



US\$2.900bn Market cap	48.1% Free float	US\$16.90mn Avg. daily volume
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Target price	8.00	2.5% over current
Consensus price	8.70	11.5% over current
Current price	7.80	as at 25/8/2010

Research Department
Andrew Haskins, Head of Equity Research
 Tel +966 1 211 9233, haskinsar@alrajhi-capital.com

Underweight	Neutral	Overweight
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Zain KSA

Good plan but not yet enough

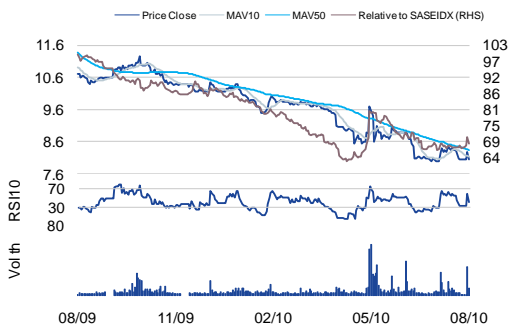
Key themes

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

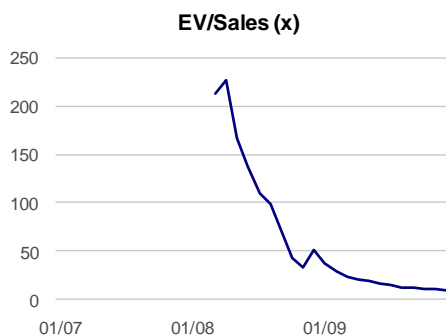


Earnings

Period End (SAR)	12/09A	12/10E	12/11E	12/12E
Revenue (SARmn)	3,004	5,650	7,705	9,516
Revenue Growth	494.6%	88.1%	36.4%	23.5%
EBITDA (SARmn)	(1,073)	328	1,484	2,474
EBITDA Growth	-15.2%		351.8%	66.7%
EPS	- 2.21	- 1.65	- 0.84	- 0.12
EPS Growth	36.0%	-25.4%	-49.3%	-85.4%

Source: Company data, Al Rajhi Capital

Valuation



Source: Company data, Al Rajhi Capital

Zain KSA has announced its financial restructuring plan. The proposed capital reduction and subsequent capital increase look sensible, and seem to have been designed to avoid dilution to minority shareholders. Zain KSA's restructuring plan will probably succeed, and will leave the company financially stronger than it is now. However, we expect Zain to remain highly geared even after the restructuring, with net debt equal to 1.7x 2010 sales or 39% of enterprise value. We believe, therefore, that additional financial restructuring measures may be needed in the future. We retain our Neutral rating and target price of SAR8.0.

Restructuring plan has two parts: Zain KSA announced its long-awaited financial restructuring plan on 20th August, 2010. The plan has two parts. Firstly, Zain KSA intends to stage a capital reduction, which will involve cancelling just under 48% of its issued shares and reducing its share capital from around SAR14.0bn to SAR7.3bn. It will then stage a capital increase, which is intended to raise its share capital from approximately SAR7.3bn to SAR11.7bn.

Plan should avoid dilution to minority shareholders: The proposed capital increase is not straightforward. The new capital will be raised in two ways: a debt-for-equity swap open only to Zain KSA's founding shareholders, and a conventional rights issue open to all other shareholders. Based on our discussions with the company, it appears to be expected that the debt-for-equity swap will raise 50% of the new capital and the rights issue the other 50%, i.e. SAR2.2bn in each case. This structure appears to have been designed to reduce the risk of dilution to minority shareholders. It should also help ensure that 50% of Zain KSA's shares remain in the hands of Saudi public investors, which is a condition of the terms of the company's telecoms operating licence.

The plan does not go far enough: Zain KSA's restructuring plan ought to succeed, and will leave the company financially stronger than it is now. But the plan should only lower Zain KSA's net debt by 31% to SAR9.6bn. This will still amount to 1.7x our estimate of 2010 sales of SAR5.65bn, compared to under 0.5x for both STC and Mobily. Similarly, net debt will still represent 39% of enterprise value of SAR24.9bn, compared to 17-22% for STC and Mobily. In order to stand on a firmer footing compared to its rivals, we think Zain KSA needs to reduce net debt to a level roughly equal to this year's sales or to 25% of enterprise value. This implies cutting net debt to about SAR6bn. We therefore think additional financial restructuring measures may be needed in the future.

Valuation and conclusion: We await approval of Zain KSA's proposals from its shareholders and the CMA, and will update our estimates formally afterwards. The key change to our estimates is likely to be lower interest costs: we estimate that the restructuring plan will cut annual net interest charges by around SAR350mn, and raise net profit by a similar amount. While the restructuring plan should help assure Zain KSA's long-run viability, it does not have a direct impact on our estimate of fair equity value for the company. For the moment we retain our target price of SAR8.0, which is equal to our fair value per share estimated by long-run discounted economic profit valuation. Our rating remains Neutral, and we continue to believe that investors should not start to consider Zain KSA as a recovery stock until after the restructuring is completed.



Corporate summary	Share information	Valuation
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 13-14%, 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 now sold the majority of its African assets to Bharti.	<p>Market cap (SAR/US\$) 10.90bn / 2.90bn</p> <p>52-week range 8.00 - 11.25</p> <p>Daily avg volume (US\$) 20.90mn</p> <p>Shares outstanding 1,400mn</p> <p>Free float (est) 48.1%</p> <p>Performance: 1M 3M 12M</p> <p>Absolute -2.5% -9.3% -26.4%</p> <p>Relative to index 0.3% -13.5% -30.1%</p> <p>Major Shareholder:</p> <p>Mobile Telecommunications Co. (Kuwait) 25%</p> <p>Faden Trading and Contracting 6.9%</p>	<p>Period End 12/09A 12/10E 12/11E 12/12E</p> <p>Revenue (SARmn) 3,004 5,650 7,705 9,516</p> <p>EBITDA (SARmn) (1,073) 328 1,484 2,474</p> <p>Net Profit (SARmn) (3,099) (2,314) (1,172) (171)</p> <p>EPS (SAR) - 2.21 - 1.65 - 0.84 - 0.12</p> <p>DPS (SAR) - - - -</p> <p>EPS Growth 36.0% -25.4% -49.3% -85.4%</p> <p>EV/EBITDA (x) NA 79.6 18.0 11.0</p> <p>P/E (x) NA NA NA NA</p> <p>P/B (x) 1.3 1.7 2.1 2.2</p> <p>Dividend Yield 0.0% 0.0% 0.0% 0.0%</p> <p>Source: Company data, Al Rajhi Capital</p>

Zain KSA will stage a capital reduction, followed by a capital increase

Restructuring plan is sensible and should succeed...

Zain KSA announced its long-awaited financial restructuring plan on 20th August, 2010. The plan has two parts. Firstly, the company plans to stage a capital reduction, which will involve cancelling just under 48% of its issued shares and reducing its share capital from around SAR14.0bn to SAR7.3bn. The capital reduction will allow Zain KSA to eliminate its accumulated loss, which stood at SAR6.7bn at the end of H2 2010. As a result of the capital reduction, the market price of the company's remaining shares will automatically nearly double. This will allow Zain KSA to proceed to stage the second part of its plan, a capital increase, since in Saudi Arabia new share issues cannot be made at a discount to the par value of SAR10.0. The capital increase is intended to raise Zain KSA's capital from approximately SAR7.3bn to SAR11.7bn, i.e. by around SAR4.3bn or 60%.

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

The capital increase of SAR4.4bn will come partly from a debt-for-equity swap and partly from a rights issue

The proposed capital increase is not as straightforward as it appears. The English text of Zain KSA's official public announcement makes it clear that the new capital will be raised through two methods: a debt-for-equity swap open only to Zain KSA's founding shareholders, and a conventional rights issue open to all other shareholders *other than* the founding shareholders. Based on our discussions with the company, it appears to be expected that the debt-for-equity swap will raise 50% of the new capital and the rights issue the other 50%, i.e. SAR2.2bn in each case.

Zain KSA's founding shareholders originally provided the company with loans of SAR2.16bn, of which Zain Kuwait accounted for SAR1.10bn. Total shareholder loans rose to SAR2.91bn in mid-2009 as the result of the advance by Zain Kuwait of an additional sum of US\$200mn or SAR750mn. Zain KSA's restructuring plan appears to envisage that all the original shareholder loans of SAR2.16bn will be converted into new equity.

The plan reduces dilution for minority investors and should help ensure that 50% of shares stay in Saudi public hands

As noted, the rights issue will be reserved to shareholders other than the founding shareholders, i.e. minority investors. We applaud the fact that Zain KSA has made this proposal, which appears designed to reduce the risk of dilution to minority shareholders. The proposal may also be designed to help ensure that 50% of Zain KSA's shares remain in the hands of Saudi public investors, since this is a condition of the terms of the company's telecoms operating licence.

We expect the restructuring plan to succeed

We think that the restructuring plan carries a good chance of success. Regarding the founding shareholders, it is important to note that they will not be asked to contribute more money to Zain KSA, but simply to swap their loans for equity. We had worried that arguably non-strategic founding shareholders such as Almarai, which owns 2.5% of Zain KSA, might be unwilling to contribute new funds to a company which so far has not been a good investment;



however, these shareholders should be willing to swap debt for equity if that helps to ensure Zain KSA's long-run viability. Regarding minority shareholders, they should be willing to subscribe for new shares at what we expect to be a discount of around 33% to the market price, i.e. SAR10 compared to the likely market price of around SAR14.9 after the initial capital reduction. Since the rights issue will be fully underwritten by investment banks, Zain KSA should raise SAR2.2bn of new cash even if minority shareholders generally prove unwilling to subscribe.

Figure 2. Zain: expected changes in market price

Current share base (m)	1,400.00
Current market price (SAR)	7.80
Current market cap. (SAR mn)	10,920
Interim new share base after capital reduction	732.8
Implied market price (SAR)	14.9
Expected market cap. after rights issue and debt-for-equity swap	15,304
Final new share base	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

Zain KSA will clearly be stronger after the restructuring than before

We think that Zain KSA's restructuring plan will probably succeed, and it will clearly leave the company stronger financially than it is today. As a result, the company ought to be able to compete more effectively with STC and Mobily than is the case now; in particular, it should be able to raise capital expenditure if necessary. Zain KSA's operating performance since service launch in 2008 has been impressive for a no.3 mobile operator, and we can be more confident now that Zain can maintain its good record.

...but in our view does not reduce net debt sufficiently

But even after the restructuring Zain KSA's gearing ratios will be obviously inferior to those of its rivals

Nevertheless, we are concerned that Zain KSA's financial restructuring plan does not go far enough. The capital increase will raise SAR4.4bn in new equity and reduce net debt by the same amount. (The capital increase will only raise SAR2.2bn in new cash, but net debt will still fall by SAR4.4bn because SAR2.2bn of debt will be swapped for equity.) At the end of Q2 2010, Zain KSA had net debt of SAR14.0bn, net debt having jumped by SAR2.2bn from the end of Q1 due to replacement of vendor financing by a bank loan. The restructuring plan should thus reduce net debt by around 31% to SAR9.6bn. While this may look like a steep reduction, net debt will still amount to 1.7x our estimate of 2010 revenues of SAR5.65bn, compared to under 0.5x for both STC and Mobily. Similarly, net debt will still amount to 39% of Zain KSA's enterprise value of SAR24.9bn, compared to 17% at present for Mobily and 22% for STC. Note: the capital restructuring plan should not directly have any impact on Zain KSA's enterprise value. i.e. (in simple terms) the sum of the market value of its equity and the market value of its debt.

Figure 3.1 Zain: estimated changes in net debt

(SAR mn)		% chg.
Net debt at end Q2 2010	14,024	
Reduction from debt-for-equity swap	-2,200	
Reduction from rights issue	-2,200	
Final net debt	9,624	-31.4%

Source: Company data, Al Rajhi Capital

Figure 3.2 Zain: gearing ratios

	2010e	2011e
Net debt/sales (x)	1.7	1.2
Net debt/EBITDA (x)	29.3	6.5
Net debt/equity (%)	86%	96%
Net debt as % of enterprise value	39%	41%

Source: Company data, Al Rajhi Capital

We think Zain KSA needs to cut net debt to SAR6.0bn

In order to stand on a firmer footing compared to its competitors, we believe that Zain KSA needs to reduce net debt to a level roughly equivalent to this year's revenues or to about one-quarter of enterprise value. This implies reducing net debt to around SAR6bn. Based on our estimates for Zain KSA's results for 2011 (when the company will have grown to be substantially larger than in 2010), with net debt of SAR6.0bn Zain KSA would still have a net debt/sales ratio of 0.8x and a net debt/EBITDA ratio of 4.1x. The latter figure may be compared to our assumed usual upper limit of safety for a mature telecoms operator of 3x.

This suggests that further financial restructuring measures are necessary

In order to reduce net debt by a further 38% from SAR9.6bn to SAR6.0bn, we think Zain KSA will have to consider additional financial restructuring measures. As we argued in research reports on the company published earlier this year, one of the most obvious such measures is



The restructuring plan should cut net interest costs by about SAR350mn, allowing Zain KSA to report a net profit in 2012

We retain our target price of SAR8.0 and our Neutral rating

a debt-for-equity swap open to the company's banks as well as its founding shareholders. Bank debt on Zain KSA's balance sheet currently stands at SAR11.7bn, although we think only a small portion of this total would need to be swapped for equity. We do not believe, therefore, that the risk of dilution for minority shareholders in the company has completely disappeared.

Valuation and conclusion

Zain KSA awaits approval of its proposals from its shareholders, from the Saudi Capital Market Authority (CMA) and from other parties. We do not intend to update our earnings estimates for the company until it seems clear that the CMA in particular is happy with the proposals. The key change to our estimates is likely to be lower interest expenses. Zain KSA is currently paying a very high interest rate of around 8.1% on gross debt (based on our calculation for H1 2010). If the restructuring plan is implemented, we estimate that it will reduce annual net interest charges by around SAR350mn, and boost net profit by a similar amount. This would allow Zain KSA to report a net profit in 2012 rather than 2013 as we currently assume.

While the restructuring plan should help assure Zain KSA's long-run viability, it does not have a direct impact on our estimate of fair equity value for the company. For the moment we retain our target price of SAR8.0, which is equal to our fair value per share estimated by long-run discounted economic profit valuation. Our rating on Zain KSA remains Neutral, and we continue to believe that investors should not start to consider the company as a recovery stock until after the restructuring is completed.



We raised our sales estimates for the next three years by 5-6% after the Q2 results

Currently, 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	5,650	7,705	9,516
Cost of Goods Sold	(489)	(2,127)	(3,307)	(3,921)	(4,472)
Gross Profit	16	877	2,343	3,783	5,043
Government Charges		-			
S.G. & A. Costs	(1,281)	(1,950)	(2,015)	(2,299)	(2,569)
Operating EBIT	(1,700)	(2,467)	(1,194)	(203)	698
Cash Operating Costs	(1,770)	(4,077)	(5,322)	(6,221)	(7,042)
EBITDA	(1,265)	(1,073)	328	1,484	2,474
Depreciation and Amortisation	(435)	(1,394)	(1,523)	(1,687)	(1,776)
Operating Profit	(1,700)	(2,467)	(1,194)	(203)	698
Net financing income/(costs)	(226)	(634)	(1,119)	(975)	(874)
Forex and Related Gains	-	-	-	-	-
Provisions	-	-	-	-	-
Other Income	65	1	-	-	-
Other Expenses	(418)	-	-	-	-
Net Profit Before Taxes	(2,278)	(3,099)	(2,314)	(1,177)	(176)
Taxes	-	-	-	5	4
Minority Interests	-	-	-	-	-
Net profit available to shareholders	(2,278)	(3,099)	(2,314)	(1,172)	(171)
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)	(0.565)	0.367	1.146
EPS (SAR)	(1.627)	(2.214)	(1.653)	(0.837)	(0.122)
DPS (SAR)	0	0	0	0	0
Growth	12/08A	12/09A	12/10E	12/11E	12/12E
Revenue Growth		494.6%	88.1%	36.4%	23.5%
Gross Profit Growth		5228.5%	167.2%	61.4%	33.3%
EBITDA Growth		-15.2%		351.8%	66.7%
Operating Profit Growth		45.1%	-51.6%	-83.0%	
Net Profit Growth		36.0%	-25.4%	-49.3%	-85.4%
EPS Growth		36.0%	-25.4%	-49.3%	-85.4%
Margins	12/08A	12/09A	12/10E	12/11E	12/12E
Gross profit margin	3.3%	29.2%	41.5%	49.1%	53.0%
EBITDA margin	-250.4%	-35.7%	5.8%	19.3%	26.0%
Operating Margin	-336.4%	-82.1%	-21.1%	-2.6%	7.3%
Pretax profit margin	-450.9%	-103.2%	-40.9%	-15.3%	-1.8%
Net profit margin	-450.9%	-103.2%	-40.9%	-15.2%	-1.8%
Other Ratios	12/08A	12/09A	12/10E	12/11E	12/12E
ROCE	-12.5%	-11.7%	-6.0%	-1.0%	3.5%
ROIC		-10.7%	-5.7%	-0.9%	3.2%
ROE	-38.9%	-30.5%	-31.0%	-20.5%	-3.4%
Effective Tax Rate	0.0%	0.0%	0.0%	0.4%	2.5%
Capex/Sales	5130.5%	63.0%	21.8%	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	21.2	6.8
P/B (x)	0.9	1.3	1.7	2.1	2.2
EV/Sales (x)	42.9	7.6	4.6	3.5	2.9
EV/EBITDA (x)	NA	NA	79.6	18.0	11.0
EV/EBIT (x)	NA	NA	NA	NA	39.0
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	1,242	1,837	2,855
Inventories	60	39	93	125	143
Other current assets	369	312	446	446	446
Total Current Assets	1,182	1,850	2,031	2,658	3,694
Fixed Assets	2,409	3,847	4,547	5,488	6,527
Investments	-	-	-	-	-
Goodwill	-	-	-	-	-
Other Intangible Assets	23,075	22,133	21,145	20,137	19,129
Total Other Assets	-	-	-	-	-
Total Non-current Assets	25,484	25,980	25,692	25,624	25,656
Total Assets	26,665	27,830	27,723	28,283	29,350
Short Term Debt	9,479	-	2,194	2,194	2,194
Trade Payables	3,055	6,247	4,899	5,982	6,776
Dividends Payable	-	-	-	-	-
Other Current Liabilities	556	543	707	707	707
Total Current Liabilities	13,090	6,789	7,800	8,883	9,677
Long-Term Debt	1,849	12,408	13,269	13,919	14,364
Other LT Payables	-	-	330	330	330
Provisions	4	10	15	15	15
Total Non-current Liabilities	1,854	12,418	13,614	14,263	14,708
Minority interests	-	-	-	-	-
Paid-up share capital	14,000	14,000	14,000	14,000	14,000
Total Reserves	(2,278)	(5,378)	(7,691)	(8,864)	(9,035)
Total Shareholders' Equity	11,722	8,622	6,309	5,136	4,965
Total Equity	11,722	8,622	6,309	5,136	4,965
Total Liabilities & Shareholders' Equity	26,665	27,830	27,723	28,283	29,350

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	15,213	15,862	16,308
Net Debt/EBITDA (x)	-	8.49	11.10	46.32	10.69
Net Debt to Equity	91.7%	138.0%	241.1%	308.8%	328.5%
EBITDA Interest Cover (x)	(5.6)	(1.7)	0.3	1.5	2.8
BVPS (SAR)	8.37	6.16	4.51	3.67	3.55

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)	(2,314)	(1,177)	(176)
Depreciation & Amortisation	435	1,394	1,523	1,687	1,776
Decrease in Working Capital	796	2,060	503	456	(242)
Other Operating Cashflow	-	638	578	5	4
Cashflow from Operations	(1,048)	994	291	970	1,363
Capital Expenditure	(25,919)	(1,892)	(1,234)	(1,620)	(1,808)
New Investments	1	-	-	-	-
Others	65	3	0	-	-
Cashflow from investing activities	(25,853)	(1,889)	(1,234)	(1,620)	(1,808)
Net Operating Cashflow	(26,901)	(895)	(943)	(650)	(445)
Dividends paid to ordinary shareholders	-	-	-	-	-
Proceeds from issue of shares	14,000	-	-	-	-
Effects of Exchange Rates on Cash	-	-	-	-	-
Other Financing Cashflow	(226)	(575)	(2,344)	-	-
Cashflow from financing activities	27,484	818	688	650	445
Total cash generated	583	(78)	(256)	-	-
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%	21.8%	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.

Contact us

Dr. Saleh Alsuhaibani
Head of Research
Tel : +966 1 2119434
alsuhaibanis@alrajhi-capital.com

Al Rajhi Capital
Research Department
Head Office, King Fahad Road
P.O. Box 5561
Riyadh 11432
Kingdom of Saudi Arabia
Email: research@alrajhi-capital.com

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