BATELCO

الوطني NBK

August 19, 2007

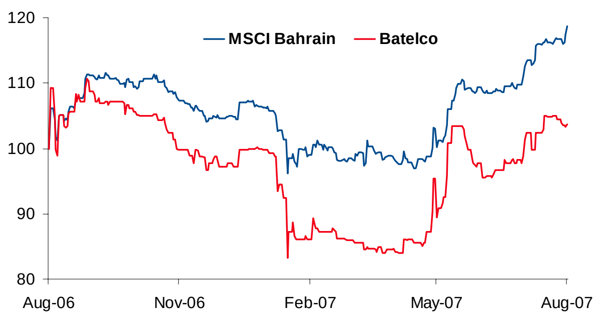
Key Data

Current Price*	Avg. Value Traded per Day
BHD 0.987	BHD 72,740.88
52-Week High	**Market Cap**
BHD 1.000	BHD 1,184 mln
52-Week Low	**Current Number of Shares**
BHD 0.792	1,200 mln
Reuters	**Bloomberg**
BTEL.BH	BALTECO BI

Ownership Structure
Government:75% Public:21% Privately Held: 4%

Sources: Reuters, Zawya, and MENA Equity Research
** Price as of close on August 16, 2007*

Rebased Performance



Sources: MSCI, Reuters, and MENA Equity Research

Key Ratios

	2006 a	2007 f	2008 f	2009 f	2010 f
P/E	13.3	12.4	11.8	10.8	9.9
EPS Growth	4%	7%	5%	9%	9%
EV/ EBITDA	10.1	8.9	8.2	7.8	7.4
EBITDA Margin	49%	48%	48%	47%	47%
EBITDA Growth	11%	13%	8%	5%	6%
Dividend Yield	5.3%	6.1%	7.2%	7.9%	9.1%
PBV	3.3	3.0	2.8	2.6	2.5
ROAE	26%	25%	25%	25%	26%

1H2007 EBITDA a	2H2007 EBITDA f
BHD 65.43 mln	BHD 64.74 mln
1H2007 EBITDA f	**1H2008 EBITDA f**
BHD 63.65 mln	BHD 69.71 mln

Sources: Reuters and MENA Equity Research
a = actual, f = forecast

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Highlights

12-Month Fair Value: BHD 1.119

Recommendation: Accumulate – Risk Level: 4**

Reason for Report: First-Half 2007 Update

- Batelco grew its revenues in 1H2007 by 28% compared with the same period last year. That growth is mainly due to its expansion outside Bahrain. According to management, 28% of revenues came from Batelco's presence in Kuwait, Jordan, Egypt, and Yemen. 1H2006 figures did not include Jordan operations since Umniah was acquired in 2H2006.
- The EBITDA margin dropped in 1H2007 compared with the same period last year, from 53% to 48%, due primarily to increases in most expenses, especially with the acquisition of Umniah.
- Batelco's results for 1H2007 were in line with our expectations. Hence, we have not made any major changes to our forecasts. However, we did start consolidating Sabafon operations using the equity method.
- To consolidate Sabafon's operations, we forecast its net income using the net income per subscriber achieved during 1H2007 as well as the forecast penetration rate in Yemen from the Informa database and our estimation of its market share over the forecast horizon.
- We increase our fair value estimate of Batelco's share price to BHD 1.119. To arrive at this fair value estimate, we used a combination of discounted cash flow (DCF) and peer comparison based on forward price/earnings-to-growth (PEG) and EV/EBITDA multiples. Given an upside potential of 13% from yesterday's close, our new recommendation is "Accumulate."
- Based on our subjective criteria for rating risk, we assigned Batelco a risk rating of 4 on a scale of 1 to 5.
- This report is an update. Readers are advised to read this report in conjunction with our initiation-of-coverage report published April 1, 2007.
- Since our last report Batelco's share price has risen by about 21% to BHD 0.987.

*** Please refer to page 5 for recommendations and risk ratings.*

VALUATION

Batelco's results for the first half of 2007 (1H2007) were in line with our expectations. With better disclosure on the Sabafon acquisition we were able to consolidate Batelco's stake in the company using the equity method. This led to a revision of our forecasts for Batelco; hence we have increased our fair value estimate of the company's share price from BHD 0.923 to BHD 1.119. To arrive at this fair value estimate, we used a combination of discounted cash flow (DCF) and peer comparison based on forward price/earnings-to-growth (PEG) and EV/EBITDA multiples. We specified a weight for each method, as shown in Figure 1. Given an upside potential of 13% from yesterday's close, our recommendation remains "Accumulate."

Our 12-month fair value estimate of Batelco's share price increased 21% from our previous estimate. This change was driven primarily by a 17% increase in the fair value using the DCF method and a 32% increase using the peer comparison method. The prospect of the issuance of a third mobile license in Bahrain seems to have faded away, and therefore we did not take that into consideration.

Our new 12-month fair value for Batelco is BHD 1.119

Figure 1 Fair Value per Share

Valuation Method	Old		New		Change
	Weight	Value	Weight	Value	
Discounted Cash Flow	60.0%	BHD 0.984	70.0%	BHD 1.156	17.5%
Discounted Cash Flow - 3rd License Scenario	10.0%	BHD 0.983	0.0%	BHD 0.000	-100.0%
Peer Comparison	30.0%	BHD 0.782	30.0%	BHD 1.033	32.1%
Weighted Average Fair Value	**100.0%**	**BHD 0.923**	**100.0%**	**BHD 1.119**	**21.2%**

Source: MENA Equity Research

DISCOUNTED CASH FLOW VALUATION

Our DCF valuation (Figure 2) is based on financial results forecast through 2012, including the Sabafon acquisition. However, we did not incorporate in our model the fixed-line license in Saudi Arabia until further details are made available. We believe that acquisition will impart an upside potential to the fair value of Batelco in the future.

We used the same cost of equity of 12.5%, which reflects the perceived risk from home market saturation, stiff competition in Jordan, and a small market in Yemen.

Using the DCF valuation method, we arrived at a fair value per share of BHD 1.16

Figure 2 DCF Valuation

Figures in BHD Thousands*	Forecast				
Fiscal Year Ends December	2008	2009	2010	2011	2012
Net Operating Profit after Tax	**104,101**	**109,958**	**116,567**	**123,536**	**129,583**
Add: Depreciation and Amortization	34,604	35,267	35,840	36,203	36,521
Gross Cash Flow	**138,705**	**145,225**	**152,408**	**159,739**	**166,103**
(Incr.)Decr. in Working Capital	2,559	2,416	2,054	1,822	1,777
(Incr.)Decr. in Operating Fixed Assets	(18,165)	(10,879)	(9,385)	(5,949)	(5,195)
Free Cash Flow from Operations	**123,099**	**136,762**	**145,077**	**155,612**	**162,685**
Terminal Value					**1,077,763**

Value of Operations in 12 Months	**1,220,716**
Add: Excess Cash	222,619
Add: Value of Long-Term Investments	88,542
Add: Value of Other Long-Term Assets	-
Less:Total Debt	(136,269)
Less: Minority Interest	(8,488)
Value of Equity in 12 Months	**1,387,120**
Per Share Value in BHD	**1.16**

*Source: MENA Equity Research * Except per share value*

Sensitivity Analysis

We performed a sensitivity analysis (Figure 3) on two important inputs for our DCF valuation model: the cost of equity and the perpetual growth rate used in computing the terminal value.

The DCF valuation is sensitive to our choice of cost of equity and the perpetual growth rate

Figure 3 DCF Sensitivity

		Growth				
		4.50%	4.75%	5.00%	5.25%	5.50%
Cost of Equity*	11.5%	BHD 1.26	BHD 1.27	BHD 1.27	BHD 1.27	BHD 1.28
	12.0%	BHD 1.21	BHD 1.21	BHD 1.21	BHD 1.21	BHD 1.21
	12.5%	BHD 1.16	BHD 1.16	BHD 1.16	BHD 1.15	BHD 1.15
	13.0%	BHD 1.11	BHD 1.11	BHD 1.11	BHD 1.11	BHD 1.11
	13.5%	BHD 1.07	BHD 1.07	BHD 1.07	BHD 1.06	BHD 1.06

*Source: MENA Equity Research * Variations in the cost of equity result in variations in WACC*

FIRST-HALF PERFORMANCE

- Batelco's footprint is characterized by saturation in its home market, stiff competition in Jordan, and a small market in Yemen. Yet Batelco was able to grow its revenues in 1H2007 by 28% compared with the same period last year. That growth is mainly due to its expansion outside Bahrain. According to management, 28% of revenues came from Batelco's presence in Kuwait, Jordan, Egypt, and Yemen. It is worth noting that the 1H2006 figures did not include the Umniah operations because that acquisition did not take place until 2H2006.

- Revenues from mobile services saw the highest growth in 1H2007—42% compared with the same period last year. However, fixed-line services decreased around 8%, although the total number of telephone lines grew to 201,000 at the end of June 2007. According to Batelco management, the lines of broadband subscribers are added to the PSTN stats, while broadband revenue is under Domestic data - Internet category.

- Batelco's earnings before interest, taxes, depreciation, and amortization (EBITDA) margin dropped in 1H2007 compared with the same period last year, from 53% to 48%, due primarily to increases in most expenses, especially with the acquisition of Umniah.

- Batelco acquired 20% of Yemeni operator Sabafon for BHD 59.57 million. That portion of Sabafon reported profits of BHD 0.477 million for the first half of this year.

- Batelco saw an increase of 10% in net income during the first six months of 2007 compared with the same period in 2006. This was mainly due to a one-off gain of BHD 4.7 million from the reversal of an impairment provision and the recovery of an impaired bank deposit. Without the one-off gain, Batelco would have posted flat growth of just 0.3% (Figure 4).

Net income increased by 10% in 1H2007

Figure 4 First-Half Performance

Income Statement (BHD Thousands)	First-Half Results			Common Size	
	2006	2007	Change	2006	2007
Total Revenue	**105,987**	**136,389**	**28.7%**	**100.0%**	**100.0%**
Staff Costs	15,408	20,314	31.8%	14.5%	14.9%
Other general and administrative expenses	16,460	24,479	48.7%	15.5%	17.9%
Out-payments to telecommunications Operators	12,658	17,578	38.9%	11.9%	12.9%
Licence fees	934	2,683	187.3%	0.9%	2.0%
Cost of sales	4,216	5,901	40.0%	4.0%	4.3%
EBITDA	**56,311**	**65,434**	**16.2%**	**53.1%**	**48.0%**
Depreciation/amortization	13,061	18,155	39.0%	12.3%	13.3%
Operating Income	**43,250**	**47,279**	**9.3%**	**40.8%**	**34.7%**
Share of Profit of Associate	0	477		0.0%	0.3%
Finance Costs	0	(1,090)		0.0%	-0.8%
Interest income	3,539	882	-75.1%	3.3%	0.6%
Investment income	997	812	-18.6%	0.9%	0.6%
Loss from disposal of property, plant and equipment	(54)	(52)	-3.7%	-0.1%	0.0%
Reversal of impairment provision	0	3,637		0.0%	2.7%
Recovery of impaired bank deposit	0	1,043		0.0%	0.8%
Other, net	358	487	36.0%	0.3%	0.4%
Net Income Before Taxes	**48,090**	**53,475**	**11.2%**	**45.4%**	**39.2%**
Minority interest	628	1,195	90.3%	0.6%	0.9%
Net Income	**47,462**	**52,280**	**10.2%**	**44.8%**	**38.3%**

Source: Batelco financial statements

OUTLOOK

First-Half Results

Batelco's 1H2007 results were in line with our previous expectations. Hence, we have not made any major changes to our forecasts (Figure 5). However, for this report we started consolidating the Sabafon operations using the equity method as described below.

Consolidation of Sabafon

We addressed the issue of the Sabafon acquisition in our publication dated April 1, 2007. In March 2007, Batelco announced the acquisition of 20% of Sabafon, a private mobile operator in Yemen. We still view this acquisition as too small, since Batelco's share in Sabafon's net profit was only 0.9% of Batelco's total net profit for the first half of 2007.

To consolidate Sabafon's operations we forecast its net income using its net income per subscriber achieved during 1H2007 as well as the forecast penetration rate in Yemen from the Informa database and our estimation of its market share over the forecast horizon.

The changed forecast reflects an improvement in the wholesale revenues and the consolidation of Sabafon

Figure 5 New vs. Old Forecasts for FY2007

Income Statement (BHD Thousands)	2007 Forecast		
	Old	New	Change
Total Revenue	268,115	271,187	1%
Cost of Revenue	53,623	54,237	1%
Gross Profit	**214,492**	**216,950**	**1.1%**
Selling/General/Admin. Expenses	85,797	86,780	1%
Depreciation/Amortization	31,145	31,145	0%
Operating Income	**97,550**	**99,025**	**1.5%**
Equity Income Associates	-	608	
Interest Income (Exp), Net Non-Operating	899	(1,067)	-219%
Net Income before Taxes	**98,449**	**98,566**	**0.1%**
Provision for Income Taxes	1,295	1,279	-1%
Net Income after Taxes	**97,154**	**97,286**	**0**
Minority Interest	(1,575)	(1,575)	0%
Net Income	**95,579**	**95,711**	**0.1%**

Source: MENA Equity Research

Risk and Recommendation Guide

Recommendation	Upside (Downside) Potential	Risk Level*				
		1	2	3	4	5
Buy	more than 20%					
Accumulate	between 10% and 20%				■	
Hold	between -5% and 10%					
Reduce	between -10% and -5%					
Sell	less than -10%					

** 1 being least risky*

FINANCIAL STATEMENTS

Balance Sheet (BHD Thousands)		Historical				Forecast			
Fiscal Year Ends December	2004	2005	2006	2007	2008	2009	2010	2011	2012
ASSETS									
Cash and Short-Term Investments	136,369	162,747	45,756	209,491	250,363	222,597	250,604	277,695	299,262
Total Receivables, Net	43,350	34,005	38,054	43,390	46,982	50,372	53,256	55,812	58,307
Total Inventory	590	873	1,213	1,627	1,762	1,889	1,997	2,093	2,187
Prepaid Expenses	4,333	3,196	8,734	8,136	8,809	9,445	9,985	10,465	10,933
Other Current Assets, Total	-	-	-	-	-	-	-	-	-
Total Current Assets	**184,642**	**200,821**	**93,757**	**262,643**	**307,915**	**284,304**	**315,842**	**346,066**	**370,688**
Property/Plant/Equipment, Total - Net	153,277	151,224	203,038	195,374	180,054	156,783	131,446	102,310	72,103
Goodwill, Net	-	-	124,380	124,380	124,380	124,380	124,380	124,380	124,380
Intangibles, Net	623	-	32,181	31,063	29,945	28,827	27,709	26,591	25,473
Long Term Investments	23,821	35,039	27,828	88,419	88,498	88,564	88,578	88,600	88,612
TOTAL ASSETS	**362,363**	**387,084**	**481,184**	**701,880**	**730,791**	**682,858**	**687,955**	**687,947**	**681,256**
LIABILITIES & EQUITY									
Accounts Payable	15,864	13,762	18,794	21,695	23,491	25,186	26,628	27,906	29,154
Current Port. of LT Debt/Capital Leases	-	-	3,659	52,538	48,879	-	-	-	-
Other Current Liabilities, Total	40,573	42,485	63,451	70,509	76,345	81,855	86,540	90,695	94,749
Total Current Liabilities	**56,437**	**56,247**	**85,904**	**144,742**	**148,715**	**107,041**	**113,168**	**118,601**	**123,902**
Long-Term Debt	-	-	6,342	140,155	138,664	110,633	82,602	54,571	26,540
Deferred Income Tax	-	-	7,033	7,385	7,754	8,142	8,549	8,976	9,425
Minority Interest	6,087	6,511	8,488	8,488	8,488	8,488	8,488	8,488	8,488
Other Liabilities, Total	-	-	10,741	5,371	2,685	-	-	-	-
Total Liabilities	**62,524**	**62,758**	**118,508**	**306,140**	**306,306**	**234,304**	**212,806**	**190,636**	**168,355**
Total Equity	**299,839**	**324,326**	**362,676**	**395,740**	**424,486**	**448,554**	**475,149**	**497,311**	**512,901**
TOTAL LIABILITIES AND EQUITY	**362,363**	**387,084**	**481,184**	**701,880**	**730,791**	**682,858**	**687,955**	**687,947**	**681,256**

Income Statement (BHDThousands)		Historical				Forecast			
Fiscal Year Ends December	2004	2005	2006	2007	2008	2009	2010	2011	2012
Total Revenue	203,764	211,616	234,990	271,187	293,635	314,828	332,848	348,828	364,419
Cost of Revenue	26,561	40,277	43,648	54,237	58,727	62,966	66,570	69,766	72,884
Gross Profit	**177,203**	**171,339**	**191,342**	**216,950**	**234,908**	**251,862**	**266,278**	**279,062**	**291,535**
Selling/General/Admin. Expenses	66,626	68,280	76,463	86,780	93,963	103,893	109,840	115,113	120,258
Depreciation/Amortization	32,376	25,714	29,921	31,145	34,604	35,267	35,840	36,203	36,521
Operating Income	**78,201**	**77,345**	**84,958**	**99,025**	**106,341**	**112,702**	**120,598**	**127,746**	**134,756**
Equity Income in Associates	-	-	-	608	687	753	767	789	801
Interest Income (Exp), Net Non-Operating	5,581	9,571	5,877	(1,067)	(2,236)	932	4,581	7,895	11,050
Net Income before Taxes	**83,782**	**86,916**	**90,835**	**98,566**	**104,792**	**114,386**	**125,946**	**136,430**	**146,607**
Provision for Income Taxes	-	-	-	1,279	2,609	3,131	4,438	4,637	5,622
Net Income after Taxes	**83,782**	**86,916**	**90,835**	**97,286**	**102,183**	**111,255**	**121,509**	**131,793**	**140,985**
Minority Interest	(1,198)	(1,315)	(1,500)	(1,575)	(1,654)	(1,736)	(1,823)	(1,914)	(2,010)
Net Income	**82,584**	**85,601**	**89,335**	**95,711**	**100,529**	**109,518**	**119,685**	**129,879**	**138,975**

Sources: Annual reports and MENA Equity Research

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