

Zain KSA

Telecoms

ZAINKSA AB: Saudi Arabia

23 February 2010

الراجحي المالية
Al Rajhi Capital



US\$3.700bn Market cap
51.7% Free float
US\$9.90mn Avg. daily volume

Target price **7.98** -19.8% over current
Consensus price **11.20** 12.6% over current
Current price **9.95** as at 21/2/2010

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Underweight

Neutral

Overweight

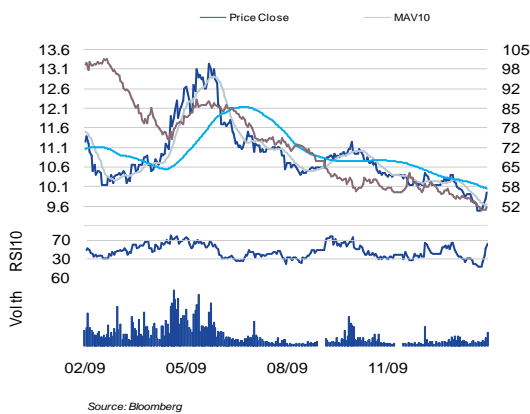
Key themes

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

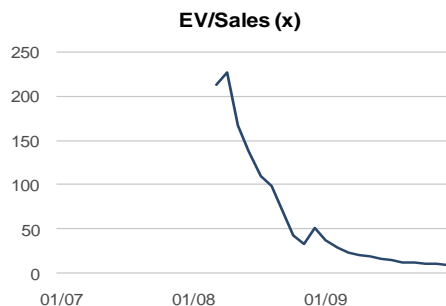


Earnings

Period End (SAR)	12/09A	12/10E	12/11E	12/12E
Revenue (SARmn)	3,004	5,444	7,629	9,264
Revenue Growth	494.6%	81.2%	40.1%	21.4%
EBITDA (SARmn)	(1,072)	394	1,450	2,501
EBITDA Growth	-15.3%		268.0%	72.6%
EPS	- 2.21	- 1.35	- 0.68	- 0.08
EPS Growth	36.0%	-39.0%	-49.4%	-88.7%

Source: Company data, Al Rajhi Capital

Valuation



Source: Company data, Al Rajhi Capital

Zain KSA

Good news but hard work ahead

Zain KSA's plan to raise new capital is clearly positive; so too is its parent's planned deal with Bharti. However, we believe Zain needs to cut net debt by SAR6.0bn. Doing so will be difficult and may require a debt-for-equity swap targeted at Zain's banks as well as its founding shareholders. This implies dilution and other risks for external investors. With no reason yet to change our estimates or target price, we maintain our Underweight rating.

Zain needs to cut debt by SAR6.0bn. Zain KSA's net debt of SAR11.9bn is 2.4x our estimate of 2010 sales of SAR5.4bn. As a first step, we believe Zain needs to reduce net debt to around 1.0x sales, i.e. by nearly 50% or SAR6.0bn. Aiming to lower net debt to 25% of enterprise value – a proportion slightly higher than for STC or Mobily – similarly implies reducing net debt by SAR5.4bn.

We predict a rights issue and two debt-for-equity swaps. In a sensible and almost inevitable move, Zain KSA officially announced on 17 February that it was considering raising new share capital. However, we doubt very much that a rights issue alone can raise SAR6.0bn – which is 43% of market capitalisation. We expect that Zain will try to swap SAR2.9bn of debt in the form of advances from its founding shareholders for equity. If Zain cannot raise all the remaining SAR3.1bn from minority shareholders, then it may have to try to swap a portion of its SAR9.1bn of Murahaba bank financing for equity too.

Staging a rights issue may be hard. Two key factors complicate a rights issue. The first is potential dilution. Zain's founding shareholders own 51% of its shares. To avoid major dilution to minority investors after a debt-for-equity swap for its founders, we think Zain would have to stage something close to a 1 for 2 rights issue reserved for minority investors. The second is the fact that Zain cannot issue new shares at below their nominal value of SAR10.0. To offer new stock at an attractive discount, therefore, Zain has to find a way to push its share price back up to the SAR11.0-12.0 range. It is hard to see how it can do this.

Africa deal will not lower debt. Bharti of India offered to buy the majority of the African assets of Zain Kuwait for US\$10.7bn (SAR40.1bn) on 15th February. While the terms are not finalised, we expect the deal to go ahead and expect Bharti to pay largely in cash. The proceeds will accrue to Zain Kuwait, not to KSA. However, after the Africa sale we expect Zain KSA to be the Zain group's most important asset, and it is reasonable to expect Zain Kuwait to be willing to support its Saudi unit by extending it further loans out of the sale proceeds. To that extent, the news of the deal should ease market concerns about Zain KSA's liquidity. Note, however, that further shareholder loans will still count as debt.

Valuation and conclusion. Until Zain and its advisers reach firm decisions, we can only speculate about the terms of capital raising and their impact on Zain's valuation. We have, therefore, no reason yet to revise either our profit forecasts for Zain or our estimate of fair equity value of SAR8.0 per share, which remains our target price. While we recognise that prospects for Zain have improved, we therefore retain our Underweight rating. The chief risk to our cautious view is a strong rally in the stock market, which would hopefully carry Zain's share up with it and make it easier to stage a rights issue at a discount.



Corporate summary

Zain KSA is the third-placed telecoms operator in Saudi Arabia, with a market value of nearly US\$4bn; it launched service in Q3 2008. By our estimate Zain has a market share of mobile accounts of 13%, although its revenue share is lower at 8-9%. 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 now plans to sell the majority of its African assets to Bharti.

Share information

Market cap (SAR/US\$)	13.90bn / 3.700bn		
52-week range	9.50 - 13.25		
Daily avg volume (US\$)	9.90mn		
Shares outstanding	1,400mn		
Free float (est)	51.7%		

Performance:	1M	3M	12M
Absolute	-4.3%	-4.8%	-10.8%
Relative to index	-4.6%	-6%	-47.5%

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

Source: Bloomberg, Al Rajhi Capital

Valuation

Period End	12/09A	12/10E	12/11E	12/12E
Revenue (SARmn)	3,004	5,444	7,629	9,264
EBITDA (SARmn)	(1,072)	394	1,450	2,501
Net Profit (SARmn)	(3,098)	(1,890)	(956)	(108)
EPS (SAR)	- 2.21	- 1.35	- 0.68	- 0.08
DPS (SAR)	-	-	-	-
EPS Growth	36.0%	-39.0%	-49.4%	-88.7%
EV/EBITDA (x)	NA	68.4	19.1	10.8
P/E (x)	NA	NA	NA	NA
P/B (x)	1.6	2.1	2.4	2.5
Dividend Yield	0.0%	0.0%	0.0%	0.0%

Source: Company data, Al Rajhi Capital

How much money does Zain KSA need to raise?

Zain's net debt of SAR11.9bn is 2.4x 2010 revenues

Before assessing how Zain KSA can raise new capital, we must first ask how much money the company needs to raise. To answer this question, we must first work out by how much the company needs to reduce its debt. At the end of 2009, Zain had gross debt of SAR12.4bn, split between long-term debt Murahaba financing of SAR9.5bn and long-term shareholder advances of SAR2.9bn; there was no short-term debt. Since Zain had cash of SAR0.5bn, net debt was SAR11.9bn. While equity analysts traditionally use the net/debt equity ratio or related measures of gearing, we much prefer the net debt/EBITDA ratio widely used by credit analysts. In the global telecoms sector, this ratio typically varies between about 0.0x and 3.0x; a ratio of over 3.0x would usually be seen as high. Unfortunately this measure is of little use for Zain, since the company has only recently broken even at the EBITDA level on a monthly basis. For 2010, we forecast EBITDA of SAR0.4bn, on which basis Zain's net debt/EBITDA ratio is 33.0x.

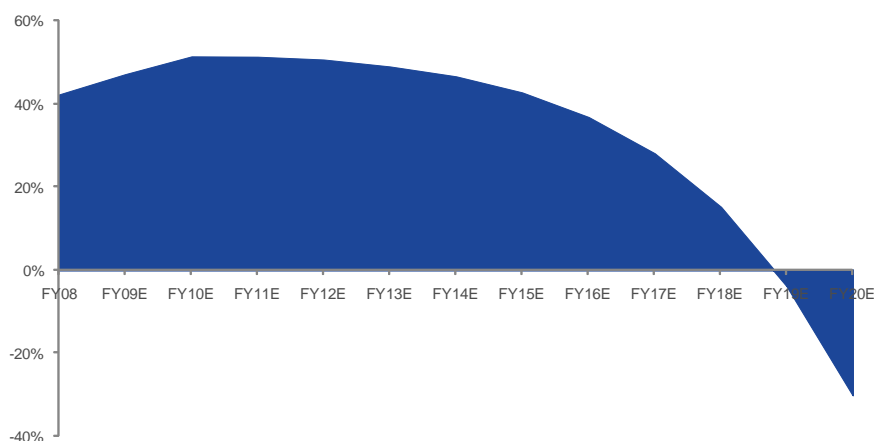
We think Zain needs to reduce net debt to SAR6.0bn or around 1x sales

In our view, it makes more sense to consider net debt in relation to revenues. Zain KSA's net debt of SAR11.0bn is equivalent to 2.4x our estimate of the company's 2010 revenues of SAR5.4bn. This is a very high ratio by any standards: by contrast, the net debt/revenues ratio for STC is 0.4x and for Mobily it is 0.5x. As a first step, we believe that Zain should aim to reduce net debt towards little more than 1.0x revenues. This suggests that the company needs to cut net debt roughly in half, to around SAR6.0bn.

Aiming to reduce net debt to 25% of enterprise value implies a similar reduction

Net debt may also be considered as a proportion of enterprise value (in simple terms, market capitalisation plus net debt). At present, net debt accounts for 47% of Zain KSA's enterprise value of SAR25.8bn. While we have seen many cases in which net debt accounts for a greater proportion of enterprise value than this, this proportion is far higher than for Zain's rivals: we calculate that net debt represents 21% of enterprise value for STC and 19% for Mobily. To reduce net debt to, say, 25% of enterprise value (i.e. SAR6.5bn) implies that Zain needs to raise SAR5.4bn – not far short of the SAR6.0bn figure that we estimated above.

Figure 1. Zain KSA: net debt as a proportion of enterprise value



Source: Al Rajhi Capital



Zain could reduce net debt to SAR6.0bn through a debt-for-equity swap of SAR2.9bn and a rights issue of SAR3.1bn

To avoid major dilution, Zain might have to call on 49% of its shareholders to supply SAR3.1bn in new equity

This implies something close to a 1 for 2 rights issue

Zain has to find a way to push its share price back to SAR11-12 for a rights issue to succeed

We anticipate a second, smaller debt-for-equity swap targeted at Zain KSA's banks

We conclude, therefore, that Zain KSA needs to reduce net debt by nearly SAR6.0bn. Raising this much money through an equity issue alone is implausible, since it represents 43% of the company's market capitalisation. In our view, the first and most obvious step towards achieving the debt reduction target would be for Zain to convert the shareholder advances or loans of SAR2.9bn into equity through a debt-for-equity swap. (We are naturally assuming here that Zain Kuwait - which accounts for nearly SAR1.9bn or 64% of the shareholder loans - and the other founding shareholders would agree to such a transaction.) Zain KSA would then have to raise SAR3.1bn through an equity issue or some other method. This figure is equivalent to 22% of the company's current market capitalisation of SAR13.9bn.

Likely structure of capital raising

In our view, Zain KSA faces two particular problems in raising the additional capital required. We comment on these problems below.

Avoidance of dilution

Zain KSA's founding shareholders hold about 51% of its shares; minority shareholders own 49% (or 45% excluding one large holding of 4%). If the founding shareholders exchange debt for equity, then the interest of minority shareholders in the company will be hugely diluted unless any equity issue - most probably, a traditional right issues - is reserved for them. While minority shareholders might naturally be willing to accept a degree of dilution, in simple terms this means that the Zain will have to call on 49% of its shareholders to supply 100% of the SAR3.1bn that we think needs to be raised in new equity.

Zain KSA has 1,400mn shares outstanding. Minority investors thus hold roughly 685mn shares. For reasons that we explain below, Zain KSA cannot offer new stock for sale at under SAR10.0 per share. In order to raise SAR3.1bn at this price, the company needs to sell 310mn new shares. This suggests that Zain will need to invite minority shareholders to participate in something close to a 1 for 2 rights issue (one new share for every two held) with little or no discount in order to raise the funds it requires.

Issue price and potential sweeteners

As with most rights issues, one would normally assume that Zain KSA would have to offer new shares at a significant discount to the market price to persuade investors to participate. But the company faces a major problem in this respect. We had assumed that Zain would be able to offer new shares at a 10-20% discount to the current market price of just under SAR10.0, implying that a rights issue would be priced at between about SAR8.0 and SAR9.0. However, we had overlooked the fact that the nominal value of all shares in Saudi Arabia is SAR10.0, and that new shares cannot be offered at a discount to nominal value.

Zain KSA needs, therefore, to find a way to push its share price back up to at least the SAR11.0-12.0 range before it can raise new capital at the minimum price per share of SAR10.0. How can Zain do that? The company can obviously try to increase optimism about its prospects by simple measures such as staging investor meetings or a roadshow and by ensuring that its CEO and officers of its parent company are regularly quoted on positive developments such as recent strong subscriber growth or the Bharti deal. However, if simple measures fail, Zain KSA may have to resort to some kind of "sweetener" to boost its price. One potential sweetener would be the promise of a dividend. However, this is unlikely to work since Zain is loss-making and, in our view, likely to remain so for three years.

In other countries, an alternative possibility would be for Zain KSA to combine a rights issue with a convertible bond issue. Convertible bonds would carry the attraction for shareholders of a regular income stream in the form of coupon payments. Hypothetically, staging a convertible issue would not necessarily increase Zain KSA's financial costs since coupon payments on the bond would replace interest payments removed by the debt-for-equity swap for founding shareholders. Unfortunately, convertible bonds do not yet exist in Saudi Arabia. The same applies to warrants, or traded securities which allow holders to subscribe for new shares in a company at a specified price.

Debt-for-equity swap for the banks

Given the circumstances described above, we think that it will be difficult for Zain KSA to raise SAR3.1bn in new equity except in the event of a strong rally in the stock market. This would hopefully carry Zain's share up with it towards SAR11.0 or SAR12.0, and make it much easier to stage a rights issue at a discount. However, barring a stock market rally, we think that the only practical way for Zain KSA to reduce net debt by around SAR6.0bn would be to combine a debt-for-equity swap for founding shareholders with a rights issue and a second



debt-for-equity swap targeted at the consortium of banks which hold the SAR9.5bn of Murahaba financing. Zain would probably need to swap only a small portion of this total for equity – perhaps little over SAR1.obn. Doing so would imply a degree of dilution for both founding shareholders and external shareholders, but we think that those parties would be agreeable if they thought that it was in the best interests of the company as a whole. However, we can imagine that there might be significant disagreements between the banks about which kept their loans in full and which converted a portion to equity.

Investors should note that Zain KSA has appointed three banks, including Al Rajhi Capital, to advise it on capital raising. The author of this report is not privy to any discussions regarding Zain KSA's capital raising plans by Al Rajhi Capital's investment banking operations. Until Zain and its advisers reach and publish firm decisions, we can only speculate about the precise terms of capital raising and their impact on Zain's financial structure.

Conclusion

We think that Zain KSA needs to reduce net debt by around SAR6.obn. We believe that the most practical way for the company to do this is to combine a rights issue with two debt-for-equity swaps: a large one targeted at its founding shareholders, and a smaller one targeted at its banks. While we think that Zain can reduce net debt by the amount required, the mechanics of the process will be difficult – especially the staging of the rights issue. Until Zain and its advisers reach and publish firm decisions, we can only speculate about the precise terms of capital raising and their impact on Zain's financial structure. We have, therefore, no reason at this stage to revise either our profit forecasts or our estimate of fair equity value for the company. We recognise that prospects for Zain have improved. Nevertheless, since our estimate of fair equity value remains unchanged at SAR11.2bn or SAR8.0 per share, we retain our Underweight rating.

The chief risk to our cautious stance on Zain is a strong rally in the stock market, which would hopefully carry Zain's share price up with it and make it much easier to stage a rights issue at a discount. Conversely, however, if Zain's share price were to weaken sharply, then refinancing the company could become substantially more difficult.

A strong stock market rally is the key risk to our cautious stance



Zain should achieve very strong growth over the next few years, albeit from a lower base than its rivals

We expect Zain to pay a dividend for 2013

The EBITDA margin should swing upwards rapidly from now on

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

Income Statement (SARmn)	12/08A	12/09A	12/10E	12/11E	12/12E
Revenue	505	3,004	5,444	7,629	9,264
Cost of Goods Sold	(489)	(2,127)	(3,196)	(3,891)	(4,447)
Gross Profit	16	877	2,248	3,738	4,817
Government Charges	-	-	-	-	-
S.G. & A. Costs	(1,281)	(1,949)	(1,854)	(2,289)	(2,316)
Operating EBIT	(1,700)	(2,466)	(1,567)	(596)	295
Cash Operating Costs	(1,770)	(4,076)	(5,050)	(6,180)	(6,763)
EBITDA	(1,265)	(1,072)	394	1,450	2,501
Depreciation and Amortisation	(435)	(1,394)	(1,961)	(2,045)	(2,206)
Operating Profit	(1,700)	(2,466)	(1,567)	(596)	295
Net financing income/(costs)	(226)	(634)	(372)	(385)	(406)
Forex and Related Gains	-	-	-	-	-
Provisions	-	-	-	-	-
Other Income	65	1	-	-	-
Other Expenses	(418)	(0)	-	-	-
Minority Interests	-	-	-	-	-
Net Profit Before Taxes	(2,278)	(3,098)	(1,938)	(981)	(111)
Taxes	-	-	48	25	3
Net Profit	(2,278)	(3,098)	(1,890)	(956)	(108)
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)	(1.217)	0.050	0.778	1.498
EPS (SAR)	(1.627)	(2.213)	(1.350)	(0.683)	(0.077)
DPS (SAR)	0	0	0	0	0

Growth	12/08A	12/09A	12/10E	12/11E	12/12E
Revenue Growth		494.6%	81.2%	40.1%	21.4%
Gross Profit Growth		5228.6%	156.3%	66.3%	28.9%
EBITDA Growth		-15.3%		268.0%	72.6%
Operating Profit Growth		45.1%	-36.5%	-62.0%	
Net Profit Growth		36.0%	-39.0%	-49.4%	-88.7%
EPS Growth		36.0%	-39.0%	-49.4%	-88.7%

Margins	12/08A	12/09A	12/10E	12/11E	12/12E
Gross profit margin	3.3%	29.2%	41.3%	49.0%	52.0%
EBITDA margin	-250.4%	-35.7%	7.2%	19.0%	27.0%
Operating Margin	-336.4%	-82.1%	-28.8%	-7.8%	3.2%
Pretax profit margin	-450.9%	-103.1%	-35.6%	-12.9%	-1.2%
Net profit margin	-450.9%	-103.1%	-34.7%	-12.5%	-1.2%

Other Ratios	12/08A	12/09A	12/10E	12/11E	12/12E
ROCE	-12.5%	-11.7%	-7.8%	-3.0%	1.5%
ROIC		-10.7%	-7.3%	-2.9%	1.5%
ROE	-38.9%	-30.5%	-24.6%	-15.3%	-1.9%
Effective Tax Rate	0.0%	0.0%	2.5%	2.5%	2.5%
Capex/Sales	5130.5%	63.0%	22.9%	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	202.5	13.1	6.8
P/B (x)	1.2	1.7	2.1	2.5	2.5
EV/Sales (x)	49.5	8.7	5.0	3.7	3.0
EV/EBITDA (x)	NA	NA	69.3	19.3	11.0
EV/EBIT (x)	NA	NA	NA	NA	93.0
EV/IC (x)	1.1	1.2	1.4	1.4	1.4
Dividend Yield	0.0%	0.0%	0.0%	0.0%	0.0%

Source: Company data, Al Rajhi Capital



With equity representing 31% of the balance sheet, Zain is undercapitalised compared to its peers

Balance Sheet (SARmn)	12/08A	12/09A	12/10E	12/11E	12/12E
Cash and Cash Equivalents	583	506	250	250	781
Current Receivables	317	1,007	2,060	2,689	3,179
Inventories	60	39	89	114	139
Other current assets	369	697	697	697	697
Total Current Assets	1,182	1,850	2,696	3,351	4,397
Fixed Assets	2,409	3,847	4,563	5,550	6,533
Investments	-	-	-	-	-
Goodwill	-	-	-	-	-
Other Intangible Assets	23,075	22,133	20,704	19,275	17,846
Total Other Assets	-	-	-	-	-
Total Non-current Assets	25,484	25,980	25,268	24,825	24,379
Total Assets	26,665	27,830	27,964	28,175	28,775
Short Term Debt	9,479	-	-	-	-
Trade Payables	3,055	6,247	7,425	7,880	8,589
Dividends Payable	-	-	-	-	-
Other Current Liabilities	556	543	543	543	543
Total Current Liabilities	13,090	6,789	7,967	8,423	9,131
Long-Term Debt	1,849	12,408	13,254	13,966	13,966
Other LT Payables	-	-	-	-	-
Provisions	4	10	10	10	10
Total Non-current Liabilities	1,854	12,418	13,264	13,976	13,976
Minority interests	-	-	-	-	-
Paid-up share capital	14,000	14,000	14,000	14,000	14,000
Total Reserves	(2,278)	(5,378)	(7,268)	(8,224)	(8,332)
Total Shareholders' Equity	11,722	8,622	6,732	5,776	5,668
Total Equity	11,722	8,622	6,732	5,776	5,668
Total Liabilities & Shareholders' Equity	26,665	27,830	27,964	28,175	28,775

We forecast that net debt will reach 2.4x revenues for 2010

Ratios	12/08A	12/09A	12/10E	12/11E	12/12E
Net Debt (SARmn)	10,745	11,902	13,004	13,716	13,185
Net Debt/EBITDA (x)	(8.49)	(11.11)	33.02	9.46	5.27
Net Debt to Equity	91.7%	138.0%	193.2%	237.5%	232.6%
EBITDA Interest Cover (x)	(5.6)	(1.7)	1.1	3.8	6.2
BVPS (SAR)	8.37	6.16	4.81	4.13	4.05

A large positive movement on working capital supported cash flow in 2009. This may not be sustainable

Cashflow Statement (SARmn)	12/08A	12/09A	12/10E	12/11E	12/12E
Net Income before Tax & Minority Interest	(2,278)	(3,098)	(1,938)	(981)	(111)
Depreciation & Amortisation	435	1,394	1,961	2,045	2,206
Decrease in Working Capital	796	2,065	76	(199)	194
Other Operating Cashflow	-	634	48	25	3
Cashflow from Operations	(1,048)	995	146	890	2,291
Capital Expenditure	(25,919)	(1,892)	(1,248)	(1,602)	(1,760)
New Investments	1	-	-	-	-
Others	65	3	-	-	-
Cashflow from investing activities	(25,853)	(1,889)	(1,248)	(1,602)	(1,760)
Net Operating Cashflow	(26,901)	(894)	(1,102)	(712)	531
Dividends paid to ordinary shareholders	-	-	-	-	-
Proceeds from issue of shares	14,000	-	-	-	-
Increase in Loans	13,710	1,080	846	712	-
Effects of Exchange Rates on Cash	-	-	-	-	-
Other Financing Cashflow	(226)	(262)	-	-	-
Cashflow from financing activities	27,484	818	846	712	-
Total cash generated	583	(77)	(256)	-	531
Cash at beginning of period	-	583	506	250	250
Implied cash at end of year	583	507	250	250	781

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%	22.9%	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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