Zain KSA

Telecoms – Mobile

ZAINKSA AB: Saudi Arabia

24 October 2010

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Al Rajhi Capital

US$2.912bn	48.1%	US$11.30mn
Market cap	Free float	Avg. daily volume

Target price	8.00	2.6% over current
Consensus price	8.40	7.7% over current
Current price	7.80	as at 23/10/2010

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Underweight | **Neutral** | **Overweight**

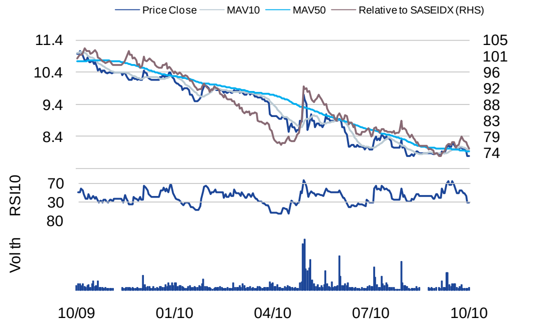
Key themes

We expect mobile to continue to outperform fixed-line telecoms in Saudi Arabia over the next few years, driven by mobile data. We think that STC has slightly lost its way in the domestic mobile market, to the benefit of its competitors.

Implications

Zain KSA is performing well on many measures and we expect it to achieve strong market share gains over the next decade, even though it is less strong in mobile data than Mobily. Unfortunately, Zain is hobbled by a high debt burden, which reduces the share of enterprise value attributable to equity shareholders.

Performance

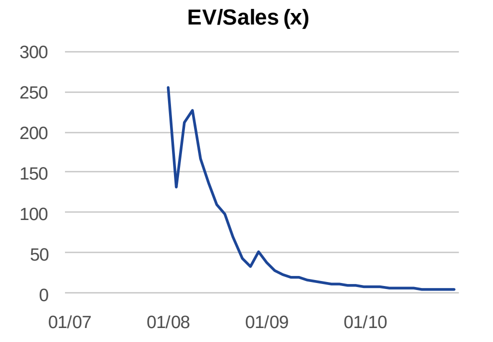


Earnings

Period End (SAR)	12/09A	12/10E	12/11E	12/12E
Revenue (mn)	3,004	5,925	8,225	10,325
Revenue Growth	494.6%	97.2%	38.8%	25.5%
EBITDA (mn)	(1,073)	311	1,374	2,375
EBITDA Growth	-15.2%		342.5%	72.8%
EPS	- 2.21	- 1.66	- 1.09	- 0.36
EPS Growth	36.0%	-25.0%	-34.5%	-66.5%

Source: Company data, Al Rajhi Capital

Valuation



Source: Company data, Al Rajhi Capital

Zain KSA
Still too risky to invest

This report follows our Flash View of 13th October. While Zain KSA again achieved strong sales growth in Q3, its results also featured rising SGA costs and high depreciation and interest charges. We have raised our sales forecasts but left our profit forecasts little changed, and our target price remains SAR8.0. We expect Zain's share price to be driven not by its results, but by Etisalat's bid for Zain Kuwait – whose implications in our view are negative for its affiliate – and the timing of financial restructuring. We remain Neutral.

Sales growth very strong: As in Q2, Zain KSA reported impressive revenue growth. Sales of SAR1,662mn were up by 95% year-on-year and by 15% versus Q2; sales were 7% above our estimate of SAR1,554mn. We believe that this strong performance reflected continuing robust subscriptions growth and high call volumes. However, we do not see evidence that mobile broadband accounts growth accelerated significantly during Q3.

Gross profit strong, but SG&A rising: Gross profit of SAR712mn was up by 193% year-on-year and was 9% above our estimate of SAR653mn. We believe that one of the key reasons for this strong performance was further roll-out of Zain KSA's network; this should have reduced roaming payments to Mobily. While gross profit was well above our forecast, sales, general and administrative costs were also above our estimate. Consequently, by our calculation Q3 EBITDA stood at SAR135mn, or 3% below our estimate of SAR139mn.

Depreciation and financial charges still weigh on net profit: Combined depreciation and amortisation charges remained high at SAR370mn. Zain KSA's operating loss thus came in SAR235mn, or 4% below our estimate of a loss of SAR246mn. Net financial costs, which jumped in Q2, remained high in Q3 at SAR309mn. Consequently, Zain KSA reported a net loss of SAR544mn. This was 2% above our estimated net loss despite the strong sales and gross profit.

Financial costs surge: High financial costs reflect the ongoing impact of the jump in gross debt from SAR11.97bn at the end of Q1 to SAR14.07bn by the end of Q3. On the basis of our new sales forecast for 2010 of SAR5,925mn, Zain KSA's net debt/sales ratio remains very high at 2.4x (1.7x for 2011). Zain's high gearing explains why we regard financial restructuring as essential.

Our new forecasts: Zain KSA has published financial targets for 2011 which we see as broadly achievable. We have raised our estimates of sales for the company but have not pushed up our estimates of EBITDA or net profit correspondingly. A significant increase in net profit is contingent on completion of Zain's financial restructuring, which would reduce the company's huge interest costs. With higher sales but profit forecasts little changed, our estimate of fair value per share on a long-run DEP basis is essentially unaltered at around SAR8.0.

Valuation and conclusion: We believe that issues largely beyond Zain KSA's control will determine the direction of its share price: namely, Etisalat's bid for Zain Kuwait and the timing of financial restructuring. Even though Zain KSA's recent results have shown strong operating progress, we have not changed our view that it is too risky to invest in the company as a potential recovery stock until after the financial restructuring is completed – something which the offer for Zain's parent puts in question. We retain our target price of SAR8.0, which is equivalent to the long-run fair value, and retain our Neutral rating.

Corporate summary

Zain KSA is the third-placed telecoms operator in Saudi Arabia, with a market value of US$2.9bn; it launched service in Q3 2008. By our estimate Zain has a market share of mobile accounts of 13-14%, although its revenue share is lower at 9-10%. Zain has no presence in the fixed-line market. Zain KSA is an affiliate of the Zain group of Kuwait. Zain Kuwait is an emerging telecoms player operating in 24 markets in the Middle East and Africa, but it has sold the majority of its African assets to Bharti and now faces a takeover offer from Etisalat of the UAE.

Share information

Market cap (SAR/US$)	10.92bn / 2.912bn
52-week range	7.80 - 11.05
Daily avg volume (US$)	11.30mn
Shares outstanding	1,400mn
Free float (est)	48.1%

Performance:	1M	3M	12M
Absolute	-1.3%	-2.5%	-28.8%
Relative to index	1%	-5.7%	-25.3%

Major Shareholder:	
Mobile Telecommunications Co. (Kuwait)	25%
Faden Trading and Contracting	6.9%

Source: Bloomberg, Al Rajhi Capital

Valuation

Period End	12/09A	12/10E	12/11E	12/12E
Revenue (SARmn)	3,004	5,925	8,225	10,325
EBITDA (SARmn)	(1,073)	311	1,374	2,375
Net Profit (SARmn)	(3,099)	(2,326)	(1,522)	(510)
EPS (SAR)	- 2.21	- 1.66	- 1.09	- 0.36
DPS (SAR)	-	-	-	-
EPS Growth	36.0%	-25.0%	-34.5%	-66.5%
EV/EBITDA (x)	na	82.5	19.7	11.6
P/E (x)	na	na	na	na
P/B (x)	1.3	1.8	2.4	2.7
Dividend Yield	0.0%	0.0%	0.0%	0.0%

Source: Company data, Al Rajhi Capital

Details of Q3 results: positive operating but weak financial trends

Sales growth very strong

As in Q2, Zain KSA reported impressive revenue growth. Sales of SAR1,662mn were up by 95% year-on-year and by 15% versus Q2; sales were 7% above our estimate of SAR1,554mn. This strong performance reflected continuing robust subscriptions growth and high call volumes. Zain did not publish a figure for mobile accounts at the quarter-end; our estimate was 7.43mn, compared to our estimates of 4.30mn and 7.00mn for one year previously and the end of Q2 respectively. Note, however, that we do not see evidence that broadband accounts growth accelerated significantly during Q3; we estimate that Zain had only 140,000 broadband mobile accounts at the end of the period, far behind its rivals.

Gross profit strong, but SG&A rising

Gross profit of SAR712mn was up by 193% year-on-year and was 9% above our estimate of SAR653mn. We believe that one of the key reasons for this strong performance was further roll-out of Zain KSA's network (according to Zain, network coverage is now 93%); this should have reduced roaming payments to Mobily. While gross profit was well above our forecast, sales, general and administrative costs were also above our estimate. Consequently, by our calculation Q3 EBITDA stood at SAR135mn, or 3% below our estimate of SAR139mn.

Depreciation and financial charges still weigh on net profit

Combined depreciation and amortisation charges remained high at SAR370mn, within the SAR360-375mn range of the past four quarters but below our estimate of SAR386mn. This meant that Zain KSA's operating loss came in SAR235mn, which was about 4% below our estimate of a loss of SAR246mn. Net financial costs, which jumped in Q2, remained very high in Q3 at SAR309mn. Consequently, Zain KSA reported a net loss of SAR544mn. This was 2% above our estimate of a net loss of SAR532mn despite the strong sales and gross profit.

Financial costs surge

Net debt is 2.4x our estimate of 2010 sales

The high financial costs reflect the ongoing impact of the jump in gross debt from SAR11.97bn at the end of Q1 to SAR14.02bn at the end of Q2. (This jump resulted from Zain KSA's decision to arrange a short-term debt facility with BNP Paribas to refinance its obligations under existing vendor financing contracts.) From Zain KSA's balance sheet we calculate that net debt was little changed at the end of Q3 at SAR14.07bn, compared to our estimate of SAR14.41bn. However, we expect net debt to rise further over the next couple of years due in part to ongoing capex requirements. On the basis of our new sales forecast for 2010 of SAR5,925mn, Zain KSA's net debt/sales ratio remains very high at 2.4x; this ratio falls to 1.7x for 2011. Based on our new estimates the net debt/EBITDA ratio for 2011 is over 11x; this may be compared to our recommended maximum level for a mature telecoms operator of around 3x. Zain's very high gearing explains why we regard financial restructuring as so essential.

Details of our new forecasts

We have significantly raised our sales forecasts for Zain, but have not correspondingly raised our forecasts for EBITDA

Zain KSA has stated that it hopes to achieve 10.0mn mobile accounts, sales of over SAR8bn and EBITDA of SAR1.5bn in 2011. These targets were not far removed from our existing estimates for next year of 10.42mn mobile accounts, sales of SAR7.61bn and EBITDA of SAR1.46bn. That said, for the past two quarters Zain KSA has reported stronger revenues than we had expected. We believe that the chief reason for this is continuing strong subscriptions growth, together with a rising contribution from broadband service even though broadband accounts growth for Zain seems to have been much slower than for its rivals. Accordingly, we have pushed up our revenue forecasts by about 6% for 2010 and about 9% for 2011. However, we have not correspondingly raised our estimates of EBITDA due to the continuing upward pressure on SG&A costs we have mentioned. In fact, we have slightly lowered our EBITDA forecast for 2010, and lowered our EBITDA forecasts for 2011 and 2011 by 7% and 4% respectively. Our new EBITDA forecast of SAR1.34bn for 2011 is about 8% below Zain KSA's target for next year.

A significant increase in net profit depends on completion of the restructuring plan

Regarding the lower half of the profit and loss account, significant improvement is contingent on successful completion of Zain KSA's financial restructuring (i.e. the planned debt-for-equity swap and subsequent rights issue), which would reduce the company's huge interest costs. Without financial restructuring, we do not expect Zain to record a net profit until 2013. If financial restructuring is carried out, we think Zain could achieve net profit in 2012.

Our target price remains SAR8.0 per share; this would SAR13.1 following restructuring

In our long-run discounted economic profit (DEP) model, higher revenue growth compensates for the downward revision to our near-term EBITDA forecasts. Our estimate of fair value per share for Zain KSA on a long-run discounted economic profit (DEP) basis is essentially unaltered at just over SAR8.0. Our target price has been equivalent to the long-run fair value, and we have left it unchanged at SAR8.0. We should note that we have not assumed financial restructuring in our forecasts, taking account of the uncertainty relating to Zain Kuwait (see below). We refer investors to our report *Zain KSA: good plan but not yet enough* (28th August) for details of Zain KSA's financial restructuring plan. If the restructuring plan does take place, our target price share should automatically rise to around SAR13.1.

Figure 1.1 Zain: no. of shares

(m)	
Current shares	1,400.0
Share reduction	-667.2
Interim new share base	**732.8**
Rights issue and debt-for-equity swap (new shares)	438.3
Final new share base	**1,171.2**

Source: Company data

Figure 1.2 Zain: share capital

(SAR mn)		% chg.
Current share capital	14,000	
Capital reduction	-6,672	-47.7%
Interim new share capital	**7,328**	
Rights issue and debt-for-equity swap (new capital)	4,384	59.8%
Final new share capital	**11,712**	

Source: Company data, Al Rajhi Capital

Figure 2. Zain: expected changes in market price

Zain: expected changes in market price	
Capital reduction	
Current share base (m)	1,400.0
Current market price (SAR)	7.80
Current market cap. (SAR mn)	10,920
Interim new share base after capital reduction (mn)	732.8
Implied market price (SAR)	**14.9**
Debt-for-equity swap and rights issue	
Rights issue and debt-for-equity swap (new capital) (SAR mn)	4,384
Expected market cap. after rights issue and debt-for-equity swap	**15,304**
Final new share base (mn)	1,171.2
Implied market price (SAR)	**13.1**
Assumption: new shares in the rights issue are offered at SAR10 each	

Source: Company data, Al Rajhi Capital

Financial restructuring and Etisalat's bid for Zain Kuwait

in our view the implications for Zain KSA of Etisalat's offer for its parent are negative

For detailed discussion of these issues we refer investors to our report *Saudi Telecoms Sector: Mobily still our favourite* of 13th October. Here let us simply repeat our conclusion. There remains considerable uncertainty about prospects for the related issues of Zain KSA's financial restructuring and for Etisalat's offer for Zain Kuwait. However, in our opinion the overall implications for Zain KSA of Etisalat's offer for its parent are negative. This is not due to lack of interest in the Saudi telecom market; indeed, various regional telecoms operators have already expressed potential interest in acquiring the holding in Zain KSA. Rather, it is because we doubt that the majority of plausible industry or financial acquirers will seriously be willing to make the purchase until after Zain KSA's existing shareholders have strengthened the company's finances. Accordingly we believe that the recently announced Q3 results – although strong in operating terms – are not particularly relevant for the direction of Zain KSA's share price. Zain KSA's key need is for its financial restructuring plan to be completed, and this issue is probably beyond the company's control.

We have raised our revenue forecasts for Zain KSA by 6-9% for 2011-12

We do not expect net profit or a dividend till 2013

We expect rapid sales and EBITDA growth over 2010-12

The EBITDA margin should swing upwards sharply from now on

Zain is not cheap on EV/sales, which is the one of the simplest valuation measures for a loss-making company

Income Statement (SARmn)	**12/08A**	**12/09A**	**12/10E**	**12/11E**	**12/12E**
Revenue	**505**	**3,004**	**5,925**	**8,225**	**10,325**
Cost of Goods Sold	(489)	(2,127)	(3,447)	(4,142)	(4,853)
Gross Profit	**16**	**877**	**2,478**	**4,083**	**5,472**
Government Charges		-			
S.G. & A. Costs	(1,281)	(1,950)	(2,167)	(2,709)	(3,098)
Operating EBIT	**(1,700)**	**(2,467)**	**(1,186)**	**(286)**	**613**
Cash Operating Costs	(1,770)	(4,077)	(5,614)	(6,851)	(7,950)
EBITDA	**(1,265)**	**(1,073)**	**311**	**1,374**	**2,375**
Depreciation and Amortisation	(435)	(1,394)	(1,496)	(1,660)	(1,762)
Operating Profit	**(1,700)**	**(2,467)**	**(1,186)**	**(286)**	**613**
Net financing income/(costs)	(226)	(634)	(1,140)	(1,244)	(1,136)
Forex and Related Gains	-	-	-	-	-
Provisions	-	-	-	-	-
Other Income	65	1	-	-	-
Other Expenses	(418)	-	-	-	-
Net Profit Before Taxes	**(2,278)**	**(3,099)**	**(2,326)**	**(1,530)**	**(523)**
Taxes	-	-	-	7	13
Minority Interests	-	-	-	-	-
Net profit available to shareholders	**(2,278)**	**(3,099)**	**(2,326)**	**(1,522)**	**(510)**
Dividends	-	-	-	-	-
Transfer to Capital Reserve	-	-	-	-	-

	12/08A	**12/09A**	**12/10E**	**12/11E**	**12/12E**
Adjusted Shares Out (mn)	1,400	1,400	1,400	1,400	1,400
CFPS (SAR)	(1.317)	(1.218)	(0.593)	0.099	0.894
EPS (SAR)	(1.627)	(2.214)	(1.661)	(1.087)	(0.364)
DPS (SAR)	0	0	0	0	0

Growth	**12/08A**	**12/09A**	**12/10E**	**12/11E**	**12/12E**
Revenue Growth		494.6%	97.2%	38.8%	25.5%
Gross Profit Growth		5228.5%	182.5%	64.8%	34.0%
EBITDA Growth		-15.2%		342.5%	72.8%
Operating Profit Growth		45.1%	-51.9%	-75.9%	
Net Profit Growth		36.0%	-25.0%	-34.5%	-66.5%
EPS Growth		36.0%	-25.0%	-34.5%	-66.5%

Margins	**12/08A**	**12/09A**	**12/10E**	**12/11E**	**12/12E**
Gross profit margin	3.3%	29.2%	41.8%	49.6%	53.0%
EBITDA margin	-250.4%	-35.7%	5.2%	16.7%	23.0%
Operating Margin	-336.4%	-82.1%	-20.0%	-3.5%	5.9%
Pretax profit margin	-450.9%	-103.2%	-39.3%	-18.6%	-5.1%
Net profit margin	-450.9%	-103.2%	-39.3%	-18.5%	-4.9%

Other Ratios	**12/08A**	**12/09A**	**12/10E**	**12/11E**	**12/12E**
ROCE	-12.5%	-11.7%	-6.2%	-1.5%	3.2%
ROIC		-10.7%	-5.6%	-1.4%	2.8%
ROE	-38.9%	-30.5%	-31.6%	-28.5%	-11.8%
Effective Tax Rate	0.0%	0.0%	0.0%	0.5%	2.5%
Capex/Sales	5130.5%	63.0%	16.5%	21.0%	19.0%
Dividend Payout Ratio	0.0%	0.0%	0.0%	0.0%	0.0%

Valuation Measures	**12/08A**	**12/09A**	**12/10E**	**12/11E**	**12/12E**
P/E (x)	na	na	na	na	na
P/CF (x)	na	na	na	79.1	8.7
P/B (x)	0.9	1.3	1.8	2.4	2.7
EV/Sales (x)	42.9	7.6	4.3	3.3	2.7
EV/EBITDA (x)	na	na	82.5	19.7	11.6
EV/EBIT (x)	na	na	na	na	44.9
EV/IC (x)	0.9	1.1	1.2	1.3	1.3
Dividend Yield	0.0%	0.0%	0.0%	0.0%	0.0%

Source: Company data, Al Rajhi Capital

Shareholders' equity has been shrinking due to high net losses

Balance Sheet (SARmn)	12/08A	12/09A	12/10E	12/11E	12/12E
Cash and Cash Equivalents	583	506	250	250	250
Current Receivables	317	1,007	1,374	1,977	2,581
Inventories	60	39	103	135	155
Other current assets	369	312	421	421	421
Total Current Assets	**1,182**	**1,850**	**2,148**	**2,783**	**3,407**
Fixed Assets	2,409	3,847	4,309	5,387	6,594
Investments	-	-	-	-	-
Goodwill	-	-	-	-	-
Other Intangible Assets	23,075	22,133	21,155	20,147	19,139
Total Other Assets	-	-	-	-	-
Total Non-current Assets	**25,484**	**25,980**	**25,464**	**25,534**	**25,734**
Total Assets	**26,665**	**27,830**	**27,612**	**28,317**	**29,140**
Short Term Debt	9,479	-	2,194	2,194	2,194
Trade Payables	3,055	6,247	5,468	6,224	7,094
Dividends Payable	-	-	-	-	-
Other Current Liabilities	556	543	768	768	768
Total Current Liabilities	**13,090**	**6,789**	**8,430**	**9,186**	**10,056**
Long-Term Debt	1,849	12,408	12,739	14,210	14,674
Other LT Payables	-	-	330	330	330
Provisions	4	10	15	15	15
Total Non-current Liabilities	**1,854**	**12,418**	**13,084**	**14,555**	**15,019**
Minority interests	-	-	-	-	-
Paid-up share capital	14,000	14,000	14,000	14,000	14,000
Total Reserves	(2,278)	(5,378)	(7,902)	(9,424)	(9,934)
Total Shareholders' Equity	**11,722**	**8,622**	**6,098**	**4,576**	**4,066**
Total Equity	**11,722**	**8,622**	**6,098**	**4,576**	**4,066**
Total Liabilities & Shareholders' Equity	**26,665**	**27,830**	**27,612**	**28,317**	**29,140**

Net debt currently stands at 2.4x our estimate of 2010 sales

Ratios	12/08A	12/09A	12/10E	12/11E	12/12E
Net Debt (SARmn)	10,745	11,902	14,683	16,153	16,617
Net Debt/EBITDA (x)	- 8.49	- 11.10	47.29	11.76	7.00
Net Debt to Equity	91.7%	138.0%	240.8%	353.0%	408.7%
EBITDA Interest Cover (x)	(5.6)	(1.7)	0.3	1.1	2.1
BVPS (SAR)	8.37	6.16	4.36	3.27	2.90

A large positive movement on working capital supported cash flow in 2009. We see this as unsustainable

Cashflow Statement (SARmn)	12/08A	12/09A	12/10E	12/11E	12/12E
Net Income before Tax & Minority Interest	(2,278)	(3,099)	(2,326)	(1,530)	(523)
Depreciation & Amortisation	435	1,394	1,496	1,660	1,762
Decrease in Working Capital	796	2,060	1,016	122	246
Other Operating Cashflow	-	638	595	7	13
Cashflow from Operations	**(1,048)**	**994**	**781**	**260**	**1,498**
Capital Expenditure	(25,919)	(1,892)	(980)	(1,730)	(1,962)
New Investments	1	-	-	-	-
Others	65	3	0	-	-
Cashflow from investing activities	**(25,853)**	**(1,889)**	**(980)**	**(1,730)**	**(1,962)**
Net Operating Cashflow	**(26,901)**	**(895)**	**(199)**	**(1,470)**	**(464)**
Dividends paid to ordinary shareholders	-	-	-	-	-
Proceeds from issue of shares	14,000	-	-	-	-
Effects of Exchange Rates on Cash	-	-	-	-	-
Other Financing Cashflow	(226)	(575)	(2,306)	-	-
Cashflow from financing activities	**27,484**	**818**	**(57)**	**1,470**	**464**
Total cash generated	583	(78)	(256)	-	0
Cash at beginning of period	-	583	506	250	250
Implied cash at end of year	**583**	**506**	**250**	**250**	**250**

We expect the capex/sales ratio to decline steadily

Ratios	12/08A	12/09A	12/10E	12/11E	12/12E
Capex/Sales	5130.5%	63.0%	16.5%	21.0%	19.0%

Source: Company data, Al Rajhi Capital

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Additional disclosures

1. Explanation of Al Rajhi Capital's rating system

Al Rajhi Capital uses a three-tier rating system based on absolute upside or downside potential for all stocks under its coverage except financial stocks and those few other companies not compliant with Islamic Shariah law:

"Overweight": Our target price is more than 15% above the current share price, and we expect the share price to reach the target on a 6-9 month time horizon.

"Neutral": We expect the share price to settle at a level between 5% below the current share price and 15% above the current share price on a 6-9 month time horizon.

"Underweight": Our target price is more than 5% below the current share price, and we expect the share price to reach the target on a 6-9 month time horizon.

2. Definitions

"Time horizon": Our analysts make recommendations on a 6-9 month time horizon. In other words, they expect a given stock to reach their target price within that time.

"Fair value": We estimate fair value per share for every stock we cover. This is normally based on widely accepted methods appropriate to the stock or sector under consideration, e.g. DCF (discounted cash flow) or SoTP (sum of the parts) analysis.

"Target price": This may be identical to estimated fair value per share, but is not necessarily the same. There may be very good reasons why a share price is unlikely to reach fair value within our time horizon. In such a case we set a target price which differs from estimated fair value per share, and explain our reasons for doing so.

Please note that the achievement of any price target may be impeded by general market and economic trends and other external factors, or if a company's profits or operating performance exceed or fall short of our expectations.

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