (US$m) and margin (%) 2006 –11



Source: Company reports

Amid difficult operating conditions, the firm has succeeded in growing its customer base, including the fixed-line sector, which in most other regional markets is either stagnant or in decline.

At the end of September, Jawwal had 2.59m mobile customers, while Paltel had 391,000 fixed-line customers and 169,000 ADSL customers. Growth in the fixed-line sector was 6.1% in 2011 and 1.5% in 9M 2012. The number of mobile users rose by 7.4% in 2011 and 7.0% in 9M 2012, with about 90% of these customers using pre-paid services.

Paltel's returns are stronger in the fixed-line business. The average monthly revenue per fixed-line subscriber reached US$21.1 at end-2011, compared with US$20.2 at end-2010. ADSL connections grew from just under 30% at the end of 2010 to 40.5% at the end of 2011. However, average revenues per user declined to US$18.8 in 2011 from US$25.8 in 2010.

Paltel's strategy and outlook

Paltel's stated strategy:

- Increase market share in Palestine by expanding across the three core business lines (mobile, fixed-line and data services);
- Maintain growth by investing in infrastructure, diversifying services and lowering costs to subscribers;
- Focus marketing strategy on a young demographic;
- Expand regionally – so far, Paltel's only presence outside Palestine is an equity stake in Dubai-based VTel Holdings;
- Remain competitive by rolling out state-of-the-art technology;
- Provide its customers in Gaza and remote areas of the West Bank with a comprehensive portfolio of telecoms services;
- Keep social investment a key priority, given the difficult living conditions that much of its customer base experiences. The group is increasing its social investments via the Paltel Group Foundation.

Competitive landscape: Wataniya Mobile Palestine (Wataniya PS, US$1.20, Not Rated)

Wataniya Mobile Palestine – a new company

Wataniya Mobile Palestine, headquartered in Ramallah, Palestine, was established in November 2009 as a 57:43 partnership between the Kuwait-headquartered Wataniya International (fully owned by National Mobile Telecommunications Company (NMTC), which, in turn, is majority (92%) owned by Qatar Telecom (Q-tel)) and the Palestine Investment Fund (PIF), the investment vehicle of the Palestinian Authority (PA).

It is the second operator in the country to provide mobile telecommunications services. The company obtained a services-provision license in 2007 after winning an international tender of US$354m. The license comprises installing and operating a GSM mobile telecommunications network and a third-generation 3G network, providing voice and data telecommunications services in the West Bank and Gaza Strip, in addition to providing international telecom services from its own international gateway. Wataniya has six customer service centres in Ramallah, Jenin, Tulkarem, Bethlehem, Nablus and Hebron.

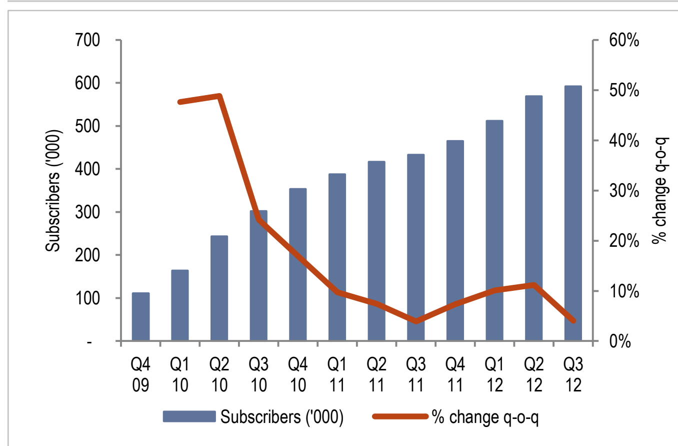
Shareholder structure – strong backers

In January 2011, Wataniya listed 15% of its shares on the Palestine Exchange, raising US$50m. The shares were priced at US$1.30. Following the listing, Wataniya International is the largest shareholder in Wataniya, with a 48.45% stake. PIF owns 36.55% of the outstanding shares. According to the license agreement with the Palestinian Ministry of Telecommunications and IT, Wataniya is required to increase its free float from the current 15% to 30%, after which Wataniya International's holding will decline to 40%, PIF's to 30% and the free float will be 30%.

Operational performance – still in start-up phase

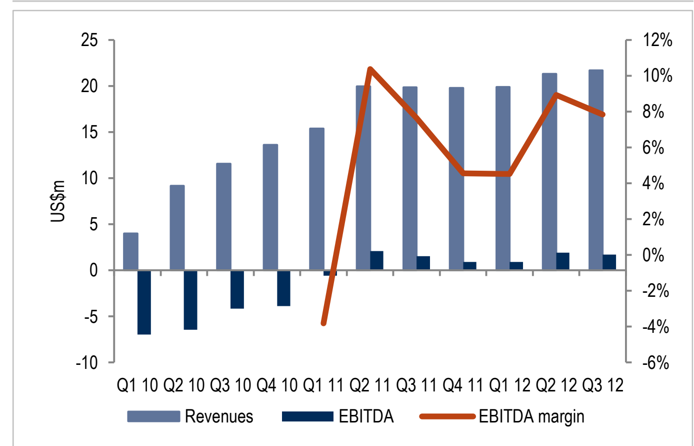
After being granted the second-generation 2G frequency in 2009, the company started providing commercial mobile telecommunications services in the West Bank. At the end of 2009, Wataniya Mobile reached a subscriber base of 110,000, and this increased rapidly to 465,000 by the end of 2011. It had a 24% market share in the mobile telecommunications market in the West Bank by end-2011.

Chart 15 : Wataniya – subscriber growth since inception



Source: Company reports

Chart 16 : Wataniya: revenue & EBITDA development



Source: Company reports

Wataniya's strategy – gain market share in a duopolistic market

Wataniya Mobile plans to gain market share (from Jawwal and four Israeli operators) in a number of ways:

- Expand into the Gaza Strip, which could put some pressure on returns for Jawwal.
- Expand services and the frequency allocations to support them.
- Aim to become subscribers' first choice for mobile telecommunications through positioning with customer service, branding (lifestyle provider) and pricing.
- Benefit from Q-tel's strategic relations with suppliers, sellers and financing banks through links with parent company Wataniya International.
- Focus on youth sector.

Wataniya will have to compete with Paltel on pricing, quality of services, coverage, tariffs and promotions. Currently in Palestine there is no system established for mobile number portability, although it may be introduced in 2013.

Third licence?

In February 2010, the MTIT announced in its Telecom Policy Statement that it intends to offer a third licence for mobile telecommunications services in Palestine, but not before 2013 at the earliest, if at all.

Macroeconomic perspectives

We believe the MENA region offers superior long-term growth prospects compared with developed markets. Palestine is a relatively small economy that faces many challenges, but that we believe has the potential to grow faster than the economies of most countries in the region in 2013 (+5.6% under IMF's baseline scenario).

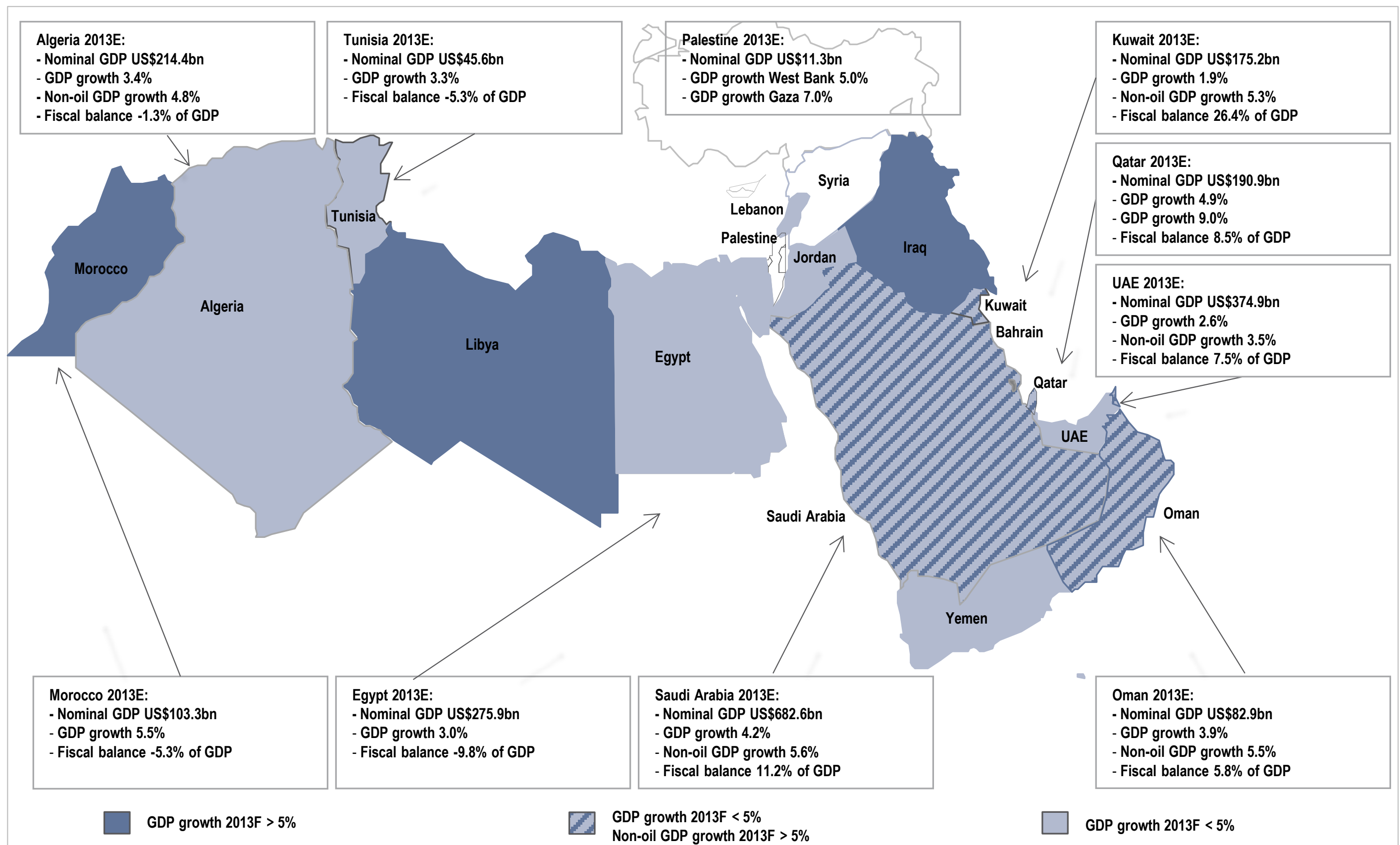
Regional outlook: superior growth prospects for MENA

The MENA region is going through a period of unprecedented change. In the 'Arab Spring' countries, political transition, pressing social demands, and an adverse external environment have combined to increase the near-term risks to macroeconomic stability. With growth faltering, unemployment rising, and continued fiscal and external pressures, 2012 is proving to be a challenging year for these countries.

Even so, the International Monetary Fund (IMF) projects growth across the region (+5.3% for 2012F and 3.6% for 2013F) that is well-above growth in developed markets and above the world average for 2012 (3.3% for 2012F and 3.6% for 2013F), but below the growth rates of China and India – with the exception of non-oil GDP growth in Qatar and Iraq.

However, there is a noticeable difference in growth prospects between the oil-exporting and relatively politically stable countries in the GCC and countries in North Africa and the Levant (see also our strategy note *Cross currents of opportunity* – 13 February 2012).

Figure 1 : MENA macro outlook: still strong growth in a global perspective



Source: IMF November 2012, Rasmala

The oil-rich GCC countries, where hydrocarbons represented 66-86% of the GDP average for 2000-09 (IMF), are benefiting from a higher oil price and increased oil production amidst relative political stability, and higher spending by governments to appease their populations (particularly in Saudi Arabia) is giving a further boost to economic growth. However, the increases in government expenditures in oil exporters in the region have also raised the break-even oil price, implying that significant oil price declines could undermine fiscal positions.

In North African and Levant countries, on the other hand, which are net importers of oil and/or food (Egypt, Jordan, Syria, Tunisia, Lebanon and Morocco are net oil importers), high commodity prices and/or political instability, as well as closer economic ties to Europe than GCC countries have, continue to have a negative impact on growth, whereas internal conflicts and their aftermath remain a source of uncertainty, and tourism has not yet recovered.

Palestinian economy highly correlated to political situation

The economy faces many challenges

Challenges for Palestine are different from those in the rest of the region, and one must consider the private sector's performance within a difficult economic and political context. As previously noted, the rate of economic growth in Palestine is driven by three main factors that are hard to control by the Palestinian public or the private sector: 1) the speed of easing of Israeli restrictions on movement and access; 2) shortfalls in donor aid; and 3) economic growth in Israel, which accounts for two-thirds of Palestine's exports.

Logistics are one of the main obstacles for the economy

Israeli control and restrictions, in particular Palestinians' lack of access to land and resources in Israeli-controlled areas, as well as import and export restrictions, remain the biggest impediments to the development of the West Bank economy, disrupting labour and trade flows, industrial capacity, and basic commerce. Temporary and permanent roadblocks and detours make logistics complicated, and Gaza remains cut off from access to and from the West Bank. In a recent economic report, the World Bank reinforced the importance of the unobstructed movement of people and goods between the West Bank and Gaza.

Israel controls borders, which has a negative impact on those sectors dependent on imports and exports. It also makes investing in infrastructure complicated, which has been a problem for sectors such as telecommunications that rely on imports of equipment and that face restrictions on the development of networks. The banking sector, however, is less affected: it is not dependent on Israel, and some banks, such as the Bank of Palestine, have direct relations with banks abroad.

In the Gaza Strip, Israeli security controls, the closure of borders and restrictions on exports have had a noticeable negative effect on economic conditions, and even more so since June 2007, when Hamas took control of the territory. Such border closures have resulted in high unemployment, elevated poverty rates, and the near collapse of the private sector, which had relied on export markets. The population is reliant on large-scale humanitarian assistance – led by UN agencies.

The Palestinian economy has rebounded rapidly since 2008-11

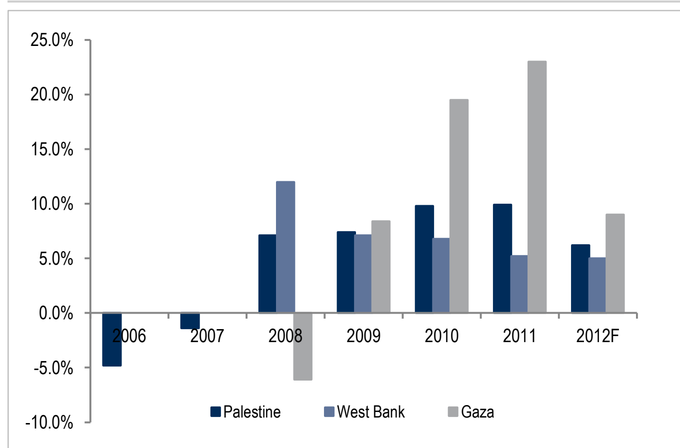
Despite these restrictions, and helped by some easing of movement and access restrictions in 2010, real GDP growth in the West Bank has been in the high single-digits since 2008, but donor aid (US$3bn in direct foreign donor assistance from mid-2007 to 2011) rather than private sector economic activity

has been the main driver of this growth. There is still a large difference between prosperity in the West Bank and that in the Gaza Strip, which has lower GDP per capita and higher unemployment rates.

In 2011, GDP growth in Palestine was a strong 9.9% and GDP per capita increased by 6.6%. Construction activity registered the highest growth rate in 2011 (26.9%), followed by public administration & defense (13.0%), transport & storage (12.3%) and agriculture & fishing (9.9%).

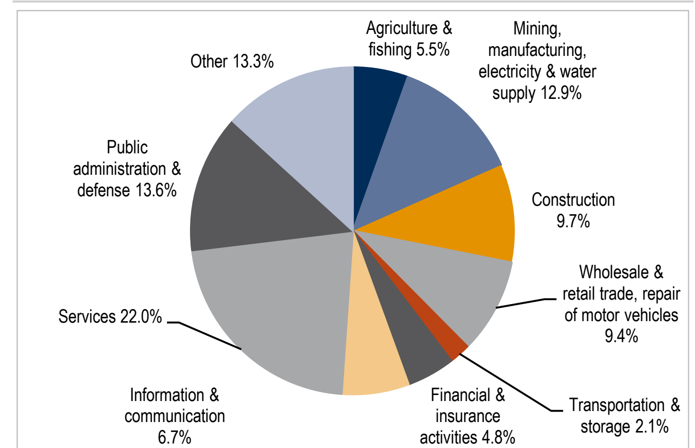
GDP growth in the Gaza Strip in 2011 (+23%) – coming from a very low base – easily outstripped growth in the West Bank (+5.2%), driven by the easing of Israeli restrictions, donor aid, Gaza's tunnel trade benefiting from the political change in Egypt, and construction activity. However, despite growth rates being well in the double digits in the Gaza Strip during the past two years, the contribution to overall GDP in Palestine is still less than 30%.

Chart 17 : Palestine – GDP % change 2006–14F



Source: IMF

Chart 18 : Contribution to GDP by economic sector



Source: IMF May 2012

Inflation remains at a relatively low level

At the same time, inflation is relatively low compared with that in other countries. The consumer price index increased by 2.9% to 132.7 during 2011 (base year 2004), as a result of increases in prices for all major groups except furniture & household goods. The PMA only expects it to rise slightly to 3.1% in 2012, largely driven by global food and fuel price changes.

The current account deficit increased during 2011 to US$1.9bn, the highest level since 2000, the result of a rise in the value of imports of goods and services; while exports remained stable. This increased the trade balance deficit by 9.2%. Compensation of employees from abroad increased during 2011 by 3.7%, and current transfers and remittances decreased by 37% from US$2.5bn in 2010 to US$1.6bn in 2011.

In Q4 2011, the current account deficit increased by 30% to US$379m versus Q3 2011, or 14.6% of GDP. The income balance surplus was US$287m (US$258 in earnings from Palestinians working in Israel and US$29m in investment income), primarily resulting from interest received on Palestinian deposits held in banks abroad.

Worryingly, the slowdown continued into 2012

Worryingly, growth in the West Bank has been slowing over the past few years (+7.1% in 2009, 6.8% in 2010 and 5.2% in 2011), as the result of falling donor support, especially from the Arab world, combined with the uncertainty caused by the Palestinian Authority's (PA) fiscal crisis, continued Israeli restrictions and the global economic crisis. The slowdown of growth in the West Bank continued into Q1 2012, and

growth fell back to 6% even in Gaza. Despite a slowdown in the latter, Gaza is still outperforming the West Bank.

Unemployment in the West Bank increased to 20.1% in Q1 2012 and in Gaza to 31.5%, and the IMF expects further increases at a time when social unrest is high, with protests against fuel price hikes, tax increases and a decline in living standards. Other indicators also point to a further slowdown: during the first four months of the year, the issuance of new business licenses dropped by 15%, and cement imports (in West Bank and Gaza) declined by 8.1%.Private sector credit growth slowed, partly due to a slowdown in growth in the West Bank, where private sector credit growth declined to 16.6% in Q4 2011 from 30.3% in Q1 2011; in Gaza, it increased to 46.7%. Total private sector credit growth in the West Bank and Gaza slowed to 13.3% in March 2012 from a peak of about 30% in H1 2011. Private sector deposit growth in the West Bank and Gaza slowed moderately to 4% in March (YoY).

The PA's fiscal crisis

A big issue, in our view, is the fiscal crisis at the PA, which we think is likely to affect the outlook for the economy directly. The PA has agreed on a 2012 budget of US$3.54bn, with a recurrent deficit forecast to decrease to less than US$1bn. The 2012 budget has reduced dependence on foreign assistance.

The IMF has praised the PA for prudent fiscal management; however, in 2011 and YTD in 2012, donor aid for recurrent spending and development projects has been lower than needed to finance tight budgets. Recurrent budgetary donor aid of US$400m in H1 2012 was 20% lower than budgeted, and the slowing of the economy exacerbated this effect; and in H1 2012, total net revenues were 7% lower than budgeted.

The IMF estimates that domestic payment arrears, including to the private sector and public pension fund, increased by about US$0.3bn in H1 2012. The financing difficulties continued into Q3, when the PA had to delay payment of 40% of public sector wages.

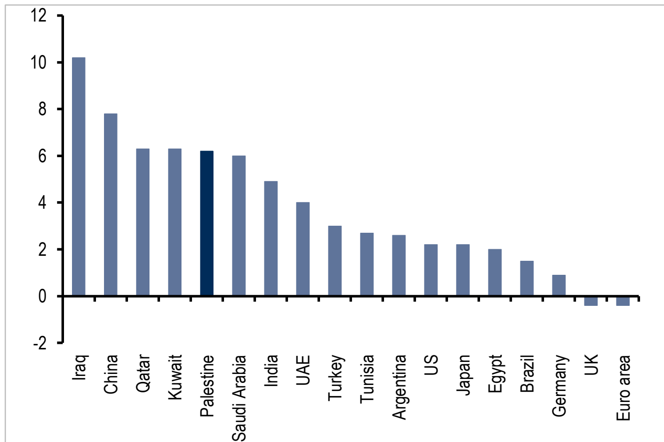
VAT revenues, which are declared to the PA voluntarily by the private sector at a rate of 14.5%, form a significant part of the PA's revenues (about 30% of tax revenues). VAT revenues increased from US$638m in 2008 to US$878m in 2011, according to the Ministry of Finance. The VAT rate went up from 14.5% to 15.0% in September 2012, which should yield additional revenues of US$2m per month over time.

The PA financed the gap by borrowing from the local banking sector; increasing the PA's debt to Palestinian banks from US$500m in 2008 to US$1.2bn at end-June this year (12% of GDP); and accumulating arrears of US$500m to the private sector, the public pension fund and tax refunds. According to the IMF, the authority has a funding gap of US$400m this year; and clearly to help the situation somewhat, the Israeli government recently transferred US$64m in tax revenues, which it collects on behalf of the PA, ahead of schedule.

Outlook for Palestinian economy

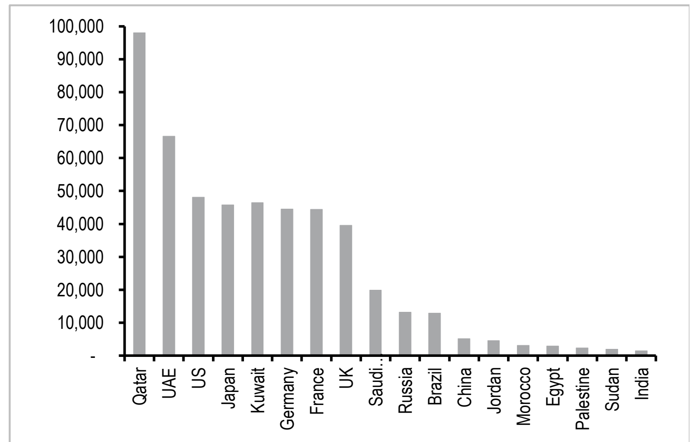
Despite the economic constraints, the IMF still expects 6.2% GDP growth for Palestine for 2012 and 5.6% for 2013. However, in its latest report on the state of the Palestinian economy, the IMF warned of a high risk of a continued slowdown in growth and a rise in unemployment in both the West Bank and Gaza over the next three years.

Chart 19 : Real GDP growth, 2012F (% change YoY)



Source: IMF

Chart 20 : GDP/capita (US$)



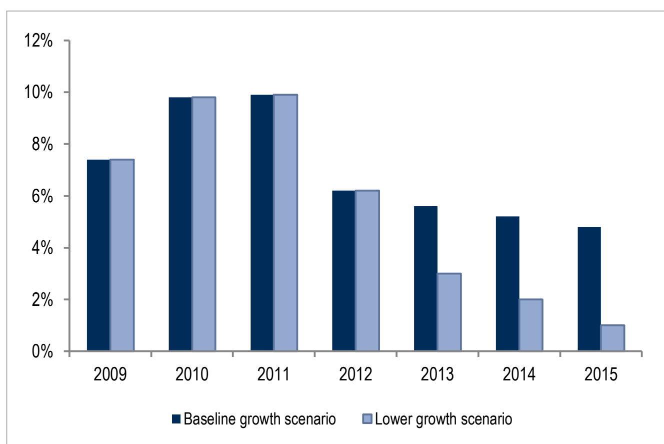
Source: IMF

The IMF looked at two scenarios (baseline and lower growth). In the baseline growth scenario, the IMF assumes limited easing of internal restrictions on movement and access, but thinks that social and political conditions will be stable enough to enable the PA to implement a prudent fiscal policy. Under this scenario, donors would disburse sufficient aid on time.

In the 'lower growth' scenario, restrictions would remain the same as they are now, inhibiting trade and private investment. Also, revenue growth would slow, while emergency spending would rise. Donor aid would remain below the level needed to finance the deficit, leading to further substantial arrears accumulation, and unemployment rates would go up from 21% in 2012F to 27% by 2015.

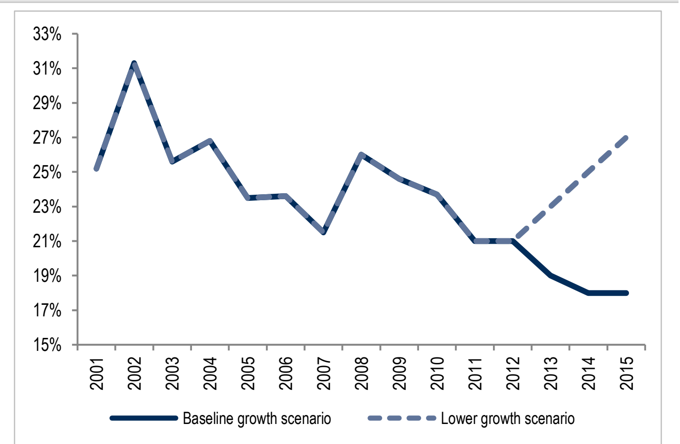
Under the former, the IMF projects real GDP growth of 5.6% in 2013F; under the latter, 3.0%. Nevertheless, even these growth rates are reasonable, we believe, when compared with those in other countries in the region, or indeed globally.

Chart 21 : Palestine – GDP growth (%)



Source: IMF

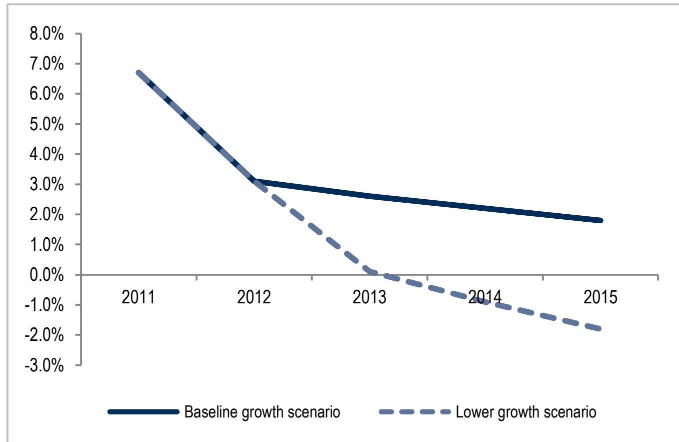
Chart 22 : Unemployment (%)



Source: IMF

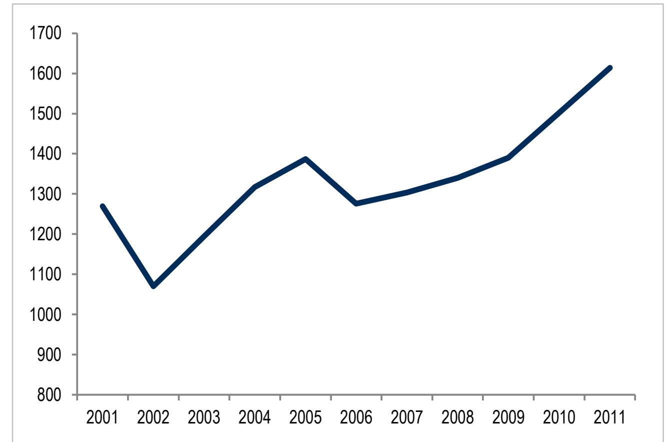
Beyond 2013, the IMF still expects growth, but at a very low level. In the lower case scenario, the IMF is forecasting real GDP growth of only 2.6% for the West Bank and 4.0% for Gaza in 2013F, followed by 1.6% and 3.0%, respectively, for 2014F and even lower growth of 1% for 2015F. The lower growth scenario would likely lead to deterioration in GDP per capita, which is already one of the lowest globally.

Chart 23 : GDP per capita (% change)



Source: IMF September 2012

Chart 24 : GDP per capita (US$)



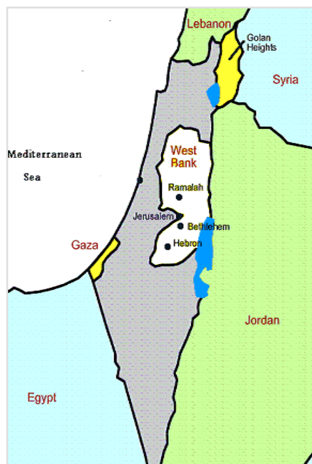
Source: IMF May 2012

Demographics are key investment driver

We see demographics as a key driver for growth and as a major attraction for investors. Palestine's population is relatively small, with about 4.2m people, but it is also very young and growing very fast, and levels of disposable income have been improving.

Palestine

Figure 2: Palestine



Source: Paltel Group IR presentation

Palestine is not currently a member of the United Nations, and some western countries do not recognize Palestine as a state. The Palestinian National Authority (PNA) was established in 1993 as the administrative organisation to govern both the West Bank and Gaza; however, Hamas has governed the Gaza Strip independently from the PNA since 2007.

In 1993, the Palestine Liberation Organisation (PLO) and Israel engaged in peace negotiations, which resulted in a set of agreements that established a Palestinian governing authority with limited powers and jurisdiction. Under these agreements, the West Bank was divided into three distinct administrative areas labelled A, B and C:

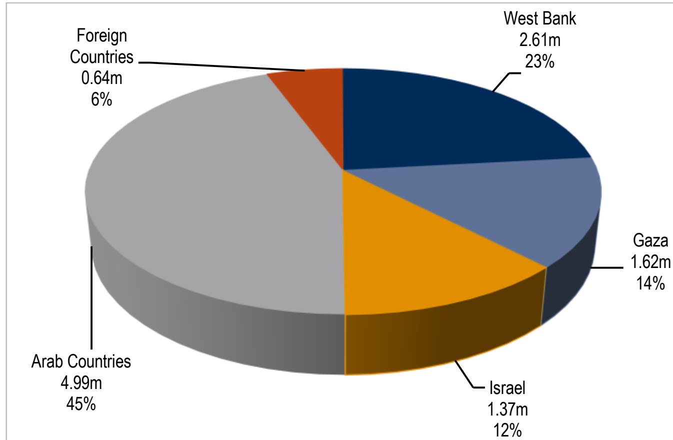
- Area A (c18% of the landmass of the West Bank), where the Palestinian National Authority (PNA) maintains full control over security and civil affairs.
- Area B (c21%), where the PNA controls civil affairs and the Israeli authorities control security.
- Area C (c61%), where the Israeli authorities maintain total civil and security control. The vast majority (96%) of the Palestinian West Bank population live in Areas A and B, and the remaining 4% in Area C.

The Oslo II Agreement did not divide the Gaza Strip into separate administrative areas, and the Strip is classified as Area A, under full administrative control of the PNA. Furthermore, under the disengagement plan adopted by the Israeli Government on 6 June 2004, Israeli forces unilaterally pulled out of Gaza after dismantling all settlement blocks; however, Israel maintains full control over international borders.

Population is small, but fast-growing

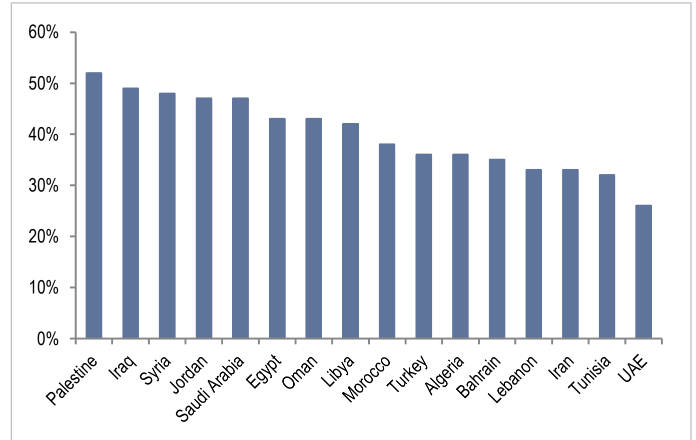
The Palestinian Central Bureau of Statistics (PCBS) estimates the total population of Palestine (West Bank including Jerusalem and Gaza Strip) to be about 4.2m as of 2011, split between the West Bank (c2.6m) and the Gaza Strip (1.6m). The PCBS estimates that there are a further 7m Palestinians in the Diaspora, split between Israel (1.4m) and the Arab countries (5m), with the remaining 0.6m outside the region. In addition, there are more than 0.5m settlers in the West Bank, half of whom are in Jerusalem. Population density is high at 703 capita/km^2 at the end of 2011, but the Gaza Strip in particular, with 4,429 capita/km^2, is one of the most densely populated areas globally.

Chart 25 : Palestinians by country of residence 2011



Source: PCBS

Chart 26 : Population under 19 years of age

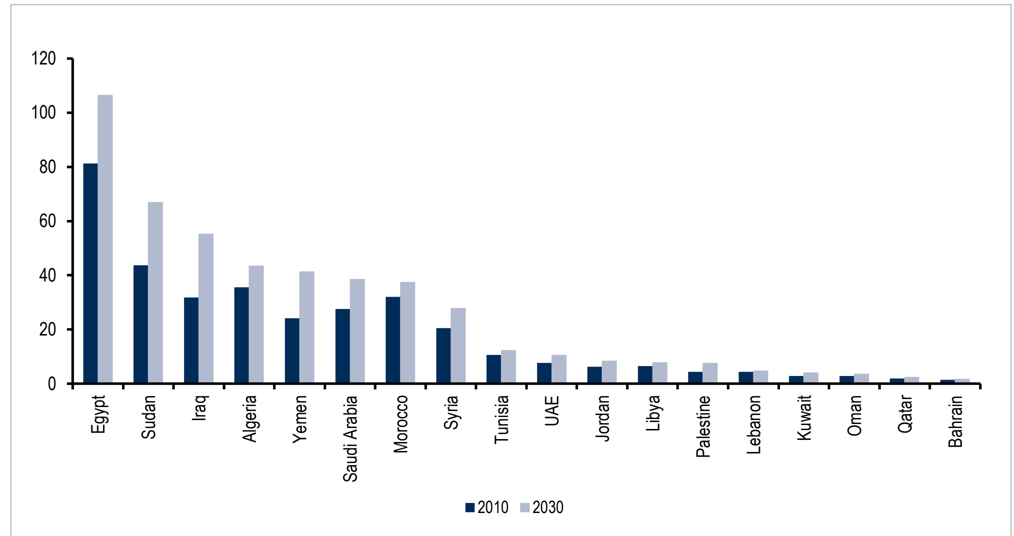


Source: IMF

Population – a key driver

As we have discussed in previous strategy publications *(Cross currents of opportunity,* 13 February 2012, and *MENA consumer markets,* 23 February 2012), young and rapidly growing populations are a key driver for the region in general.

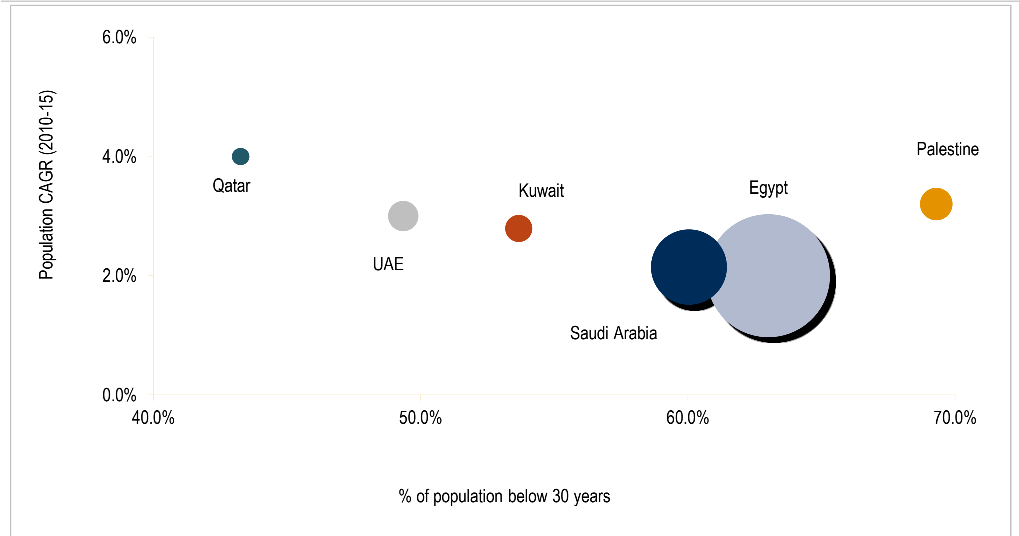
Chart 27 : Population in 2010 and 2030 across the MENA region



Source: United Nations

From a demographic and stock market point of view, Egypt and Saudi Arabia stand out. Egypt is the most populous country in the Arab world, with a population of about 80m, which has been growing, on average, at a rate of 2.0% per annum for the past few years and which we think is likely to add 1m-2m new inhabitants each year for at least the next 20 years, reaching roughly 106m by 2030, based on United Nations projections. With a population of about 27.6m as of 2010, Saudi Arabia is the most populous country in the Gulf Cooperation Council (GCC). The country’s population experienced a CAGR of 3.1% over 2001-10, and, according to the UN, it is likely to increase at an average annual rate of 2.1% to reach about 38m by 2030.

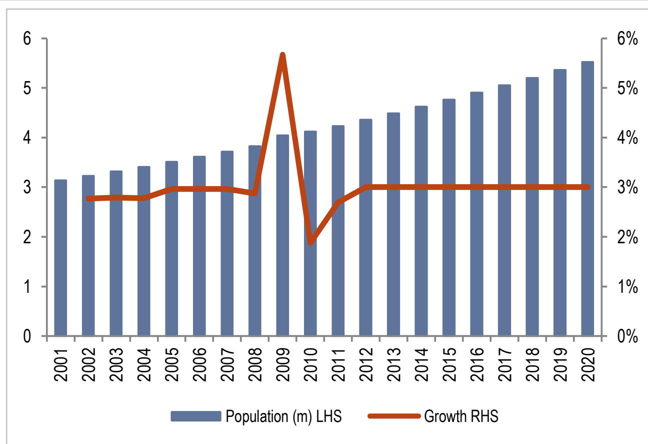
Chart 28 : Demographical statistics in GCC, Egypt and Palestine



Size of bubble represents population size.
Source: US Census Bureau, IMF

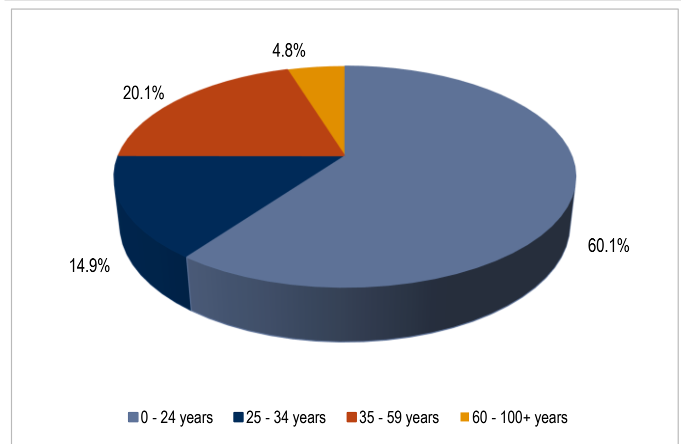
The population in Palestine may be relatively small, at about 4.2m people, but we believe it has some of the most attractive characteristics globally from an investment point of view. About 69% of Palestine's population is under the age of 30, a much higher percentage than in Egypt (63%), Saudi Arabia (60%), Kuwait (53.7%), Qatar (43.3%) and the UAE (49.3%). The population growth rate has been 3.1%, on average, over the past 10 years, and the UN expects this growth rate, one of the highest globally, to continue.

Chart 29 : Population (m) 2001-22F of Palestine



Source: PCBS and Rasmala

Chart 30 : Palestine demographic profile



Source: PCBS

This combination of a young and fast-growing population means that the population in the Palestinian Territories could almost double from the 4.2m in 2011 to around 7.6m by 2030 if the 3%+ growth rate persists, or adding more than 3m new people. From an investment perspective, and combined with growing GDP per capita, this looks interesting. The drawback is that population density, which is already high, will increase further, to about 1,200 capita/square km in the Palestinian Territories, and to about 7,900 in Gaza, an area with one of the highest densities and comparable to city states such as Singapore and Hong Kong.

Income per capita low, but improving

Despite the high rate of population growth, income per capita in Palestine is growing faster than in the other countries in the region (albeit from a low base). However, after suffering an almost decade-long downturn following the start of the second intifada in 2000, GDP per capita has recovered only to the levels of the late-1990s. The poverty rate improved slightly from 26.2% of the population in 2009 to 25.7% in 2010. There remains a gap between the poverty rate in the West Bank (18.3% in 2010) and the Gaza Strip (38.0%).

Table 1 : MENA statistics, 2010/11

Country	Population (m)	GDP/capita (US$)	Unemployment rate	Urbanisation	Population growth (2010-15)
Egypt	79.8	2,789	9.7%	43%	2.0%
Iran	75.1	4,741	14.6%	71%	1.7%
Sudan	43.2	1,705	13.7%	40%	2.6%
Algeria	34.3	4,435	9.9%	66%	1.5%
Morocco	32.1	3,249	9.8%	58%	1.0%
Iraq	31.5	2,564	15.3%	66%	2.3%
Saudi Arabia	27.1	16,996	10.8%	82%	2.1%
Yemen**	22.5	1,282	15.7%	32%	3.0%
Syria	20.9	2,877	8.3%	56%	2.5%
Tunisia	10.4	4,200	14.0%	67%	1.0%
Libya**	6.5	11,314	20.7%	78%	n/a
Jordan	6.5	4,500	13.4%	79%	2.3%
United Arab Emirates**	4.7	59,717	4.2%	84%	3.0%
Lebanon	4.3	10,044	7.0%	87%	1.3%
Palestinian territories*	**4.2**	**1,485**	**25.7%**	**72%**	**3.2%**
Kuwait	3.1	36,412	3.1%	98%	2.0%
Oman	2.7	18,657	n/a	73%	3.2%
Qatar	1.7	76,168	0.5%	96%	4.0%
Bahrain	0.8	20,475	3.6%	89%	2.0%

*Palestinian territories data as of 2011.
**Unemployment rate for UAE, Yemen, Libya as of 2009.
Source: CIA, IMF, Government Statistics

The labour participation rate is still low, but increased to 43.0% in 2011 from 41.1% in 2010, with a 12.6% increase in the size of the labour force to 837,000 employees in 2011 from 744,000 in 2010. The trade, restaurants and hotels segments in the West Bank recorded the highest growth rate of 13.7% during 2011, followed by mining & manufacturing at 13.0%. As a result, the unemployment rate in Palestine decreased to 20.9% in 2011 from 23.7% in 2010.

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The telecommunications sector in Palestine

There are two operators in the telecoms market in Palestine: incumbent Paltel and since end-2009, Wataniya Mobile. In our view, the telecoms market in Palestine offers strong potential for growth: penetration is low, GDP per capita is growing, and the population is one of the youngest and fastest-growing globally.

Overview of the Palestinian telecoms market

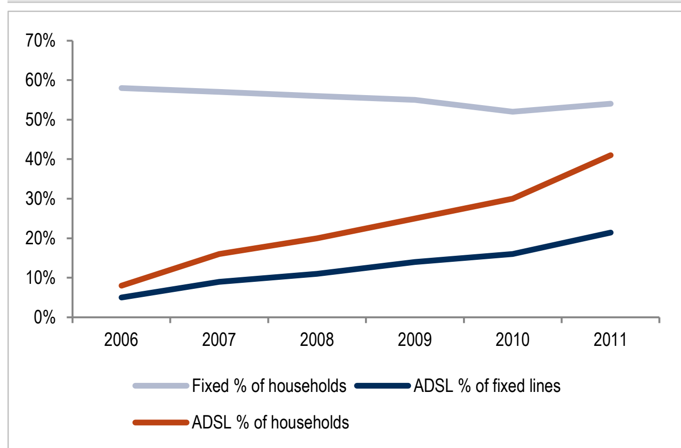
Competitive landscape and trends

Palestine currently has one fixed line and two mobile licensed telecommunications operators. Palestine Telecommunications Company (Paltel) is the incumbent and largest telecom operator in Palestine. Paltel offers fixed, mobile, internet and data services throughout Palestine – for now, it is the only operator in Gaza.

Until recently, the Paltel Group was the only operator in the country, except for some presence by Israeli operators, but after being granted the second-generation 2G frequency in 2009, Wataniya started providing commercial mobile telecommunications services in the West Bank as of 1 November 2009. Wataniya reached a 24% market share in the mobile telecommunications market in the West Bank by end-2011.

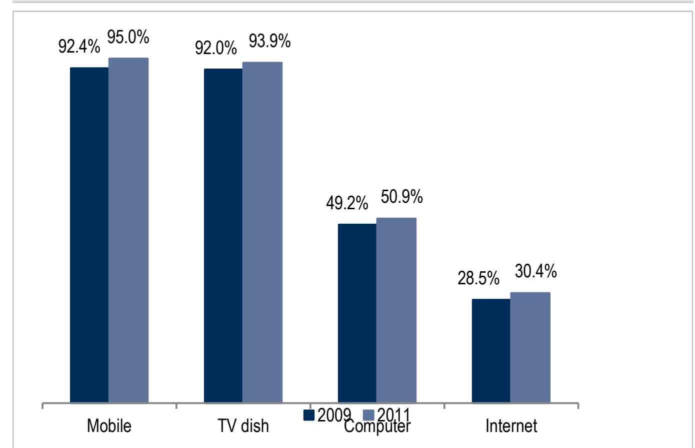
Penetration is still relatively low for both fixed line and mobile. The percentage of households with a computer in Palestine was 50.9% in 2011 compared with 49.2% in 2009. In addition, 30.4% of households had an internet connection in 2011 compared with 28.5% in 2009. The percentage of households that own a TV satellite dish in Palestine was 93.9% in 2011 compared with 92.0% in 2009. In 95.0% of Palestinian households, at least one member possessed a mobile phone in 2011 compared with 92.4% in 2009.

Chart 31 : Penetration rates fixed line and ADSL



Source: Paltel

Chart 32 : Percentage of Households with ICT Equipment



Source: PCBS Palestine Yearbook 2011

Challenges – mainly the political situation

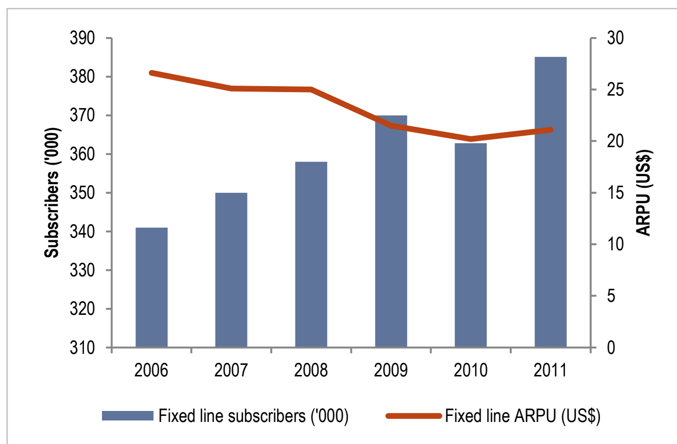
The main challenges for telecoms operators in Palestine, in our view, centre around the political situation in Palestine and Israeli restrictions. Israel controls frequencies, imports telecom equipment and installs equipment in Area C. It takes a while to get equipment into Gaza and Area C in the West Bank, although the lead time has been reduced from about 2 years to 6-8 months currently.

Furthermore, Palestine does not have 3G services yet due to Israeli spectrum restriction, officially attributed to security reasons. The Israeli authorities are the only body that will release frequencies and permission to operate a 3G network, and it is still unclear when these restrictions will be lifted (Israel has used the issue of frequencies as part of its negotiations with the PA); the operators are working through a number of channels to have Israel release more spectrum.

Fixed-line market – Paltel is the only operator

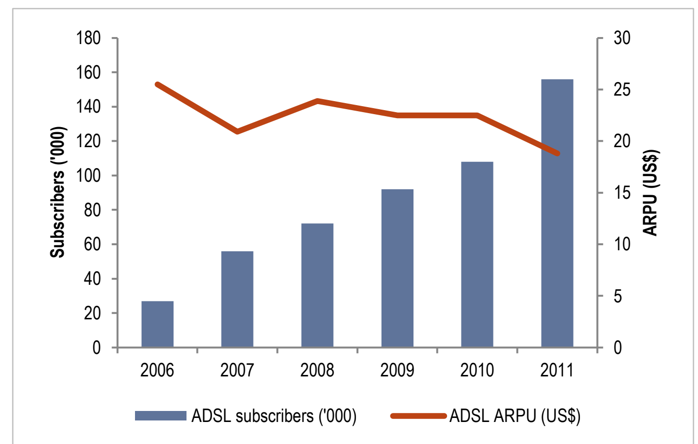
Paltel is the only fixed-line operator in Palestine. After a dip in both ARPU and the number of subscribers in 2010 (-6% and -2%, respectively), both grew again in 2011 by a respective 5% and 6%, after Paltel launched new campaigns. Over 2006-11, the number of fixed-line subscribers increased, on average, by 2.4%.

Chart 33 : Fixed-line market: subscribers & ARPU



Source: Company reports

Chart 34 : ADSL market: subscribers & ARPU



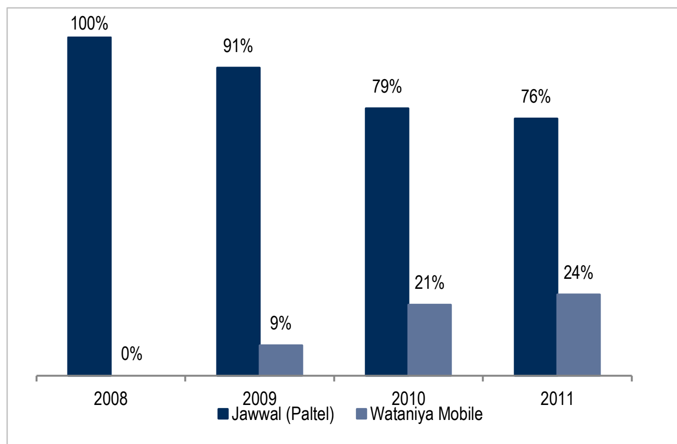
Source: Company reports

At the same time, Paltel reported a strong increase of 44% in the number of ADSL subscribers in 2011, from 108,000 in 2010 to 156,000 in 2011, but the monthly ARPU fell by 16% from US$22.5 in 2010 to US$18.8 in 2011. Growth in the number of ADSL subscribers averaged 42% per year from 2006 to 2011.

Mobile market

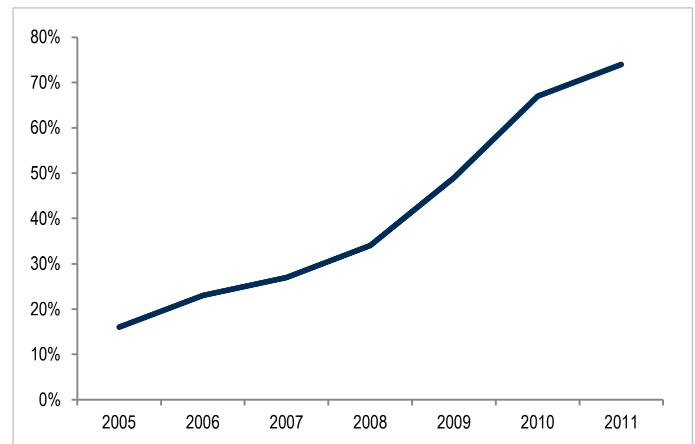
There are two operators in the mobile segment: Jawwal, Paltel's wholly owned mobile telecommunications subsidiary, which has c2.6m subscribers, and Wataniya, which reached 592,000 (end-September 2012) after it started providing commercial mobile telecommunications services in the West Bank (as of 1 November 2009).

Chart 35 : West Bank: mobile market shares



Source: Wataniya Mobile reports

Chart 36 : Palestine: mobile penetration rates



Source: Wataniya Mobile reports

In addition to Jawwal, Wataniya Mobile competes with unlicensed Israeli operators that offer their SIM cards and scratch cards via dealers in the Palestinian market. Israeli providers are unable to openly advertise their products in the Palestinian market, are restricted to offering prepaid services and are not able to offer customer services to customers in Palestine. The Ministry of Telecommunications and Information Technology (MTIT) has taken, and continues to take, actions to curb the availability of Israeli SIM cards within the West Bank and Gaza. There are currently no publicly available official statistics as to the number of Israeli SIMs in the Palestinian market. However, Wataniya Mobile management estimates that Israeli operators have between 150,000 and 250,000 subscribers in Palestine.

Outlook for the Palestinian telecoms market

The market in a regional perspective

In the MENA region, the growth in subscriber numbers has been strong (a CAGR of 20% over the five-year 2006-11 period, according to Bloomberg data); and in 2011, subscriber numbers grew in double digits in the North African countries in particular as well as in Jordan.

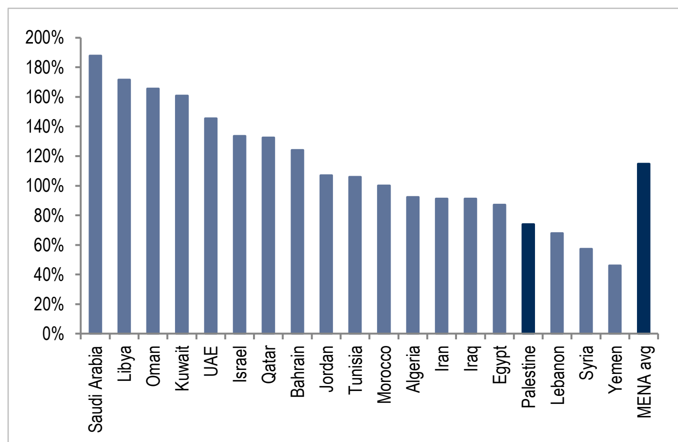
Table 2 : Wireless subscribers (m) by country

Country	2006	2007	2008	2009	2010	2011	CAGR 2006-2011
Algeria	21.0	27.6	26.9	32.7	32.8	35.4	11%
Bahrain	0.8	1.1	1.5	1.5	1.6	1.7	15%
Egypt	18.0	31.1	41.8	55.4	70.6	83.1	36%
Iraq	10.9	14.3	18.5	20.6	23.3	24.4	18%
Israel	8.4	9.0	9.2	9.6	9.9	9.8	3%
Jordan	4.2	4.8	5.5	6.3	6.6	7.5	12%
Kuwait	2.5	2.8	3.2	4.0	4.5	5.0	14%
Libya	3.9	4.5	7.4	9.5	10.9	10.0	21%
Morocco	15.9	20.0	22.7	25.3	32.0	36.6	18%
Oman	1.8	2.5	3.2	4.0	4.6	4.8	21%
Palestine	**0.8**	**1.0**	**1.3**	**1.8**	**2.5**	**2.8**	**28%**
Qatar	0.9	1.3	1.7	2.5	2.8	2.8	25%
Saudi Arabia	19.7	28.4	36.0	44.8	51.6	53.7	22%
Tunisia	7.3	9.0	9.3	9.8	11.1	12.6	11%
United Arab Emirates	5.8	7.3	9.8	10.7	10.9	11.7	15%
Total - MENA	**121.2**	**163.5**	**196.7**	**236.7**	**273.1**	**299.0**	**20%**

Source: Bloomberg, Rasmala

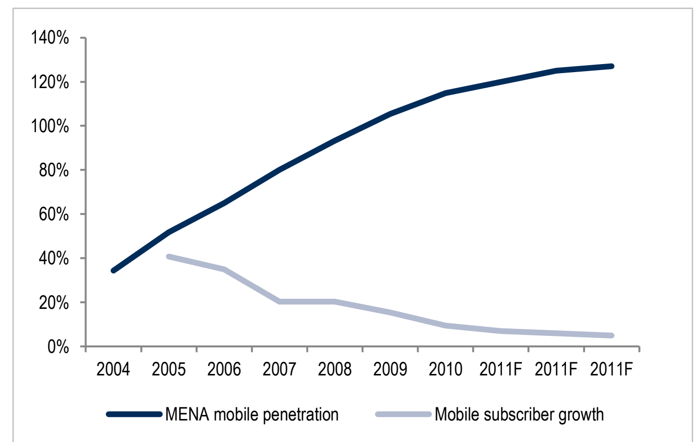
Growth of 28% annually, on average, in the Palestinian telecommunications market over the same period was amongst the highest in the MENA region, coming from a low base perhaps, but achieved despite all the political challenges the industry was facing. Mobile penetration rates are still low (70% at end-2011) and at the lower end of the range for the region, or elsewhere globally, where penetration rates are above the 100% level, despite the strong growth over the past five years.

Chart 37 : Mobile penetration rates – MENA region



Source: Bloomberg, Rasmala

Chart 38 : Mobile penetration rates – Palestine



Source: ITU, Company data, Rasmala estimates

Palestine – expect continued subscriber growth

With overall mobile penetration in the MENA region reaching the maturity part of the life cycle, we expect mobile subscriber growth in the forthcoming years to be much more constrained across the region, and we project a CAGR of 6% for 2011-15, rather than the high double-digit growth rates the industry has enjoyed in the recent past.

For the Palestinian market, we expect market growth in the low double digits over 2011-15F. We believe that the combination of high economic growth, relatively low penetration rates and favourable demographics remain strong drivers for future subscriber growth. Despite the entry of Wataniya Mobile into the market at the end of 2009, both Paltel and Wataniya have managed to increase revenues and EBITDA since then, even though there was some slowdown in the first half of 2012.

But some pressure on ARPUs and revenue growth for Paltel

For the most part, domestic operations remain the prime revenue generator for the MENA operators. Competition in the mobile telecommunications markets, as elsewhere, is dictated by pricing, quality of services, coverage, tariffs and promotions. Hence, in some Middle Eastern countries where new licenses have been granted in the past, the result has been pressure on ARPUs and growth. For Palestine, this has also been the case.

Table 3 : Domestic market contribution to revenues (2010)

Operator	Domestic market	Domestic market contribution to revenue
Paltel Group	**Palestine**	**100%**
Wataniya Mobile	**Palestine**	**100%**
Mobily	Saudi Arabia	100%
Etisalat	UAE	85%
Mobinil	Egypt	100%
Zain Saudi	Saudi Arabia	100%
Q-tel	Qatar	80%
Du	UAE	100%
Jordan Telecom	Jordan	100%
Wataniya	Kuwait	65%
Telecom Egypt	Egypt	100%
Vodafone Qatar	Qatar	100%
Oman Telecoms	Oman	97%
Nawras	Oman	100%

Source: Company data

Indeed, revenue growth for FY10 and FY11 was insubstantial for most mature operators, due to the combination of a maturing life cycle and increasing competition. Paltel's revenue growth was still relatively strong, despite increased competition, although revenues declined 4% and 6% in Q2 and Q3 2012 respectively. ARPUs at Paltel have been under pressure, but are still higher than those of Wataniya.

Table 4 : Key indicators by operator

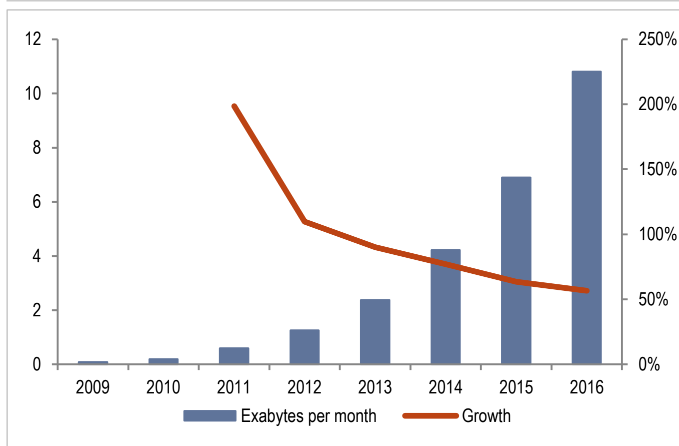
Operator	Revenue growth		Subscriber growth*		ARPU change**	
	2009-10	2010-11	2009-10	2010-11	2009-10	2010-11
Paltel Group	**7%**	**9%**	**22%**	**8%**	**-13%**	**-1%**
Wataniya Mobile	**nm**	**76%**	**219%**	**32%**	**nm**	**13%**
Mobily	23%	12%	17%	6%	-6%	-3%
Etisalat	4%	2%	9%	12%	-10%	-8%
Mobinil	-2%	0%	18%	16%	-19%	-12%
Zain Saudi	98%	na	41%	na	15%	na
Q-tel	13%	10%	31%	11%	8%	-5%
Du	33%	20%	28%	17%	-1%	-1%
Jordan Telecom	1%	-3%	16%	6%	-11%	-12%
Wataniya	15%	17%	38%	9%	-14%	-6%
Telecom Egypt	4%	4%	15%	2%	-11%	-9%
Vodafone Qatar	n/m	159%	n/m	71%	n/m	-29%
Oman Telecoms	1%	-1%	11%	8%	-14%	-9%
Nawras	10%	10%	11%	11%	-6%	-1%

*Subscribers include mobile, Internet and fixed lines. ** Rasmala calculation of ARPU
Source: Company data, Zawya, Rasmala

Data growth giving a boost

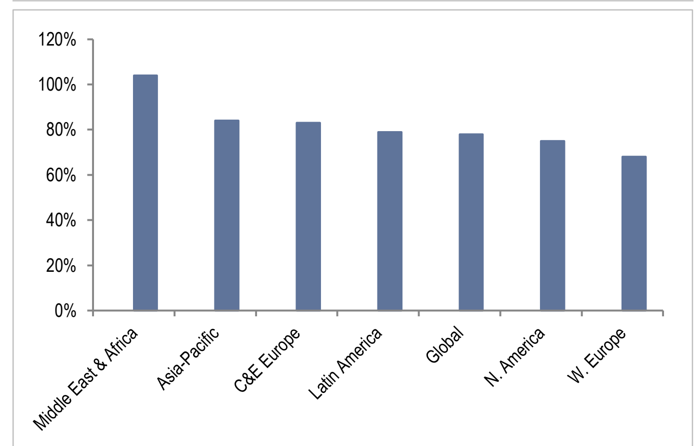
In this environment, operators are seeking alternative revenue streams. Indeed, the global data market is still fast-growing, driven by the global handset and media device market. The number of people accessing mobile internet is growing rapidly, and the International Telecommunications Union (ITU) expects mobile access to overtake desktop web access in the next few years. Significantly, the mobile phone penetration rate outnumbers the fixed-line penetration rate, and we believe this trend will continue for internet access too. This is true for the region and may be further boosted by the fact that mobile phone customers in the region tend to use two or more mobile phones, increasingly for much more than voice.

Chart 39 : Global mobile and internet traffic



Source: Cisco

Chart 40 : Mobile and internet traffic CAGR 2011-16



Source: ITU

According to the Cisco Visual Networking Index (VNI) Global Mobile Data Forecast, global mobile data traffic should increase by 78% from 2011-16, and the Middle East and Africa should experience the highest CAGR of 104%.

Going forward, we believe that one of the key reasons behind the uptake in data demand will be handset compatibility and network coverage. We believe technology development has played a larger role in the Middle East telecoms market than in any other emerging market because of the unique culture, high youth population and strong purchasing power of the MENA population. More than 60% of the MENA population is under the age of 30, and their strong purchasing power means they tend to purchase more expensive data and multimedia services, yielding higher value for domestic operators.

However, this is where Palestine is still behind, as network coverage is still expanding and 3G has not yet been introduced. Nevertheless, the data segment, albeit small, has been a fast-growing segment for Paltel (a 29% CAGR in revenues over 2006-11), and we expect this to continue, with about a 21% CAGR over 2011-14F. Once networks can be upgraded, we believe this growth can even be accelerated, making it one of the more important segments for the company.

Palestine: still low mobile penetration rates, but growing rapidly

All in all, we see the main drivers for growth for the Palestinian market as:

- Low penetration rates (70% for mobile at end-2011, 54% fixed)
- Scope to extend coverage, thus creating new markets that did not previously have mobile services from a Palestinian operator
- Palestinian operators should be able to take over coverage that is now done by (illegal) Israeli operators
- Further expansion of coverage in Gaza (population 1.6m)
- Some of the most favourable demographics globally: the total population is relatively small (4m) and amongst the youngest in the region, with 52% below 19 years of age. Furthermore, with the population growing at 3.2% pa, there is a continuous rise in the number of potential subscribers in the mobile market.
- Introduction of 3G once Israel allows it, which could be a significant boost for future data traffic growth.

Paltel Group – Financial outlook

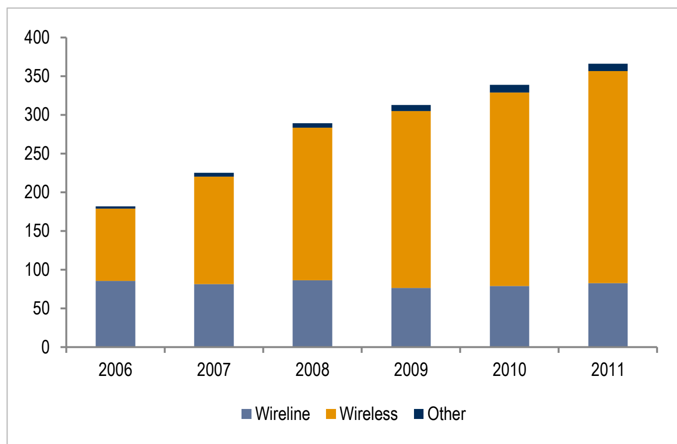
We expect revenue and net profit growth to be in the low single digits over our forecast horizon. Paltel's balance sheet remains strong, and, based on its limited capex requirements of less than 15% of revenues, we expect Paltel to maintain a healthy dividend pay-out.

Revenues – growth despite increased competition

We project single-digit revenue growth rates for Paltel, given the increased competition from Wataniya, the possible launch of Wataniya into Gaza, where Paltel still has a monopoly, and the uncertainty of when 3G will be introduced.

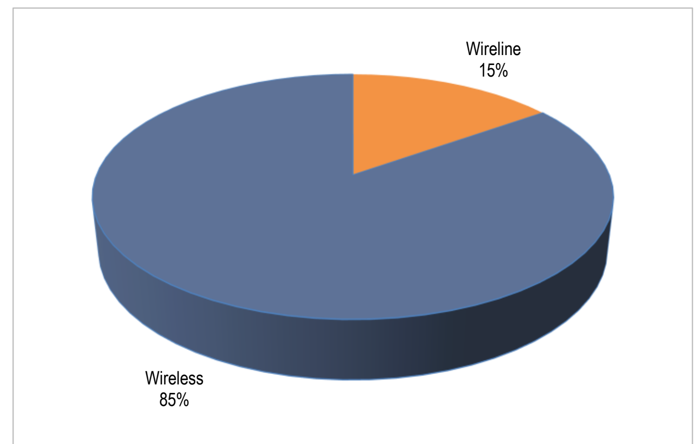
Wireless is by far the most important segment for the Paltel Group (74% of revenues and 85% of pretax profits in 2011), and revenues grew, on average, by 24% per year between 2006 and 2011. Only the Data segment grew faster during that period, by 29%, but it still represented only 3% of revenues (2011).

Chart 41 : Revenues by segment (JODm)



Source: Company reports

Chart 42 : Pretax profit by segment, 2011

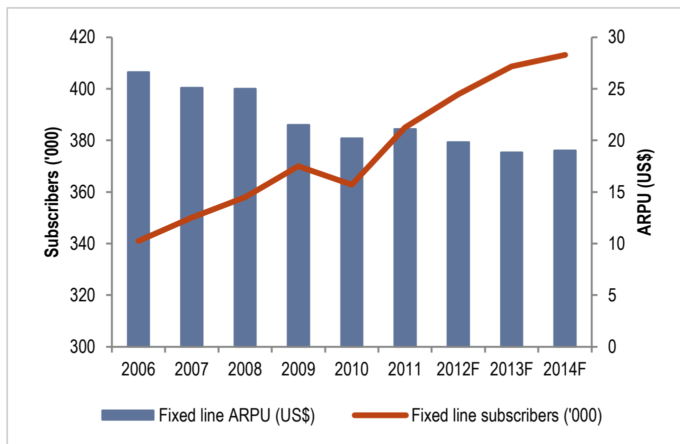


Source: Company reports

Paltel: fixed-line and ADSL

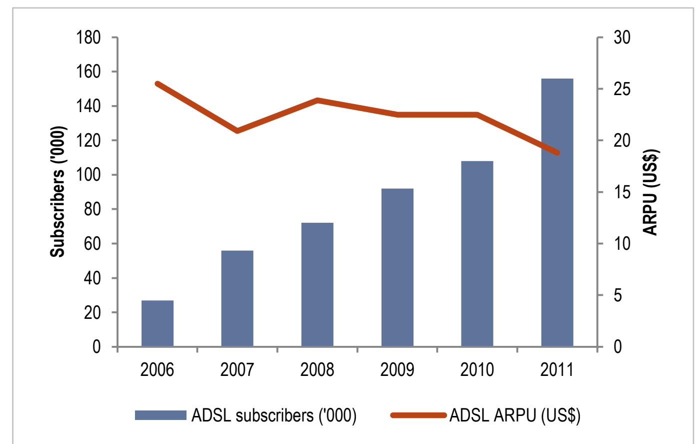
Paltel's number of fixed-line subscribers grew, on average, by 2.5% per year over 2006–11, but grew by 6% in 2011, following a dip of 2% in 2010. In the first three quarters of 2012, the number of subscribers grew by about 1.5% versus end-2011. For the full year, we are forecasting growth of under 3% YoY, but for 2011-14F, we are assuming a growth rate, on average, of about 2.4%, based on estimated population growth and an expected 51% penetration rate of households (vs 54% in 2011).

Chart 43 : Paltel fixed-line subscribers ('000) and ARPU (US$)



Source: Company reports, Rasmala forecasts

Chart 44 : Paltel ADSL subscribers ('000) and ARPU (US$)



Source: Company reports

Fixed-line ARPUs already dropped from US$26.6 in 2006 to US$21.1 in 2011, reaching a low of US$20.2 in 2010. We assume a dip of 6% to US$19.8 for 2012F (US$19.6 in Q3 2012), followed by a further drop of 5% in 2013F. If the regulator were to allow competition in fixed line, this could put pressure on returns and market share, but so far, we have not seen an indication that this may happen in the near future.

For ADSL, we are assuming continued double-digit growth in the number of subscribers, i.e. 17%, for 2011-14F (the CAGR was 42% in 2006-11) and a steady increase in the penetration rate from 41% at end-2011 to 60% by 2014F, offset by some pressure on ARPUs. We assume a further drop in ADSL ARPUs from US$18.8 in 2011 to US$15.4 by 2014F.

Jawwal: mobile competition, but still growing

The number of mobile subscribers (Jawwal) showed much stronger growth of 24% per year, on average, in 2006–11, but growth slowed to a still-respectable 7% in 2011, despite increased competition from Wataniya.

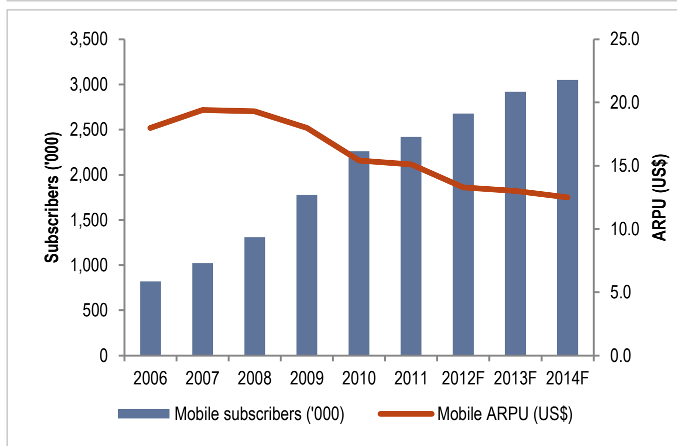
Growth continued into 2012, with the number of subscribers growing from 2.42m at end-2011 to 2.59m at end-September 2012, or 7% growth, although this represents a small decline compared with 2.61m subscribers at end-June 2012.

The market grew faster at 11% in the first half of the year, resulting in a small decline in Jawwal's market share from 81% at end-2011 to 79% by end-June, a period during which Wataniya increased its market share to 17%.

For our forecast period, we are assuming a CAGR of 8% in the number of subscribers for 2011-14F, based on projected population growth and an expected increase in the penetration rate from 70% in 2011 to 90% by 2014. We assume that Paltel will be able to maintain growth, even if Wataniya were to expand into Gaza, but our forecasts imply a loss in market share from about 81% in 2011 to 74% by 2014F.

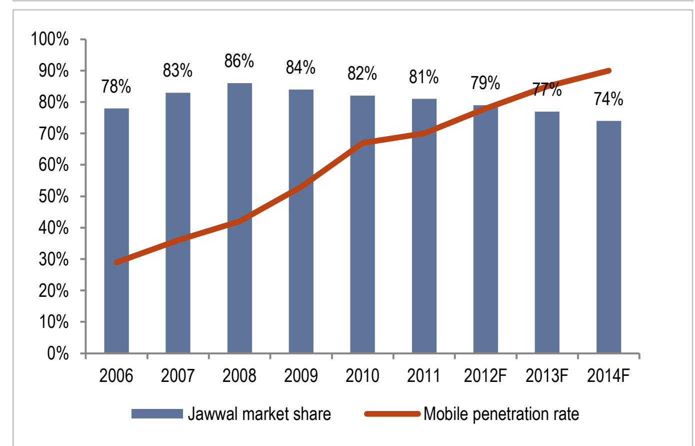
ARPUs decreased from a high of US$19.4 in 2007 to US$15.1 in 2011 and US$13.1 in Q3 2012. We are assuming a further drop in ARPU of 12% to US$13.3 in 2012, and further declines in 2013F and 2014F, resulting in ARPU of US$12.5 in 2014F.

Chart 45 : Jawwal mobile subscribers ('000) and ARPU (US$)



Source: Company reports, Rasmala forecasts

Chart 46 : Jawwal market share and market penetration rate



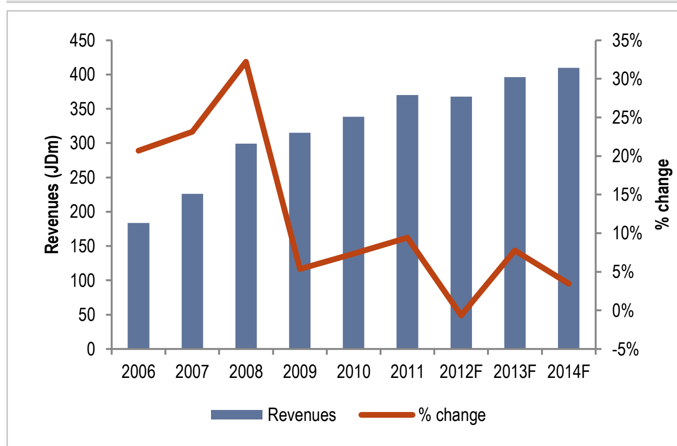
Source: Company reports

Revenues – growth slowing to single digits

These assumptions lead us to forecast a revenue CAGR of about 3% over 2011-14F, with an assumed revenue CAGR of about 2% for Jawwal, 0% for fixed and 13% for ADSL.

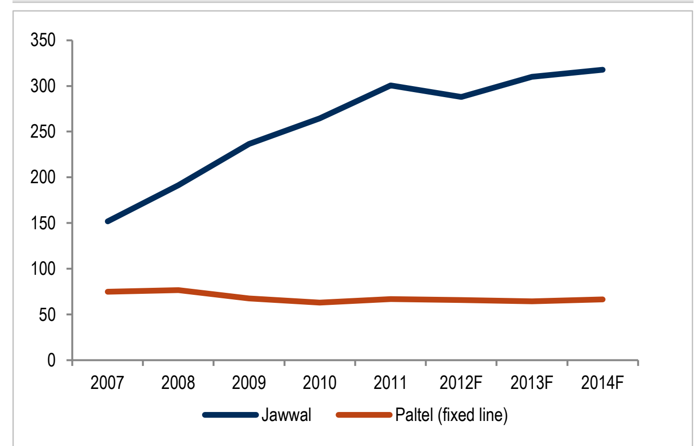
For the first three quarters of 2012, Paltel Group reported a drop of 2% in revenues compared with the same period last year, and for the full year, we forecast a drop of 1%, followed by some positive momentum in 2013 and 2014 (with revenue growth projected at 7.7% and 3.8%, respectively).

Chart 47 : Paltel revenues 2006–14F (JODm)



Source: Company reports, Rasmala forecasts

Chart 48 : Estimated revenues for wireless and wireline (JODm)



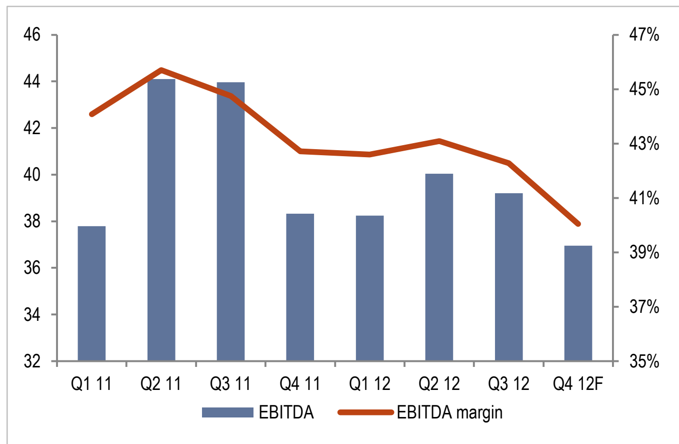
Source: Company reports, Rasmala forecasts

Profitability – expect to remain high

Paltel went through an internal restructuring in 2010, which resulted in an improvement in the EBITDA margin from 42% in 2010 to 44% in 2011, the latter being in line with the 2006-11 five-year average (the EBITDA margin fluctuated between 42% and 47% during that period) and also in line with the average for the MENA telecoms sector at around 44% in 2011. As Wataniya is still in the start-up phase, profitability and margins are still low and not relevant for comparison. However, in the first three quarters of 2012, the EBITDA margin went from 44.9% in the same period of last year to 42.7%, and the operating margin went from 35.2% to 31.8%. Operating profits declined by 1% YoY to JOD88m during that period, and EBITDA was down by 46.6% YoY to JOD117m.

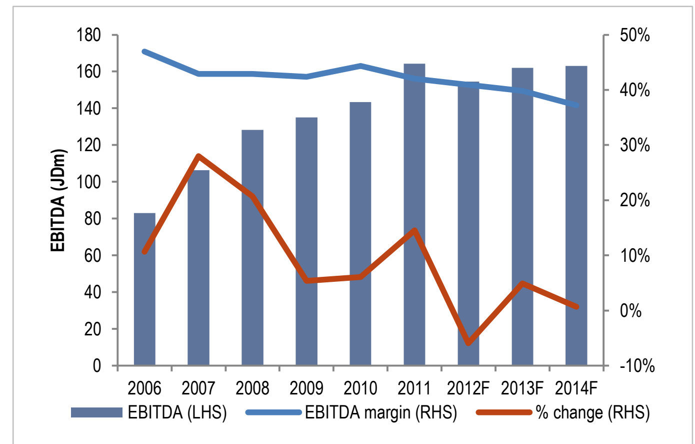
We understand from management that EBITDA margins are higher in the mobile segment (mid-40% area) than in the fixed-line segment (in the low-30% area). The company believes that, for the mobile segment, EBITDA margins above 40% are sustainable, which, given the importance of the mobile segment in the results, could also lead to a sustainable group margin in the 40% area for the longer term. We are slightly more cautious and assume an EBITDA margin in the low 40% area for 2012-13, followed by a margin just below 40% after 2013. This could result in a flat EBITDA performance for 2011-14F, in our view, but with a drop in 2012 (-6%), followed by a return to growth of 4.9% in 2013.

Chart 49 : Paltel quarterly EBITDA (JODm) and margin (%)



Source: Company reports, Rasmala forecasts

Chart 50 : Paltel EBITDA (JODm) and margin (%) 2006–14F



Source: Company reports, Rasmala forecasts

Tax rate has negatively affected net income in 2012

In 2012, Paltel Group voluntarily elected to waive its right to the partial exemption to pay an income tax rate of 50% of the nominal tax rate for a period of two years, which increases its tax rate from about 10% in 2011 to our forecast of 22% for 2012F. For 2013F, we have assumed a tax rate of 23%. After 2013, we have assumed that the tax rate will revert back to 12%, which is the main driver of our forecast for net income growth of 15% in 2014F (we forecast flat pretax profits for that year).

Table 5 : Quarterly forecasts (JODm)

	2011	Q1 12	Q2 12	Q3 12	Q4 12F	H1 12	9M 12	2012F	2013F	2014F
Revenue	**370**	**90**	**93**	**93**	**92**	**183**	**275**	**368**	**396**	**410**
% change	9.4%	4.7%	-3.7%	-5.6%	2.9%	0.3%	-1.8%	-0.7%	7.7%	3.4%
Telecommunications services costs	-30	-7	-8	-9	-8	-16	-25	-33	-35	-36
License fees	-27	-7	-7	-7	-7	-13	-20	-27	-29	-31
Other costs	-25	-6	-6	-6.52	-6.10	-12	-19	-25	-26	-27
Telecom service costs, license fees & other	-82	-20	-21	-21.93	-21.29	-42	-63	-85	-90	-94
Gross Profit	**288**	**70**	**72**	**71**	**71**	**141**	**212**	**283**	**306**	**316**
Operating and administrative expenses	-161	-41	-41	-42	-45	-83	-124	-170	-192	-202
Operating Income	**127**	**28**	**30**	**29**	**26**	**59**	**88**	**113**	**114**	**114**
% change	13.7%	-3.1%	-14.4%	-15.3%	-8.9%	-9.2%	-11.3%	-10.8%	0.5%	0.1%
Gain/Loss from Investments	-18	-2	-2	-2	-2	-4	-5	-7	-3	-3
Finance cost	-2	0	0	0	-1	-1	-1	-2	-1	-1
Foreign Exchange Gain (Loss)	-6	0	0	0	0	0	0	0	0	0
Other	0	2	-4	0	1	-2	-1	0	0	0
Pre-tax Income	**101**	**28**	**24**	**27**	**25**	**53**	**80**	**104**	**110**	**110**
Income tax	-10	-5	-6	-6	-6	-11	-17	-23	-25	-13
Tax rate	10.2%	19.4%	23.2%	22.5%	23.1%	21.2%	21.6%	22.0%	23.0%	12.0%
Net income before XO	**91**	**23**	**19**	**21**	**19**	**41**	**63**	**81**	**85**	**97**
Minority Interests	0	0	0	0	0	0	0	0	0	0
Net Inc Avail to Common Shareholders	**91**	**23**	**19**	**21**	**19**	**41**	**63**	**81**	**85**	**97**
% change		-10.4%	-16.0%	-9.9%	-4.0%	-13.0%	-12.0%	-10.3%	3.9%	14.9%
Depreciation & Amortisation	37	10	10	10	11	20	30	41	48	49
EBITDA	164	38	40	39	37	78	117	154	162	163
% change		1.2%	-9.2%	-10.8%	-3.6%	-4.4%	-6.6%	-5.9%	4.9%	0.7%
EBITDA Margin	44.3%	42.6%	43.1%	42.3%	40.0%	42.8%	42.7%	42.0%	40.9%	39.8%
Gross Margin	77.8%	77.6%	77.0%	76.3%	76.9%	77.3%	77.0%	76.9%	77.3%	77.1%
Operating Margin	34.3%	31.6%	32.4%	31.4%	27.8%	32.0%	31.8%	30.8%	28.7%	27.8%
Net margin	24.5%	25.2%	20.2%	22.9%	20.4%	22.7%	22.7%	22.1%	21.4%	23.7%

Source: Company reports, Rasmala forecasts

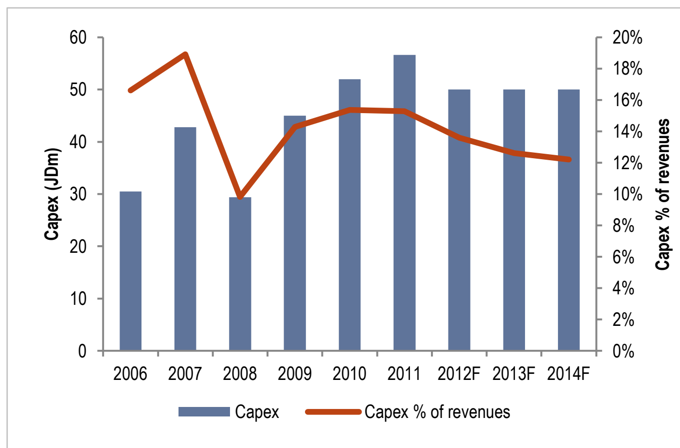
Capital expenditures and dividend pay-out

Compared with Wataniya Mobile, Paltel's capex requirements are relatively low: the company has indicated a level of under JOD50m per year for 2012 and 2013. During 2009-11, capital expenditures averaged about 14-15% of revenues. We assume that Paltel Group will get permission for 3G in 2014, when we expect a level of capex in excess of JOD60m for that purpose (although we have not yet factored this into our revenue forecast). After 2014, we expect capex to go down to a level of about JOD30m per year.

With a net cash position of JOD36m (end-2011), the balance sheet is comfortable, in our view, and supportive of a continued dividend pay-out%. We expect Paltel to maintain a dividend of at least JOD0.40 per share, given the strength of the balance sheet and limited capex requirements.

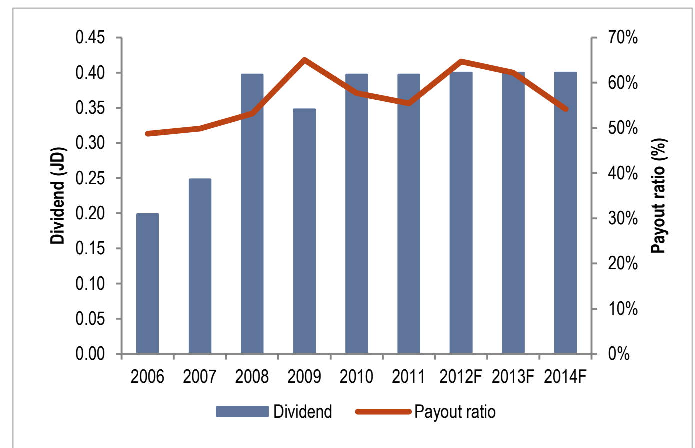
Paltel reduced interest-bearing debt by 31% to JOD50m from 2010 to end-2011. EBITDA/debt improved from 2.8x in 2010 to 4.6x in 2011, and the current ratio is 1.95x.

Chart 51 : Paltel capex (JODm) and capex % of revenues



Source: Company reports, Rasmala

Chart 52 : Paltel dividend (JOD) and pay-out ratio



Source: Company reports, Rasmala

Disclosure Appendix

Recommendation structure

Absolute performance, long term (fundamental) recommendation: The recommendation is based on implied upside/downside for the stock from the target price and only reflects capital appreciation. A Buy/Sell implies upside/downside of 10% or more and a Hold less than 10%.

Performance parameters and horizon: Given the volatility of share prices and our pre-disposition not to change recommendations frequently, these performance parameters should be interpreted flexibly. Performance in this context only reflects capital appreciation and the horizon is 12 months.

Target price: The target price is the level the stock should currently trade at if the market were to accept the analyst's view of the stock and if the necessary catalysts were in place to effect this change in perception within the performance horizon. In this way, therefore, the target price abstracts from the need to take a view on the market or sector. If it is felt that the catalysts are not fully in place to effect a re-rating of the stock to its warranted value, the target price will differ from 'fair' value.

Relative views: Our strategy teams and analysts may provide strategy views on sectors and/or markets. An Overweight, Underweight or Neutral view implies outperformance, under-performance or a neutral performance in an indicated relative context

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