



**US\$2.464bn** Market cap  
**48.3%** Free float  
**US\$16.50mn** Avg. daily volume

Target price **7.30** 12.31% over current  
Consensus price **7.62** 17.2% over current  
Current price **6.50** as at 3/8/2011

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Underweight **Neutral** Overweight

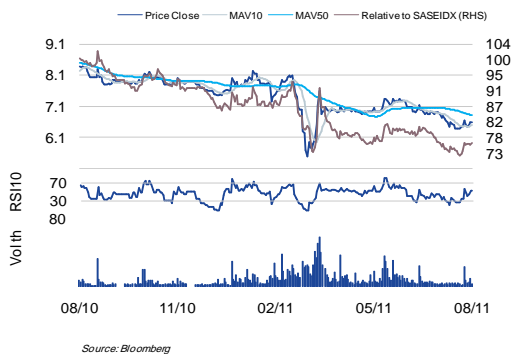
### Key themes

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 is performing decent as a number 3 operator, trying to tap the growth in voice and data services. The problem for Zain is its high debt burden, which reduces the share of enterprise value attributable to equity shareholders.

### Performance

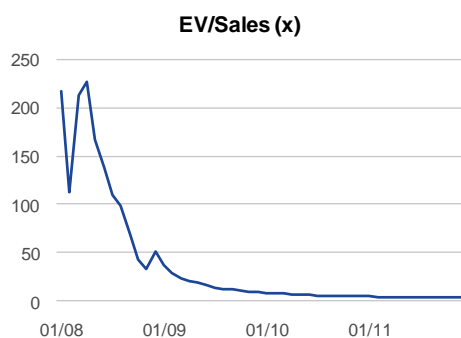


### Earnings

Period End (SAR)	12/10A	12/11E	12/12E	12/13E
Revenue (mn)	5,934	7,594	10,417	12,233
Revenue Growth	97.5%	28.0%	37.2%	17.4%
EBITDA (mn)	331	1,195	2,292	3,119
EBITDA Growth		261.4%	91.8%	36.1%
EPS	(1.68)	(1.17)	(0.48)	0.04
EPS Growth	-23.9%	-30.7%	-59.0%	

Source: Company data, Al Rajhi Capital

### Valuation



Source: Company data, Al Rajhi Capital

## Zain KSA bogged down by high debt

Zain achieved respectable growth in revenues and an impressive improvement in Gross & EBITDA margins in Q2. Nevertheless, high amortization expenses (license fees) prevented the company from achieving an operating profit. Moreover, surging interest costs (SAR304mn) aggravated losses, resulting in a SAR448mn of net loss. In our view, Zain desperately needs a financial restructuring which can only happen after the proposed 25% stake sale to Batelco and Kingdom materialises. Amid these uncertainties, we have cut our target price from SAR7.5 to SAR7.3, which now implies 12% upside potential. We remain Neutral.

**Decent sales growth:** Zain recorded revenues of SAR1.75mn, up by 18% from Q2 2010 – above our estimate of SAR1, 65mn. Zain claimed over 9.0mn mobile accounts at the end of Q2, which is in line with our estimate of 9.05mn. Strong subscription growth seems to have been the key in driving sales. We believe the remaining two quarters will also be strong considering the increase in religious tourism in the Kingdom with the advent of Ramadan and Hajj season.

**Operating result have shown improvement:** Gross profit of SAR923mn was up 52% year on year and 6% above our estimate while EBITDA of SAR275mn was 1% above our estimate. In our view, the company achieved an impressive gross margin of 54% in the quarter. However, high depreciation and amortization charges still depress the operating results; the operating loss of SAR144mn was 11% higher than our estimated operating loss of 129mn.

**High net debt resulting in surging financial charges:** Net Debt in Q2 stood at SAR15.4bn leading to financial costs of SAR304mn in Q2 alone. As per our calculation, Zain pays a very high effective interest rate of 7.8% on its huge debt. The Net debt/EBITDA stands at 14.0x and with SAR20bn license fees left to be amortized, the balance sheet looks risky. The high debt/sales ratio and high effective interest rate illustrate the urgent need for Zain's financial restructuring.

**Our new forecasts:** We have raised our estimates of sales slightly 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. We also pushed our WACC up for Zain factoring in the higher interest charges, high beta, and the increase in risk associated with equity investments in the current scenario. Our new WACC is 12.5%. With slightly higher sales but profit forecasts little changed, our estimate of fair value per share on a long-run DEP basis has fallen by 3% to around SAR7.3.

**We remain Neutral:** Zain's fortune depends on its financial restructuring, which again awaits the proposed 25% stake sale to Kingdom and Batelco. On 20th July, Zain announced that it entered into a term sheet agreement with Kingdom and Batelco which will set the formalities and conditions related to the acquisition. We believe any turn around for the company is only possible after the stake sale and progress toward restructuring. Moreover, Zain trades at high EV/Sales ratio of 3.3x and PB of 2.0x. With such high multiples, Zain looks unattractive as compared to its peers. Thus, we remain Neutral.



### 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 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.

### Share information

Market cap (SAR/US\$) 9.24bn / 2.464bn  
52-week range 5.50 - 8.40  
Daily avg volume (US\$) 16.50mn  
Shares outstanding 1,400mn  
Free float (est) 48.3%

Performance: 1M 3M 12M  
Absolute -4.4% -5% -21.9%  
Relative to index -1.2% -0.9% -23.6%

Major Shareholder:  
Mobile Telecommunications Co. (Kuwait) 25%  
Faden Trading and Contracting 6.8%

Source: Bloomberg, Al Rajhi Capital

### Valuation

Period End	12/10A	12/11E	12/12E	12/13E
Revenue (SARmn)	5,934	7,594	10,417	12,233
EBITDA (SARmn)	331	1,195	2,292	3,119
Net Profit (SARmn)	(2,358)	(1,634)	(670)	55
EPS (SAR)	(1.68)	(1.17)	(0.48)	0.04
DPS (SAR)	-	-	-	-
EPS Growth	-23.9%	-30.7%	-59.0%	na
EV/EBITDA (x)	72.4	21.1	11.5	7.7
P/E (x)	na	na	na	169.1
P/B (x)	1.5	2.0	2.4	2.3
Dividend Yield	0.0%	0.0%	0.0%	0.0%

Source: Company data, Al Rajhi Capital

Find below our estimates for Q3 2011:

Figure 1. Zain: Q2 & Q3 results (actual and our estimates)

(SAR) mn	2010Q2A	2011Q2E	2011Q2A	YOY % chg.	2010Q3A	2011Q3E	YOY % chg.
<b>Revenues</b>	<b>1,450.4</b>	<b>1,650.6</b>	<b>1,704.6</b>	<b>17.5%</b>	<b>1,662.0</b>	<b>2,038.0</b>	<b>22.6%</b>
<b>EBITDA</b>	<b>57.1</b>	<b>264.1</b>	<b>275.4</b>		<b>134.7</b>	<b>315.9</b>	<b>134.5%</b>
EBITDA margin (%)	3.9%	16.0%	16.2%		8.1%	15.5%	
<b>Operating profit</b>	<b>(314.5)</b>	<b>(137.6)</b>	<b>(143.8)</b>	<b>-54.3%</b>	<b>(235.2)</b>	<b>(110.5)</b>	<b>-53.0%</b>
Operating profit margin (%)	-21.7%	-8.3%	-8.4%		-14.2%	-5.4%	
<b>Net Income</b>	<b>(631.6)</b>	<b>(488.6)</b>	<b>(448.2)</b>	<b>-29.0%</b>	<b>(543.8)</b>	<b>(419.8)</b>	<b>-22.8%</b>
Capex	341.3	264.1	70.3	-79.4%	84.8	81.5	-3.8%
<b>% of sales</b>	<b>24%</b>	<b>16%</b>	<b>4%</b>		<b>5%</b>	<b>4%</b>	
Net Debt (bn)	14.0	15.5	15.4	9.8%	14.0	15.7	11.9%
Net Debt/EBITDA	61.4	14.7	14.0		26.0	12.4	

Source: Company data, Al Rajhi Capital



We have cut our sales forecasts by an average 2%. We have also cut EBITDA forecast for 2011 by 18% and for 2012 by 9%.

We do not expect net profit or a dividend till 2013

We expect a robust sales and EBITDA growth over 2010-13

The EBITDA margin should swing upwards sharply from now on, though the growth will be capped by marketing expenses

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>7,594</b>	<b>10,417</b>	<b>12,233</b>
Cost of Goods Sold	(2,127)	(3,404)	(3,573)	(4,688)	(5,260)
<b>Gross Profit</b>	<b>877</b>	<b>2,530</b>	<b>4,021</b>	<b>5,730</b>	<b>6,973</b>
Government Charges	-	-	-	-	-
S.G. & A. Costs	(1,950)	(2,200)	(2,826)	(3,438)	(3,853)
<b>Operating EBIT</b>	<b>(2,467)</b>	<b>(1,164)</b>	<b>(402)</b>	<b>678</b>	<b>1,431</b>
Cash Operating Costs	(4,077)	(5,604)	(6,399)	(8,126)	(9,113)
<b>EBITDA</b>	<b>(1,073)</b>	<b>331</b>	<b>1,195</b>	<b>2,292</b>	<b>3,119</b>
Depreciation and Amortisation	(1,394)	(1,494)	(1,596)	(1,614)	(1,688)
<b>Operating Profit</b>	<b>(2,467)</b>	<b>(1,164)</b>	<b>(402)</b>	<b>678</b>	<b>1,431</b>
Net financing income/(costs)	(634)	(1,195)	(1,232)	(1,348)	(1,375)
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>(1,634)</b>	<b>(670)</b>	<b>56</b>
Taxes	-	-	-	-	(1)
Minority Interests	-	-	-	-	-
<b>Net profit available to shareholders</b>	<b>(3,099)</b>	<b>(2,358)</b>	<b>(1,634)</b>	<b>(670)</b>	<b>55</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)	(0.027)	0.674	1.245
EPS (SAR)	(2.214)	(1.685)	(1.167)	(0.479)	0.039
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%	28.0%	37.2%	17.4%
Gross Profit Growth	5228.5%	188.5%	58.9%	42.5%	21.7%
EBITDA Growth	-15.2%	-	261.4%	91.8%	36.1%
Operating Profit Growth	45.1%	-52.8%	-65.5%	-	111.2%
Net Profit Growth	36.0%	-23.9%	-30.7%	-59.0%	-
EPS Growth	36.0%	-23.9%	-30.7%	-59.0%	-
<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%	53.0%	55.0%	57.0%
EBITDA margin	-35.7%	5.6%	15.7%	22.0%	25.5%
Operating Margin	-82.1%	-19.6%	-5.3%	6.5%	11.7%
Pretax profit margin	-103.2%	-39.7%	-21.5%	-6.4%	0.5%
Net profit margin	-103.2%	-39.7%	-21.5%	-6.4%	0.4%
<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%	-1.8%	3.0%	7.1%
ROIC	-11.0%	-5.7%	-1.9%	3.3%	6.7%
ROE	-30.5%	-32.0%	-30.6%	-15.9%	1.4%
Effective Tax Rate	0.0%	0.0%	0.0%	0.0%	2.5%
Capex/Sales	63.0%	16.3%	8.0%	12.9%	12.0%
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	169.1
P/CF (x)	na	na	na	9.8	5.3
P/B (x)	1.1	1.5	2.0	2.4	2.3
EV/Sales (x)	7.0	4.0	3.3	2.5	2.0
EV/EBITDA (x)	na	72.4	21.1	11.5	7.7
EV/EBIT (x)	na	na	na	38.8	16.8
EV/IC (x)	1.0	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



Balance Sheet (SARmn)	12/09A	12/10A	12/11E	12/12E	12/13E
Cash and Cash Equivalents	506	702	250	342	407
Current Receivables	1,007	1,463	2,083	2,290	3,181
Inventories	39	29	66	126	183
Other current assets	312	409	510	510	510
<b>Total Current Assets</b>	<b>1,850</b>	<b>2,603</b>	<b>2,909</b>	<b>3,268</b>	<b>4,281</b>
Fixed Assets	3,847	4,298	4,119	4,858	5,646
Investments	-	-	-	-	-
Goodwill	-	-	-	-	-
Other Intangible Assets	22,133	21,155	20,237	19,229	18,221
Total Other Assets	-	-	-	-	-
<b>Total Non-current Assets</b>	<b>25,980</b>	<b>25,453</b>	<b>24,356</b>	<b>24,086</b>	<b>23,866</b>
<b>Total Assets</b>	<b>27,830</b>	<b>28,055</b>	<b>27,264</b>	<b>27,354</b>	<b>28,147</b>
Short Term Debt	-	2,194	82	82	82
Trade Payables	6,247	5,403	5,162	4,780	7,768
Dividends Payable	-	-	-	-	-
Other Current Liabilities	543	457	37	37	37
<b>Total Current Liabilities</b>	<b>6,789</b>	<b>8,054</b>	<b>5,280</b>	<b>4,898</b>	<b>7,886</b>
Long-Term Debt	12,408	13,196	16,181	17,323	15,073
Other LT Payables	-	659	1,234	1,234	1,234
Provisions	10	17	21	21	21
<b>Total Non-current Liabilities</b>	<b>12,418</b>	<b>13,872</b>	<b>17,436</b>	<b>18,578</b>	<b>16,328</b>
Minority interests	-	-	-	-	-
Paid-up share capital	14,000	14,000	14,000	14,000	14,000
Total Reserves	(5,378)	(7,871)	(9,451)	(10,122)	(10,067)
<b>Total Shareholders' Equity</b>	<b>8,622</b>	<b>6,129</b>	<b>4,549</b>	<b>3,878</b>	<b>3,933</b>
<b>Total Equity</b>	<b>8,622</b>	<b>6,129</b>	<b>4,549</b>	<b>3,878</b>	<b>3,933</b>
<b>Total Liabilities &amp; Shareholders' Equity</b>	<b>27,830</b>	<b>28,055</b>	<b>27,264</b>	<b>27,354</b>	<b>28,147</b>

Shareholders' equity has been shrinking due to high net losses

Net debt currently stands at 2.6x annualised Q1 2011 sales

Ratios	12/09A	12/10A	12/11E	12/12E	12/13E
Net Debt (SARmn)	11,902	14,687	16,012	17,062	14,747
Net Debt/EBITDA (x)	(11.10)	44.42	13.40	7.44	4.73
Net Debt to Equity	138.0%	239.6%	352.0%	439.9%	375.0%
EBITDA Interest Cover (x)	(1.7)	0.3	1.0	1.7	2.3
BVPS (SAR)	6.16	4.38	3.25	2.77	2.81

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)	(1,634)	(670)	56
Depreciation & Amortisation	1,394	1,494	1,596	1,614	1,688
Decrease in Working Capital	2,060	246	(919)	(649)	2,040
Other Operating Cashflow	638	1,246	709	-	(1)
<b>Cashflow from Operations</b>	<b>994</b>	<b>627</b>	<b>(247)</b>	<b>294</b>	<b>3,783</b>
Capital Expenditure	(1,892)	(968)	(606)	(1,345)	(1,468)
New Investments	-	-	-	-	-
Others	3	2	0	-	-
<b>Cashflow from investing activities</b>	<b>(1,889)</b>	<b>(966)</b>	<b>(606)</b>	<b>(1,345)</b>	<b>(1,468)</b>
<b>Net Operating Cashflow</b>	<b>(895)</b>	<b>(339)</b>	<b>(853)</b>	<b>(1,050)</b>	<b>2,315</b>
Dividends paid to ordinary shareholders	-	-	-	-	-
Proceeds from issue of shares	-	-	-	-	-
Effects of Exchange Rates on Cash	-	-	-	-	-
Other Financing Cashflow	(575)	(2,150)	(85)	-	-
<b>Cashflow from financing activities</b>	<b>818</b>	<b>535</b>	<b>401</b>	<b>1,142</b>	<b>(2,250)</b>
Total cash generated	(78)	196	(452)	92	65
Cash at beginning of period	583	506	702	250	342
<b>Implied cash at end of year</b>	<b>506</b>	<b>702</b>	<b>250</b>	<b>342</b>	<b>407</b>

We expect the capex/sales ratio to rise in the coming year due to rising data traffic.

Ratios	12/09A	12/10A	12/11E	12/12E	12/13E
Capex/Sales	63.0%	16.3%	8.0%	12.9%	12.0%

Source: Company data, Al Rajhi Capital



## Disclaimer and additional disclosures for Equity Research

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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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