



**US\$2.930bn** Market cap  
**48.1%** Free float  
**US\$10.37mn** Avg. daily volume

Target price **8.00** 1.9% over current  
Consensus price **8.40** 7.0% over current  
Current price **7.85** as at 24/1/2011

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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**

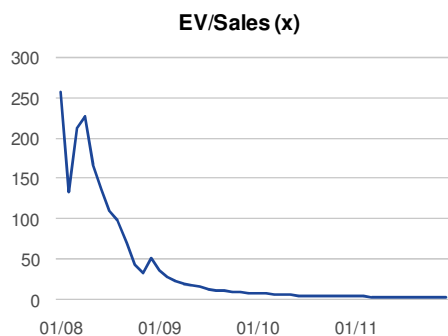


**Earnings**

Period End (SAR)	12/10A	12/11E	12/12E	12/13E
Revenue (mn)	5,934	8,283	10,357	12,155
Revenue Growth	97.5%	39.6%	25.0%	17.4%
EBITDA (mn)	331	1,481	2,434	3,343
EBITDA Growth		348.0%	64.3%	37.3%
EPS	- 1.68	- 1.05	- 0.37	0.10
EPS Growth	-23.9%	-37.8%	-64.8%	

Source: Company data, Al Rajhi Capital

**Valuation**



Source: Company data, Al Rajhi Capital

# Zain KSA

## High growth but high risk

Zain KSA's Q4 2010 results were similar to those of Q2 and Q3, showing strong growth in sales and gross profit, but a large net loss due to high financial costs on its high debt. The full results confirm that net debt stands at SAR14.7bn, or 2.1x annualised Q4 sales. We still think it is too risky to invest in Zain KSA ahead of planned financial restructuring, the timing of which is very uncertain.

**Robust sales growth:** Zain KSA ended 2010 with "more than 8mn customers". This sounds slightly lower than our estimate of year-end mobile accounts of 8.39mn, but not hugely so; we assume now that Zain ended the year with 8.05m accounts. As we had expected, the sales performance was strong: Q4 revenues of SAR1,728mn rose by 93% year-on-year and were a touch above our estimate of SAR1,718mn. For comparison, year-on-year revenue growth in Q3 was 101%.

**Operating result strong:** Gross profit of SAR826mn was up 132% year-on-year and 7% above our estimate. EBITDA of SAR209mn was 11% above our estimate; Q4 was Zain KSA's third quarter of positive EBITDA. While high depreciation and amortisation charges still depress the operating result, the operating loss of SAR179mn was 11% lower than our estimated operating loss of SAR201mn.

**High financial costs explain high net loss:** Net financial costs reached SAR342mn in Q4 compared to our forecast of SAR287mn. This represents a 55% increase year-on-year and an 11% increase quarter-on-quarter. This is the key reason why Zain KSA's reported net loss of SAR521mn was 7% above our forecast of a net loss of SAR488mn despite the strong operating performance.

**Net debt and effective interest rate continue to rise:** From Zain KSA's full 2010 results we calculate that net debt reached SAR14.68bn, up by 4% from the end of Q3 and almost exactly the same as our forecast. Net debt is equivalent to 2.1x annualised Q4 sales. Net debt rose partly because Zain Kuwait advanced an extra SAR492mn to its affiliate over Q4; we do not yet know why it did this. We calculate that Zain KSA paid a surprisingly high effective interest rate of 9.2% on gross debt in Q4 2010. The high debt/sales ratio and high effective interest rate illustrate the urgent need for Zain KSA of financial restructuring.

**New forecasts and valuation:** We have revised up our forecasts of sales, EBITDA and operating profit for Zain KSA for 2011, 2012 and beyond. However, we have also revised up our assumed effective interest rate for 2011 and 2012 and so continue to expect high financial costs and hence high net losses. (Note: we are not assuming any benefit from financial restructuring in our forecasts.) In view of the high effective interest rate, we now estimate WACC for Zain KSA at 10.7%. In our long-run discounted economic profit (DEP) model, the higher WACC counterbalances the boost to valuation from higher operating results. Consequently, our estimate of fair value per share is unchanged at SAR8.0.

**Conclusion – still too risky:** In our view, Zain KSA's very high gearing makes financial restructuring essential. However, we still do not know whether or when Zain KSA will be able to implement the financial restructuring plan agreed last year. Implementation depends in large part on the outcome of Etisalat's bid for Zain KSA's parent, Zain Kuwait – an issue that is in question after the original deadline for completion of the offer expired on 15th January. Meanwhile we think it too risky to invest in Zain KSA as a potential recovery stock. We remain Neutral with an unchanged target price of SAR8.0 (equal to our DEP fair value).



Corporate summary	Share information	Valuation
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 was 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.	<p>Market cap (SAR/US\$) 10.99bn / 2.930bn 52-week range 7.45 - 10.05 Daily avg volume (US\$) 10.37mn Shares outstanding 1,400mn Free float (est) 48.1%</p> <p>Performance: 1M 3M 12M Absolute -1.9% 0.6% -21.9% Relative to index -3.6% -6.1% -28.6%</p> <p>Major Shareholder: Mobile Telecommunications Co. (Kuwait) 25% Faden Trading and Contracting 6.9%</p> <p>Source: Bloomberg, Al Rajhi Capital</p>	<p>Period End 12/10A 12/11E 12/12E 12/13E</p> <p>Revenue (SARmn) 5,934 8,283 10,357 12,155 EBITDA (SARmn) 331 1,481 2,434 3,343 Net Profit (SARmn) (2,358) (1,468) (517) 142 EPS (SAR) - 1.68 - 1.05 - 0.37 0.10 DPS (SAR) - - - - EPS Growth -23.9% -37.8% -64.8% na EV/EBITDA (x) 77.7 17.7 11.2 8.0 P/E (x) na na na 77.3 P/B (x) 1.8 2.4 2.7 2.6 Dividend Yield 0.0% 0.0% 0.0% 0.0%</p> <p>Source: Company data, Al Rajhi Capital</p>

## Zain KSA: summary of Q4 2010 results

Figure 1. Zain KSA: final Q4 2010 results

(SAR mn)	Q4 2009 actual	Q3 2010 actual	Q4 2010 actual	% chg. y- y ARC est.	Q4 2010 ARC est.	Comment
<b>Revenues</b>	<b>895</b>	<b>1,662</b>	<b>1,728</b>	<b>93.0%</b>	<b>1,718</b>	As expected, another strong outcome: y-o-y growth of 93% in Q4 may be compared with 101% in Q3
Gross profit	356	712	826	132.3%	773	Again an impressive performance, and 7% above our estimate
Gross margin (%)	39.7%	42.8%	47.8%		45.0%	The gross margin continues to rise as Zain KSA steadily matures
<b>EBITDA</b>	<b>-70</b>	<b>135</b>	<b>209</b>	<b>-398.1%</b>	<b>189</b>	EBITDA of SAR209mn was 11% above our estimate. This is the third full quarter of positive EBITDA
EBITDA margin (%)	-7.8%	8.1%	12.1%	+4.2pp	11.0%	The EBITDA margin rose by over four percentage points versus Q3. This was a good outcome
Depn. & amortisation	-366	-370	-388	5.9%	-390	High amortisation charges continue to depress operating profit
<b>Operating profit</b>	<b>-437</b>	<b>-235</b>	<b>-179</b>	<b>-59.0%</b>	<b>-201</b>	The operating loss was about 11% below our estimate, but remains substantial
Net financial costs	-221	-309	-342	54.6%	-287	Reflecting high gearing, net financial costs were even higher than we had forecast
Other	0	0	0	-100.0%	0	n/a
Net income before tax	-658	-544	-521	-20.8%	-488	n/a
Tax and zakat	0	0	0		0	We believe that Zain KSA pays no zakat as a loss-making company
<b>Net profit</b>	<b>-658</b>	<b>-544</b>	<b>-521</b>	<b>-20.8%</b>	<b>-488</b>	The net loss was 7% above our estimate despite the strong operating performance; the main reason is very high net financial charges
Capex	727	85	503	n/a	515	Very close to our estimate. Capex appears to be falling towards a more reasonable level of sales
Capex/sales (%)	81.2%	5.1%	0	-52.1pp	30.0%	As above
Net debt	11,902	14,065	14,687	23.4%	14,683	Net debt was almost identical to our forecast, and represented 2.1x annualised Q4 revenues
Net debt/EBITDA (x)	-42.4	26.1	n/a	n/a	19.4	Very high gearing illustrates the necessity of financial restructuring

Source: Company data, Al Rajhi Capital



We have modestly raised our sales forecasts. We have raised our EBITDA forecast for 2011 by 8%, and for 2012 by 2%

We do not expect net profit or a dividend till 2013

We expect rapid sales and EBITDA growth over 2010-13

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)	12/09A	12/10A	12/11E	12/12E	12/13E
<b>Revenue</b>	<b>3,004</b>	<b>5,934</b>	<b>8,283</b>	<b>10,357</b>	<b>12,155</b>
Cost of Goods Sold	(2,127)	(3,404)	(3,880)	(4,505)	(4,983)
<b>Gross Profit</b>	<b>877</b>	<b>2,530</b>	<b>4,403</b>	<b>5,852</b>	<b>7,171</b>
Government Charges	-	-	-	-	-
S.G. & A. Costs	(1,950)	(2,200)	(2,922)	(3,418)	(3,829)
<b>Operating EBIT</b>	<b>(2,467)</b>	<b>(1,164)</b>	<b>(152)</b>	<b>697</b>	<b>1,447</b>
Cash Operating Costs	(4,077)	(5,604)	(6,801)	(7,923)	(8,812)
<b>EBITDA</b>	<b>(1,073)</b>	<b>331</b>	<b>1,481</b>	<b>2,434</b>	<b>3,343</b>
Depreciation and Amortisation	(1,394)	(1,494)	(1,634)	(1,737)	(1,896)
<b>Operating Profit</b>	<b>(2,467)</b>	<b>(1,164)</b>	<b>(152)</b>	<b>697</b>	<b>1,447</b>
Net financing income/(costs)	(634)	(1,195)	(1,323)	(1,227)	(1,301)
Forex and Related Gains	-	-	-	-	-
Provisions	-	-	-	-	-
Other Income	1	-	-	-	-
Other Expenses	-	-	-	-	-
<b>Net Profit Before Taxes</b>	<b>(3,099)</b>	<b>(2,358)</b>	<b>(1,475)</b>	<b>(530)</b>	<b>146</b>
Taxes	-	-	7	13	(4)
Minority Interests	-	-	-	-	-
<b>Net profit available to shareholders</b>	<b>(3,099)</b>	<b>(2,358)</b>	<b>(1,468)</b>	<b>(517)</b>	<b>142</b>
Dividends	-	-	-	-	-
Transfer to Capital Reserve	-	-	-	-	-
	<b>12/09A</b>	<b>12/10A</b>	<b>12/11E</b>	<b>12/12E</b>	<b>12/13E</b>
Adjusted Shares Out (mn)	1,400	1,400	1,400	1,400	1,400
CFPS (SAR)	(1.218)	(0.617)	0.118	0.871	1.456
EPS (SAR)	(2.214)	(1.685)	(1.048)	(0.369)	0.102
DPS (SAR)	0	0	0	0	0
<b>Growth</b>	<b>12/09A</b>	<b>12/10A</b>	<b>12/11E</b>	<b>12/12E</b>	<b>12/13E</b>
Revenue Growth	494.6%	97.5%	39.6%	25.0%	17.4%
Gross Profit Growth	5228.5%	188.5%	74.0%	32.9%	22.6%
EBITDA Growth	-15.2%	-	348.0%	64.3%	37.3%
Operating Profit Growth	45.1%	-52.8%	-86.9%	-	107.5%
Net Profit Growth	36.0%	-23.9%	-37.8%	-64.8%	-
EPS Growth	36.0%	-23.9%	-37.8%	-64.8%	-
<b>Margins</b>	<b>12/09A</b>	<b>12/10A</b>	<b>12/11E</b>	<b>12/12E</b>	<b>12/13E</b>
Gross profit margin	29.2%	42.6%	53.2%	56.5%	59.0%
EBITDA margin	-35.7%	5.6%	17.9%	23.5%	27.5%
Operating Margin	-82.1%	-19.6%	-1.8%	6.7%	11.9%
Pretax profit margin	-103.2%	-39.7%	-17.8%	-5.1%	1.2%
Net profit margin	-103.2%	-39.7%	-17.7%	-5.0%	1.2%
<b>Other Ratios</b>	<b>12/09A</b>	<b>12/10A</b>	<b>12/11E</b>	<b>12/12E</b>	<b>12/13E</b>
ROCE	-11.7%	-5.8%	-0.8%	3.7%	7.5%
ROIC	-10.7%	-5.5%	-0.7%	3.4%	6.9%
ROE	-30.5%	-32.0%	-27.2%	-11.7%	3.4%
Effective Tax Rate	0.0%	0.0%	0.5%	2.5%	2.5%
Capex/Sales	63.0%	16.3%	18.5%	18.0%	17.5%
Dividend Payout Ratio	0.0%	0.0%	0.0%	0.0%	0.0%
<b>Valuation Measures</b>	<b>12/09A</b>	<b>12/10A</b>	<b>12/11E</b>	<b>12/12E</b>	<b>12/13E</b>
P/E (x)	na	na	na	na	77.3
P/CF (x)	na	na	66.3	9.0	5.4
P/B (x)	1.3	1.8	2.4	2.7	2.6
EV/Sales (x)	7.6	4.3	3.2	2.6	2.2
EV/EBITDA (x)	na	77.7	17.7	11.2	8.0
EV/EBIT (x)	na	na	na	39.0	18.4
EV/IC (x)	1.1	1.2	1.3	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)	12/09A	12/10A	12/11E	12/12E	12/13E
Cash and Cash Equivalents	506	702	250	250	731
Current Receivables	1,007	1,463	2,018	2,589	3,160
Inventories	39	29	138	155	182
Other current assets	312	409	409	409	409
<b>Total Current Assets</b>	<b>1,850</b>	<b>2,603</b>	<b>2,814</b>	<b>3,403</b>	<b>4,482</b>
Fixed Assets	3,847	4,298	5,204	6,340	7,579
Investments	-	-	-	-	-
Goodwill	-	-	-	-	-
Other Intangible Assets	22,133	21,155	20,147	19,139	18,131
Total Other Assets	-	-	-	-	-
<b>Total Non-current Assets</b>	<b>25,980</b>	<b>25,453</b>	<b>25,351</b>	<b>25,478</b>	<b>25,710</b>
<b>Total Assets</b>	<b>27,830</b>	<b>28,055</b>	<b>28,165</b>	<b>28,882</b>	<b>30,192</b>
Short Term Debt	-	2,194	2,194	2,194	2,194
Trade Payables	6,247	5,403	6,871	7,183	8,352
Dividends Payable	-	-	-	-	-
Other Current Liabilities	543	457	457	457	457
<b>Total Current Liabilities</b>	<b>6,789</b>	<b>8,054</b>	<b>9,522</b>	<b>9,834</b>	<b>11,003</b>
Long-Term Debt	12,408	13,196	13,305	14,226	14,226
Other LT Payables	-	659	659	659	659
Provisions	10	17	17	17	17
<b>Total Non-current Liabilities</b>	<b>12,418</b>	<b>13,872</b>	<b>13,981</b>	<b>14,903</b>	<b>14,903</b>
Minority interests	-	-	-	-	-
Paid-up share capital	14,000	14,000	14,000	14,000	14,000
Total Reserves	(5,378)	(7,871)	(9,338)	(9,855)	(9,713)
<b>Total Shareholders' Equity</b>	<b>8,622</b>	<b>6,129</b>	<b>4,662</b>	<b>4,145</b>	<b>4,287</b>
<b>Total Equity</b>	<b>8,622</b>	<b>6,129</b>	<b>4,662</b>	<b>4,145</b>	<b>4,287</b>
<b>Total Liabilities &amp; Shareholders' Equity</b>	<b>27,830</b>	<b>28,055</b>	<b>28,165</b>	<b>28,882</b>	<b>30,192</b>

Net debt currently stands at 2.4x annualised Q4 2010 sales

Ratios	12/09A	12/10A	12/11E	12/12E	12/13E
Net Debt (SARmn)	11,902	14,687	15,248	16,170	15,689
Net Debt/EBITDA (x)	-	11.10	44.42	10.29	6.64
Net Debt to Equity	138.0%	239.6%	327.1%	390.1%	366.0%
EBITDA Interest Cover (x)	(1.7)	0.3	1.1	2.0	2.6
BVPS (SAR)	6.16	4.38	3.33	2.96	3.06

A large positive movement on working capital supported cash flow in 2009. This has proven unsustainable

Cashflow Statement (SARmn)	12/09A	12/10A	12/11E	12/12E	12/13E
Net Income before Tax & Minority Interest	(3,099)	(2,358)	(1,475)	(530)	146
Depreciation & Amortisation	1,394	1,494	1,634	1,737	1,896
Decrease in Working Capital	2,060	246	805	(277)	571
Other Operating Cashflow	638	1,246	7	13	(4)
<b>Cashflow from Operations</b>	<b>994</b>	<b>627</b>	<b>970</b>	<b>942</b>	<b>2,608</b>
Capital Expenditure	(1,892)	(968)	(1,532)	(1,864)	(2,127)
New Investments	-	-	-	-	-
Others	3	2	-	-	-
<b>Cashflow from investing activities</b>	<b>(1,889)</b>	<b>(966)</b>	<b>(1,532)</b>	<b>(1,864)</b>	<b>(2,127)</b>
<b>Net Operating Cashflow</b>	<b>(895)</b>	<b>(339)</b>	<b>(561)</b>	<b>(922)</b>	<b>481</b>
Dividends paid to ordinary shareholders	-	-	-	-	-
Proceeds from issue of shares	-	-	-	-	-
Effects of Exchange Rates on Cash	-	-	-	-	-
Other Financing Cashflow	(575)	(2,150)	-	-	-
<b>Cashflow from financing activities</b>	<b>818</b>	<b>535</b>	<b>109</b>	<b>922</b>	<b>-</b>
Total cash generated	(78)	196	(452)	0	481
Cash at beginning of period	583	506	702	250	250
<b>Implied cash at end of year</b>	<b>506</b>	<b>702</b>	<b>250</b>	<b>250</b>	<b>731</b>

We expect the capex/sales ratio to rise this year due to rising data traffic, but thereafter to decline gradually

Ratios	12/09A	12/10A	12/11E	12/12E	12/13E
Capex/Sales	63.0%	16.3%	18.5%	18.0%	17.5%

Source: Company data, Al Rajhi Capital



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#### 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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