

Saudi Telecoms Sector

Telecoms – Integrated/Mobile

Saudi Arabia

13 October 2010

الراجحي المالية
Al Rajhi Capital



US\$33.6bn Market cap
29.8% Free float
US\$25.2mn Avg. daily volume

Target mkt cap **SAR147bn** 16.7% over current
Consensus mkt cap SAR145bn 15.1% over current
Current mkt cap. SAR126bn as at 12/10/2010

Underweight **Neutral** Overweight

Key themes

We expect the Saudi mobile market to continue to outperform fixed line, driven primarily by mobile data. Consequently we expect robust growth for the next few years, despite the risk of increased pressure on prices. We regard STC's overseas expansion as confused, and think that Mobily in particular has taken advantage of STC's distraction to strengthen its position in the domestic market.

Implications

Our preferred stock in the sector is Mobily, which we rate as Overweight. Mobily is performing well operationally and offers strong growth in the near term at a reasonable valuation. STC (Neutral) lacks catalysts for share price performance, although it is modestly valued and offers a generous yield of 7.8%. Zain KSA (Neutral) is performing well for a third operator, but is hobbled by a high debt burden.

What do we think?

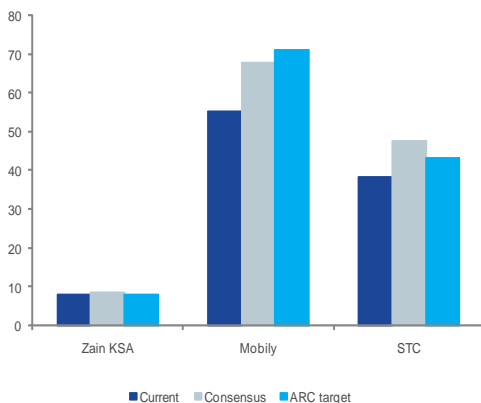
Stock	Rating	Price Target
STC	Neutral	SAR43.1
Mobily	Overweight	SAR71.0
Zain KSA	Neutral	SAR8.0

Why do we think it?

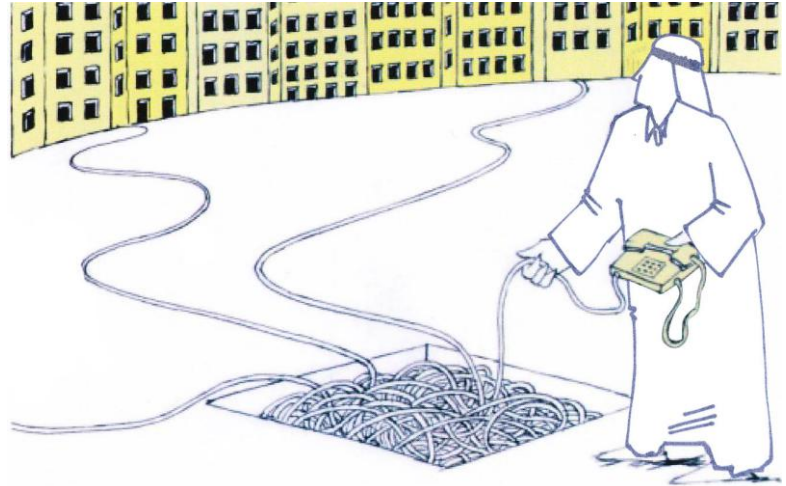
Stock	3 year EBITDA CAGR	2010 EV/EBITDA
STC	3%	5.1x
Mobily	15%	7.9x
Zain KSA	115%	80.4x

* 2009-12 for STC and Mobily, 2010-13 for Zain KSA. Source: Al Rajhi Capital

Where are we versus consensus?



Source Bloomberg, Al Rajhi Capital



Saudi Telecoms Sector: Mobily still our favourite

Mobile broadband is still surging and is the key source of growth in the Saudi telecoms market. Mobily is the leader in this area and we remain Overweight. Investment in new technology at home and expansion abroad boost long-term prospects for STC, but we do not expect growth to pick up sharply in the near term. Zain KSA's share price will be driven not by an improving operating performance but by Etisalat's bid for Zain Kuwait and the timing of financial restructuring – and we think the implications of recent events are negative.

Mobile broadband boosts Mobily: Accurate data for the size of the Saudi mobile broadband market are hard to find. However, mobile broadband has clearly overtaken fixed-line broadband, and continues to grow. Mobily's leading position in this segment should drive the highest near-term growth in the sector.

STC – recovery will take time: STC's investment in NGN systems should yield new growth opportunities and cost savings in the domestic market, but these may take some years to materialise. The contribution to sales from foreign units is rising, but rising depreciation could weigh on profits for a few years yet. We think STC's results have bottomed but do not expect growth to pick up rapidly.

Zain KSA – too much beyond its control: Operationally Zain is performing well. However, we expect Zain's share price to be driven by factors partly beyond its control, i.e. the timing of financial restructuring and Etisalat's offer for Zain Kuwait. We see this offer as negative for Zain KSA since if it succeeds we expect Etisalat to sell Zain Kuwait's stake in Zain KSA and focus on its affiliate Mobily.

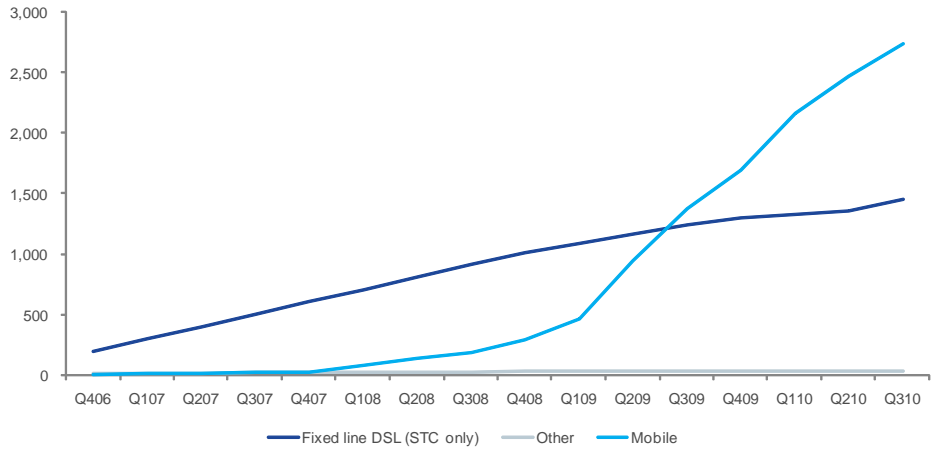
Q3 results preview – Mobily should stay ahead: We expect robust Q3 results from Mobily, though not as great as in Q1 and Q2. We expect mild improvement from STC after a poor H1. Zain KSA's results (announced today) again featured strong growth in sales and gross profit but high depreciation and interest costs. High interest reflects high debt and shows the urgency of financial restructuring.

Stock conclusions: Mobily (Overweight) is our favourite telecoms stock and offers 29% implied upside to our target price of SAR71.0. STC's 7.8% yield compensates for dull growth prospects and we remain Neutral with a marginally revised target price of SAR43.1. We also remain Neutral on Zain KSA; we think it is too risky to invest in Zain until the issues beyond its control are resolved.



Mobile broadband accounts are surging, and have overtaken fixed-line DSL

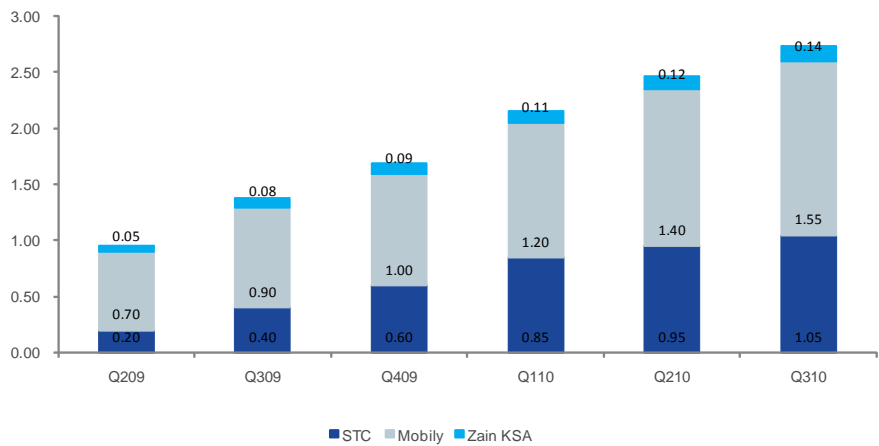
Figure 1. Combined fixed-line and mobile broadband subscriptions in KSA (000s)



Source: CITC, operators, estimates by Al Rajhi Capital

We believe mobile broadband accounts substantially exceed the official figures

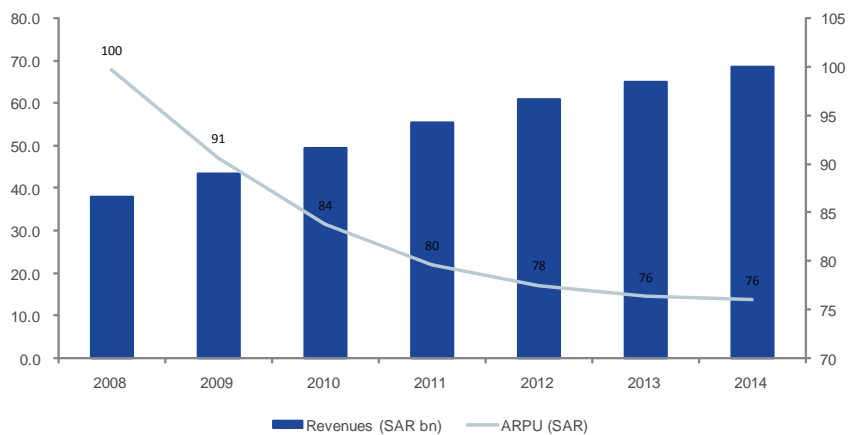
Figure 2. Saudi mobile broadband accounts (ARC estimates, mn)



Source: Al Rajhi Capital

Looking ahead we expect mobile revenues to rise but prices to continue falling

Figure 3. Saudi mobile market: forecasts for revenues and ARPU



Source: Source: Companies, CITC, Al Rajhi Capital

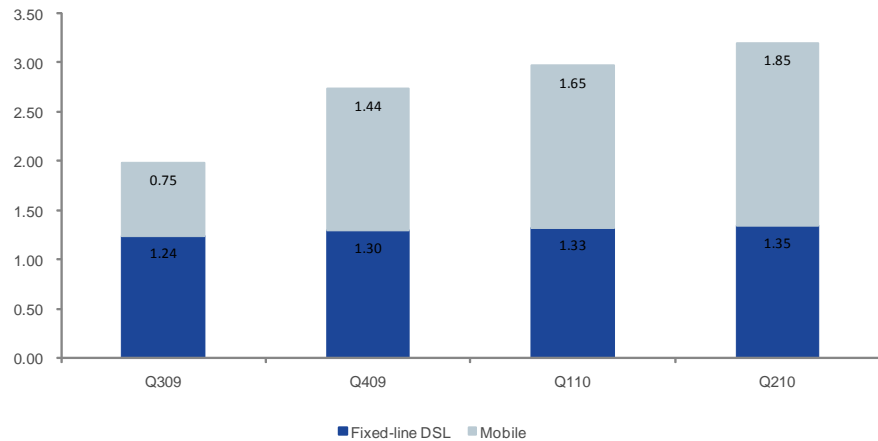


Mobile broadband growing Mobily the key beneficiary

The most recent figures from the regulator show 3.20mn fixed and mobile broadband accounts at the end of H1 2010

Accurate data for the size of the Saudi broadband market are very difficult to obtain. The Communications and Information Technology Commission (CITC), the Saudi telecoms regulator, publishes figures on the size of the telecoms and internet markets on a rather irregular basis. The most recent CITC report relates to the end of H1 2010 and was released in September. According to this report, there were “over 3.20mn” combined fixed and mobile broadband subscriptions at the end of H1 2010, with this total roughly split between wireless broadband (1.85mn accounts, including both HSPA and WiMAX) and fixed-line DSL accounts (1.35mn); we have ignored leased circuits and other smaller categories. While no report was released for Q1, the CITC figures show that total broadband accounts stood at 2.74mn at the end of 2009 (including around 1.44mn wireless accounts), and at 1.99mn at the end of Q3 2009 (including around 0.75mn wireless accounts). If these figures are taken at face value, they certainly suggest that the mobile broadband market is continuing to grow strongly, albeit with a slowdown from a boom in Q4 2009.

Figure 4. Saudi broadband accounts (official CITC figures, mn)



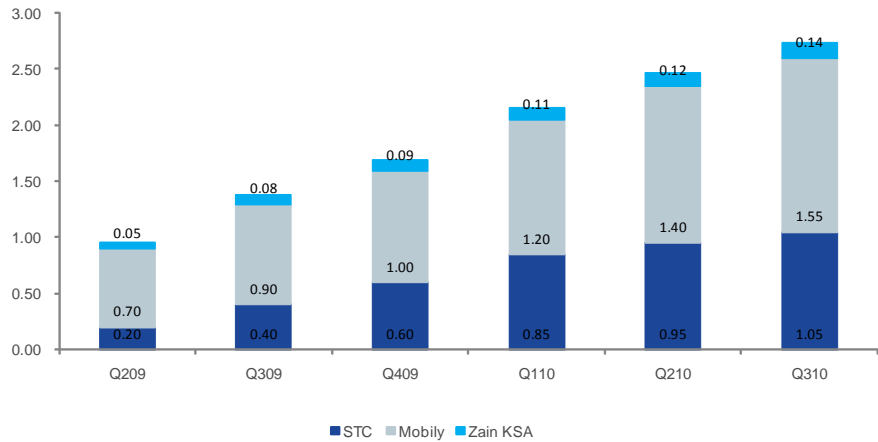
Source: CITC, with figures for 2010 extrapolated by Al Rajhi Capital

We believe mobile broadband accounts substantially exceed the CITC’s estimates

Unfortunately, the CITC’s figures for mobile broadband are impossible to reconcile with the rough indications provided by the telecoms operators. Mobily claimed 1.00mn wireless broadband accounts at the end of 2009, and we estimate that this figure had risen to 1.40mn by the end of H1 2010, and to 1.55mn by the end of Q3. STC does not disclose wireless broadband accounts, but has claimed to us twice in company visits this year that it is ahead of Mobily in this segment. While we find STC’s claim very hard to accept, we do believe that the company is expanding in mobile broadband, and estimate that it had 1.05m accounts by the end of Q3. Mobile broadband rollout for the smallest mobile operator, Zain KSA, seems to have been significantly slower than for its rivals, and we estimate that the company had only around 140,000 broadband accounts at that time. Summing these figures gives a total of 2.74mn broadband subscriptions in Saudi Arabia at the end of Q3 2010 – a figure 48% above the official total of 1.85mn for the end of H1.



Figure 5. Saudi mobile broadband accounts (ARC estimates, mn)

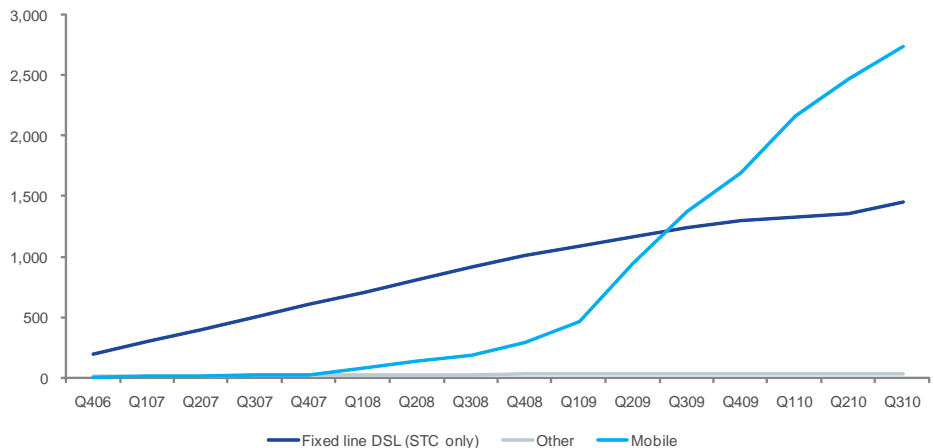


Source: Al Rajhi Capital

But even on the basis of the official figures mobile broadband is clearly growing faster than fixed-line broadband

In this short update we do not propose to discuss in detail the possible reasons for the wide discrepancy between the CITC's figures and the rough indications from the operators; investors are referred to our comprehensive report *Saudi Telecoms: we prefer jam today* (25th January, 2010) for further comment on this subject. Let it suffice to say here that, in our view, the CITC's figures understate the size of the Saudi mobile broadband segment – which consequently we see as even more robust and vibrant than the regulator acknowledges. The chart below shows the Saudi broadband market using our own estimates for mobile broadband accounts. However, even if one only accepts the official data, it is clear that mobile broadband is growing substantially faster than fixed-line broadband. With the mobile voice business mature, mobile broadband is the key source of growth in the Saudi telecoms market. This supports the original positive case that we put forward for the Saudi mobile market in our major report of January.

Figure 6. Combined fixed-line and mobile broadband subscriptions in KSA (000s)



Source: CITC, operators, estimates by Al Rajhi Capital

Mobily is the key beneficiary of growth in the mobile broadband segment

We continue to believe that Mobily has the highest market share in mobile broadband. With this market segment continuing to surge, we believe Mobily achieved strong new subscriptions growth over Q3 (although the company will not necessarily publish accounts data for the period). This should have helped drive robust revenue growth for Mobily in Q3 despite continuing promotions (notably on international calls). Further expansion in the mobile broadband segment should also have been positive for profit margins, since Mobily's recent experience strongly suggests that the mobile data business carries higher profit margins than mobile voice service.



STC: long-term initiatives promising rapid near-term acceleration unlikely

We remain perplexed by STC's recent weak revenue growth

In analysing the Saudi telecoms operators, one of the chief problems for us has been to work out why STC's recent revenue growth has been so dull. We remain very perplexed on this point. The Saudi mobile market has grown strongly over the past few years, while STC has also invested heavily abroad; foreign operations now account for about 30% of revenues. Yet over the past five quarters despite considerable volatility year-on-year revenue growth for STC has averaged just 1.8%, while year-on-year operating profit growth has averaged -26.1%. (Note: STC's last major investment abroad was in Oger Telecom with positions in Turkey and South Africa in Q2 2008. Results for the last five quarters contain no inorganic boost from overseas acquisitions.)

Figure 7. STC: year-on-year growth rates over past five quarters

	Q2 FY09	Q3 FY09	Q4 FY09	Q1 FY10	Q2 FY10	Simple avg.
Sales	5.4%	-4.5%	5.7%	3.1%	-0.7%	1.8%
EBITDA	-11.3%	-21.4%	4.5%	-20.5%	-12.3%	-12.2%
Oper. Profit	-25.7%	-32.4%	-6.4%	-38.7%	-27.4%	-26.1%

Source: Company data, Al Rajhi Capital

STC's investment in NGN infrastructure improves long-run prospects

We visited STC again recently, partly in order to assess the scope for growth rates to pick up. One of the key subjects that we addressed was STC's plans for investment in "next-generation network" (NGN) infrastructure. This is a topic that we had already considered in both our comprehensive report of January and our update report *STC: Positives and negatives balanced* of 10th May. In common with many other incumbent telecoms operators, STC believes that investment in NGN will strengthen its position in the fixed-line telecoms market, which has been under pressure for many years. STC's plan involves phased replacement of existing fixed-line infrastructure over a four year period between 2009 and 2012. On completion, the NGN should permit substantial operating cost savings as the new network equipment will require less expenditure on repairs. It should also facilitate both the delivery of faster broadband speeds – potentially up to 100 gigabytes per second – and the introduction of new services such as IP-TV.

Based on the findings from our recent visit, we maintain our view that the NGN will help STC to generate new business from government and public sector customers in particular; indeed, we believe that STC has already won important contracts of this type for strategic projects such as the government's New Economic Cities. On a related subject, STC reassured us that its rising interest in FTTH ("fibre-to-the-home") systems does not necessarily entail full replacement of copper lines across its network by optical fibre. In our view this is good, because full FTTH involves huge investment and for several important reasons we doubt that Saudi Arabia is a market where FTTH is likely to yield high returns (please see *STC: Positives and negatives balanced* for further detail on this point).

But new initiatives are unlikely to boost growth rates sharply in the near term

Overall we continue to believe that STC is engaged in exciting initiatives in the domestic telecoms market which will boost growth over time. However, new public sector contracts linked to the NGN are likely to be long-term projects spread over several years, with only modest contributions to revenues early on. We do not, therefore, expect the new initiatives that STC is taking to make a significant contribution to revenues or profitability over the next couple of years.

In our opinion, the key drivers of near-term prospects for STC remain the domestic mobile market and the progress of the company's overseas investments. Regarding the domestic mobile market, as noted we believe that Mobily remains ahead of STC in the key mobile broadband segment. Regarding the overseas operations, STC stated in our recent meeting that it was very happy with progress in South Africa (where it believes Cell C is improving strongly), Kuwait and Bahrain, but accepted that Indonesia remained very difficult. Looking at STC's overseas investments overall, we expect revenue growth to accelerate steadily from now on. However, we expect strong profits and cash flows in the most mature markets, Malaysia and Turkey, to be partially offset both by EBITDA losses in start-up ventures



(notably Kuwait and Bahrain, but also probably Indonesia) and by heavy depreciation charges, which we expect to continue rising for perhaps another two years. For these reasons we do not expect a rapid recovery in STC's growth rates in the near term.

Figure 8. STC: year-on-year growth rates (estimates for next six quarters)

	Q3 FY10E	Q4 FY10E	Q1 FY11E	Q2 FY11E	Q3 FY11E	Q4 FY11E	Simple avg.
Sales	0.6%	2.1%	2.4%	7.1%	3.3%	3.3%	3.8%
EBITDA	-1.6%	1.7%	15.5%	19.7%	2.0%	1.9%	7.9%
Oper. Profit	-5.1%	0.4%	32.9%	37.6%	2.6%	1.0%	13.9%

Source: Company data, Al Rajhi Capital

Zain KSA too much beyond its control

Key questions: will Zain KSA's financial restructuring happen, and will it succeed?

As we comment in greater detail below, we believe that Zain KSA is performing well operationally. However, in our view operating prospects are not the key factor driving Zain KSA's share price. As we see it, the two key factors driving Zain KSA's share price are, firstly, concern about the timing and degree of success of the company's forthcoming financial restructuring and, secondly, concern about whether the restructuring will happen at all in the wake of the bid by Etisalat of the UAE to acquire 46% of Zain KSA's *de facto* parent company, Zain Kuwait.

Timing and likely success of financial restructuring

Regarding the restructuring, officially nothing has changed from the time of our last report on Zain KSA of 28th August, *Zain KSA: Good plan but not yet enough*. As mentioned in that report, Zain formally announced its financial restructuring plan on 20th August. The plan has two parts. Firstly, the company 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.

We do not expect Zain KSA's financial restructuring to be completed till around mid-December

While this plan sounds straightforward enough, according to Zain KSA the Saudi CMA requires 45 days from the date of announcement of the plan to give approval. Shareholders also need to approve the plan and, while we expect them to do so, the process will take time. We therefore believe that the two transactions are unlikely to be completed until around mid-December. If this target were to slip into next year, we think Zain might lose the chance to present itself as a recovery story for 2011. In itself a delay into next year would be unlikely to derail the restructuring project, but we think it might discourage participation in the rights issue among certain investors.

Implications for Zain KSA of Etisalat's offer for Zain Kuwait

The discussion immediately above may now be out of date. This is because Etisalat, the incumbent UAE telecoms operator and one of the leading telecoms groups in the Middle East, announced at the end of September an offer to acquire 46% of Zain Kuwait, the *de facto* parent company of Zain KSA with a 25% holding. Since Zain Kuwait holds 10% of its own shares as treasury stock, acquiring 46% of the company would give Etisalat majority control. We understand that there is currently no requirement under Kuwaiti law for Etisalat to make an offer for 100% of the shares.

We think Etisalat's offer for Zain Kuwait has a high chance of success

While we cannot gauge the likely timing of completion of Etisalat's offer for Zain Kuwait, we believe that it stands a high chance of success. This is because the major shareholders in Zain Kuwait appear to support it. Zain Kuwait's largest shareholder is the Kuwait Investment Authority (KIA), with a stake of around 25%. The managing director of the KIA was recently reported to have stated that, although the KIA had not received an offer for its shares from Etisalat, it supported the deal on the grounds that it would boost Kuwait's stock market.* For its part, the Kharafi Group, in effect the second largest shareholder in Zain Kuwait with a holding of nearly 13% through its subsidiary National Investments Company, seems to be



Etisalat regards Mobily as the crown jewel among its international assets

Provided that it is allowed to do so, we expect Zain Kuwait to participate in Zain KSA's financial restructuring

But if acquired by Etisalat we do not expect Zain Kuwait to continue to support Zain KSA actively

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

clearly in favour of the offer. Indeed, National Investments Company recently declared that it had obtained support from owners collectively holding 46% of Zain Kuwait's shares through an alliance with smaller shareholders (see the comments on the two companies reported by Bloomberg News on 7th October and other sources).

** See, e.g. the TeleGeography CommsUpdate report of 12th October: "Kuwait Investment Authority (KIA), the country's sovereign wealth fund, did not receive an offer for its 24.6% stake in Zain Group as part of UAE-based Etisalat's non-binding bid for a 46% share of the Kuwaiti telecoms provider. According to Dow Jones Newswires, quoting Al Arabiya television, KIA's managing director Bader al-Saad said on Saturday [9th October] that the fund's stake – the largest single holding in Zain Group – does not form part of Etisalat's proposed share buyout, although he added that KIA supports the potential deal as it will boost the country's stock exchange."*

In our view, Etisalat is interested in all Zain Kuwait's Middle Eastern assets other than its holding in Zain KSA. Etisalat plainly considers its 27% holding in Mobily to be the crown jewel among its international assets, ahead even of its 66% holding in Etisalat Egypt. A merger between Mobily and Zain KSA seems out of the question; we do not believe that the CITC would permit it, since a merger would leave only two operators and raise the combined market share of the merged company to around 55%. Nor do we believe that the CITC would permit Etisalat to remain in indirect control of both Mobily and Zain KSA, or at least not for a prolonged period, on the grounds that the two operators would be in a position to act in concert in the market place. On this basis, assuming Etisalat does attain effective control of Zain Kuwait, we think it virtually certain that Etisalat will look to sell the stake in Zain KSA.

This raises a question about whether Zain Kuwait will actually participate in Zain KSA's debt-for-equity swap and the financial restructuring process in general. Unless the company is barred from participating by either the CMA or the CITC, we think that Zain Kuwait will participate, because in financial terms it makes little sense not to do so. At present, Zain Kuwait holds a 25% equity stake in Zain KSA worth around SAR2.78bn and the value of its shareholder loans to the company is SAR1.86bn. The equity holding – which confers voting and management rights over Zain KSA – is much more valuable to a potential new industry purchaser or financial investor in Zain KSA than the debt holding. We think that Zain KSA's right issue will go ahead, since Zain KSA is highly indebted and it is clearly in the interest of all shareholders for its balance sheet to be reinforced to avoid conceivable financial failure. We therefore assume that Zain Kuwait will go along with the debt-for-equity swap to avoid dilution of its holding.

However, this is not the same as saying that Zain Kuwait will continue to provide Zain KSA with active support. At present, the two companies work closely together: Zain Kuwait is contracted to provide management, technical and operational services to Zain KSA, including key management personnel. Following acquisition by Etisalat, we suspect that Zain Kuwait will gradually let these services lapse – not necessarily as the result of deliberate policy, indeed more probably because Zain Kuwait will simply have other priorities in the wake of the merger of two complex groups with a broad spread of international operations. Over time, we think loss of interest on Zain Kuwait's part would be detrimental to Zain KSA's operations, with the consequence that Etisalat/Zain Kuwait might end up selling a weakened company. At the least, we doubt that Etisalat/Zain Kuwait would continue to invest actively in Zain KSA, since it would not be in their interest to strengthen the company ahead of a possible sale to a regional competitor.

Conclusion for Zain KSA

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.



Q3 2010 results preview Mobily should stay ahead

We expect the results of the three large telecoms operators for Q3 2010 to show a similar pattern to Q1 and Q2. We predict robust results from Mobily, although not quite as sparkling as earlier in the year. We expect modest improvement from STC after very poor Q1 and Q2 results; however, due to the complexity of its operations and limited disclosure there is a greater margin of error in our forecasts for STC than for the other two operators. Zain KSA's results (announced today) again featured strong growth in sales and gross profit but high depreciation and interest costs. High interest reflects high debt and shows the urgency of financial restructuring.

Figure 9. Saudi telecoms sector: Q3 2010 forecast aggregate results

(SAR mn)	Q3 2009	Q2 2010	Q3 2010 est	% chg y-o-y
STC				
Revenues	12,934	12,591	13,010	0.6%
EBITDA	5,092	4,504	5,009	-1.6%
EBITDA margin (%)	39.4%	35.8%	38.5%	-1.4pp
Operating profit	3,112	2,345	2,952	-5.1%
Net profit	2,403	2,062	2,355	-2.0%
Mobily				
Revenues	3,511	3,972	4,057	15.5%
EBITDA	1,278	1,388	1,420	11.1%
EBITDA margin (%)	36.4%	34.9%	35.0%	-0.4pp
Operating profit	862	940	960	11.4%
Net profit	807	901	907	12.4%
Zain KSA (actual results for Q3 2010)				
Revenues	825	1,450	1,662	101.3%
EBITDA	-299	57	135	-145.1%
EBITDA margin (%)	-36.3%	3.9%	8.1%	n/m
Operating profit	-668	-314	-235	-64.8%
Net profit	-820	-632	-544	-33.6%
Aggregate				
Revenues	17,271	18,014	18,729	8.4%
EBITDA	6,071	5,949	6,564	8.1%
EBITDA margin (%)	35.1%	33.0%	35.0%	0.4pp
Operating profit	3,305	2,971	3,676	11.2%
Net profit	2,390	2,331	2,718	13.7%

Source: Company data, Al Rajhi Capital

STC's results should show some recovery compared to a very weak H1

STC

As noted earlier, we remain perplexed about why STC is not yet achieving stronger sales growth. Consequently we are conservatively forecasting year-on-year revenue growth of only 0.6% after a drop of 0.7% in Q2. We estimate that EBITDA reached SAR5,009mn in Q2, down by 2% year-on-year but up by 11% from the weak level of Q2. We base this assumption of quarter-on-quarter recovery in EBITDA on our belief 1) that promotional activity in the domestic market was relatively limited in Q3 and 2) that most of the overseas subsidiaries have been making gradual operating progress. We estimate that operating profit reached SAR2,952mn, down by 5% year-on-year but up by 26% from the weak level of Q2. We estimate that combined depreciation and amortisation charges exceeded SAR1.8bn, in line with the level of the past few quarters but well above the typical quarterly level of SAR1.5-1.7bn before STC started to include Oger Telecom in its accounts in Q2 2009. We have assumed that net financial expenses were in line with the level of Q2 and are not predicting major exceptional gains or losses. On this basis we predict net income of SAR2,355mn, down by 2% year-on-year but up by 14% quarter-on-quarter.



STC's financial position remains healthy

We estimate that STC ended Q3 with net debt of SAR23.0bn, down slightly from SAR24.2bn at the end of Q2. Based on our view that EBITDA is now starting to pick up, we estimate that the net debt/EBITDA ratio stood at 1.1x at the end of Q3, compared to 1.3x at the end of Q2. This is a very healthy level. With debt levels modest and earnings starting to improve, we believe that STC can maintain its annual dividend of SAR3.0, on which basis it offers a prospective yield of 7.8%.

We have trimmed our target price for STC from SAR44.2 to SAR43.1

While we believe that earnings have reached the bottom for STC, we have lowered our estimate of fair value per share on a long-run discounted economic profit (DEP) basis by 5%, from SAR44.6 to SAR42.3. This reflects the impact on our model both of our assumption of higher long-run depreciation charges and of updated WACC assumptions. Our estimate of fair value per share on the basis of comparisons with peer companies remains SAR43.8. Our target price for STC remains a simple average of our estimates of fair value under the two methods, i.e. SAR43.1 (compared to our previous target of SAR44.2). With under 15% upside to our target price, we retain our Neutral rating on STC.

We predict strong revenue growth but modest margin contraction for Mobily in Q3

Mobily

After rising by 27% year-on-year in Q1 and by 24% in Q2, we expect Mobily's revenues to rise by 16% in Q3. Three factors should have helped to drive top-line growth: further expansion in broadband business, further growth in postpaid users, and a new promotion on international calls in the period which should have boosted call volumes. Driven by broadband, data stood at 18% of revenues in Q2, and we expect a similar proportion for Q3. While mobile data business almost certainly carries higher margins than mobile voice service, we believe that the new international promotion will have weighed on margins to some extent (as was the case in Q1). Accordingly we predict EBITDA of SAR1,420mn, up by 11% year-on-year and by 2% quarter-on-quarter; we assume that the EBITDA margin reached 35.0%, compared to 36.3% in Q3 2009. We anticipate stronger EBITDA growth and a higher margin in Q4, which is traditionally the strongest quarter and which we expect to benefit from a stronger Hajj season this year than in Q4 2009. We predict net profit for Q3 of SAR1,420mn, up by 12% year-on-year.

Mobily's balance sheet should continue to strengthen

We believe that Mobily's balance sheet strengthened further in Q3. Net debt was SAR7.13bn at the end of Q2, while the net debt/EBITDA ratio was 1.3. We estimate that net debt fell to SAR6.44bn at the end of Q3, implying a net debt/EBITDA ratio of 1.1x. This is a very healthy financial position which allows Mobily to invest for growth.

Mobily dominates the surging mobile broadband market in Saudi Arabia. While in the near term trends in mobile will drive the company, Mobily's new GED ("Growth, Efficiency and Differentiation") strategy should prepare it for a future of likely greater fixed and mobile integration. We maintain our target price on Mobily of SAR71.0, which implies 29% appreciation potential from the current share price. Our rating remains Overweight and Mobily is our favourite stock in the sector.

Zain KSA

Zain KSA announced Q3 results on 13th October. We published a flash view comment on the results on the morning of that day but have not yet formally revised our forecasts. For the purposes of this update report this should not matter, since apart from higher sales than we had expected the key financial figures were close to our expectations.

Key features of Zain KSA's Q3 results

In summary, Zain KSA's results again featured strong sales growth but high depreciation and interest charges. Thus, while sales and gross profit exceeded our estimates, the net loss was slightly above our forecast. Zain has issued targets for 2011 which are in line with our assumptions. 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 with a target price of SAR8.0.

We discuss the results in greater detail below.

Sales

Zain KSA reported sales of SAR1,662mn, up by 95% year-on-year and by 15% versus Q2; sales were 7% above our estimate of SAR1,554mn. This strong performance appears to reflect continuing robust subscriptions growth and high call volumes. Zain does not seem to have published a figure for mobile accounts at the quarter-end; our estimate was 7.43mn.

Zain KSA achieved impressive sales growth



But depreciation charges and financial costs remain very high

Very high gearing makes financial restructuring essential

Gross profit and EBITDA

Gross profit of SAR712mn was up by 193% year-on-year and was 9% above our estimate of SAR653mn. We suspect 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.

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.

Net debt

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. While our existing estimate of Zain KSA's full-year revenues of SAR5.65bn now looks conservative after the strong Q3 sales performance, it is worth noting that based on this estimate Zain KSA's net debt/sales ratio is around 2.5x. On the basis of our existing forecasts for 2011, the company's net debt/sales ratio is 1.8x and its net debt/EBITDA ratio is 9.6x; the latter ratio 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.

Targets for 2011

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 may be compared with our existing estimates for next year: 10.42mn mobile accounts, sales of SAR7.61bn and EBITDA of SAR1.46bn.

Conclusion

As mentioned earlier in this report, 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 Q2 and Q3 results have shown strong progress in operating terms, 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 successfully completed. For the moment we retain our Neutral rating and our target price of SAR8.0, which is equal to our fair value per share estimated by long-run DEP profit valuation.

Disclaimer and additional disclosures for Equity Research

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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 Alsuhailani
Head of Research
Tel : +966 1 2119434
alsuhailanis@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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