



US\$3.000bn Market cap
48.1% Free float
US\$20.00mn Avg. daily volume

Target price **8.00** -0.6% over current
Consensus price **10.00** 24.2% over current
Current price **8.05** as at 20/7/2010

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Underweight **Neutral** Overweight

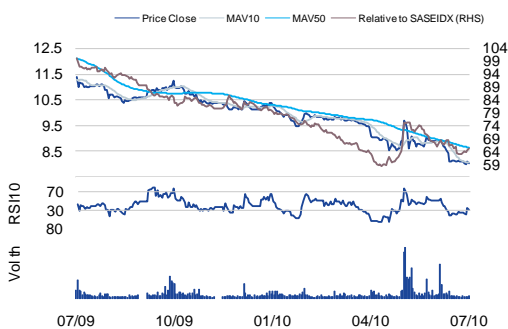
Key themes

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

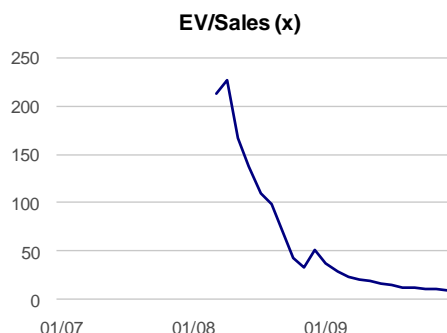


Earnings

Period End (SAR)	12/09A	12/10E	12/11E	12/12E
Revenue (SARmn)	3,004	5,650	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

We upgrade rating to Neutral

This report follows our Flash View of 18th July. Zain achieved strong growth in sales and positive EBITDA in Q2. On the other hand, net debt jumped from SAR12.0bn at the end of Q1 to SAR14.0bn. After reworking our forecasts we have left our target price unchanged at SAR8.0. In our view, the risk of high dilution makes it too risky to invest in Zain ahead of financial restructuring. For existing shareholders, however, it seems too late to sell. After its steep fall so far in 2010, we are raising our rating on Zain from Underweight to Neutral.

Sales growth very strong: Zain's results for Q2 2010 showed revenues of SAR1,450mn, up by 107% from Q2 2009 and – encouragingly – by 33% from Q1. Revenues were 9% above our estimate of SAR1,328mn. Strong subscription growth seems to have been the key factor driving sales: Zain claimed over 7.0mn mobile accounts for the end of Q2, compared to our estimate of 3.6mn one year previously and of 6.4mn at the end of Q1. Growth in postpaid service and in broadband accounts seem to be the factors behind this expansion.

EBITDA now positive: While revenues exceeded our expectations, so too did operating costs. We thus calculate that EBITDA reached SAR57mn for Q2, just below our estimate of SAR66mn. Importantly, however, this is the first full quarter for which Zain has reported positive EBITDA. This should help indicate to Zain's creditors that the company can build a sustainable long-run business.

Net debt jumps to SAR14.0bn: While operating trends were favourable, we were rather shocked by what we calculate as the jump in net debt from SAR11,970mn at the end of Q1 to SAR14,024mn at the end of Q2. The reason for this is that Zain arranged a short-term debt facility with BNP Paribas to refinance its obligations under existing vendor financing contracts. This arrangement effectively replaced SAR2.15bn of non-interest-bearing notes payable to suppliers by SAR2.19bn of interest-bearing loans. Net debt now represents 2.4x our revised estimate of 2010 revenues of SAR5.85bn.

Financial costs surge: Net financial costs were SAR317mn in Q2, up by 111% year-on-year and by 40% from SAR227mn in Q1. According to Zain, financial costs were boosted by one-time items, e.g. a charge relating to the refinancing of its vendor financing deals. We estimate that these one-time charges amounted to about SAR80mn. If so, then by our calculation Zain is currently paying an interest rate on gross debt of 7.6%, which is well above the rates paid by most Saudi companies. The jump in financial costs pushed up Zain's Q2 net loss.

Fair value unchanged: We have raised our forecasts for sales and EBITDA for Zain for both the short and the long term. However, in our long-run discounted economic profit model the higher debt cancels out the boost to fair value from the higher forecasts. Our estimate of fair value per share is thus barely changed at SAR7.93. Accordingly we retain our target price of SAR8.0 (1% higher).

We upgrade to Neutral: There is still no news on Zain's long-awaited financial restructuring plan, and in our view the risk of substantial dilution for minority shareholders makes it too risky to invest in Zain ahead of restructuring. That said, Zain has fallen by 21% since we launched coverage on 25th January and is now just a fraction above our target price. For existing shareholders, it looks too late to sell. We are accordingly raising our rating from Underweight to Neutral.



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 13-14%, 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.

Share information

Market cap (SAR/US\$) 11.30bn / 3.000bn
52-week range 8.00 - 11.40
Daily avg volume (US\$) 20.00mn
Shares outstanding 1,400mn
Free float (est) 48.1%

Performance: 1M 3M 12M
Absolute -9.6% -11.5% -29.4%
Relative to index -4.2% -1.9% -35.5%

Major Shareholder:
Mobile Telecommunications Co. (Kuwait) 25%
Faden Trading and Contracting 6.9%

Source: Bloomberg, Al Rajhi Capital

Valuation

Period End	12/09A	12/10E	12/11E	12/12E
Revenue (SARmn)	3,004	5,650	7,705	9,516
EBITDA (SARmn)	(1,073)	328	1,484	2,474
Net Profit (SARmn)	(3,099)	(2,314)	(1,172)	(171)
EPS (SAR)	- 2.21	- 1.65	- 0.84	- 0.12
DPS (SAR)	-	-	-	-
EPS Growth	36.0%	-25.4%	-49.3%	-85.4%
EV/EBITDA (x)	NA	80.6	18.3	11.1
P/E (x)	NA	NA	NA	NA
P/B (x)	1.3	1.8	2.2	2.3
Dividend Yield	0.0%	0.0%	0.0%	0.0%

Source: Company data, Al Rajhi Capital

Details of Q2 results: positive operating but weak financial trends

Below we present the key details of Zain's Q2 2010 results, together with our comments.

Figure 1. Zain KSA: Q2 2010 results

(SAR mn)	Q2 2009 actual	Q1 2010 actual	Q2 2010 actual	% chg. y-y	Q2 2010 ARC est.	Comment
Revenues	702	1,094	1,450	106.6%	1,328	Strong outcome, reflecting robust overall subscriptions growth and expansion in postpaid service
Gross profit	133	384	608	357.1%	531	Impressive and well above our forecast
Gross margin (%)	18.9%	35.1%	41.9%	23.0pp	40.0%	As above
EBITDA	-373	-70	57	n/m	66	Positive for the first time for a full quarter
EBITDA margin (%)	-53.1%	-6.4%	3.9%	n/m	0.0%	As above
Deprn. & amortisation	-333	-365	-371	11.4%	-374	Close to our forecast
Operating profit	-706	-435	-314	-55.5%	-308	Close to our forecast
Net financial costs	-151	-227	-317	109.9%	-212	Sharply up year-on-year and quarter-on-quarter due to higher interest rates and one-time charges
Other	0	0	-1	n/m	0	N/m
Net income before tax	-857	-663	-632	-26.3%	-520	Pushed down by higher financial costs
Tax and zakat	0	0	0	n/m	0	As a loss-making company, Zain pays no tax or zakat
Net profit	-857	-663	-632	-26.3%	-520	Pushed down by higher financial costs
Capex	233	38	341	46.4%	332	Up to a normal level from an unsustainably low level in Q1
Capex/sales (%)	33.2%	3.5%	23.5%	-9.7pp	25.0%	As above
Net debt	11,451	11,970	14,025	22.5%	12,167	Net debt jumped by SAR2.2bn from the end of Q1 due to replacement of vendor financing by a bank loan

Source: Company data, Al Rajhi Capital



We have raised our sales estimate for the next three years by 5-6%

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		0			
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	0	0	0	0	0
Provisions	0	0	0	0	0
Other Income	65	1	0	0	0
Other Expenses	-418	0	0	0	0
Net Profit Before Taxes	-2,278	-3,099	-2,314	-1,177	-176
Taxes	0	0	0	5	4
Minority Interests	0	0	0	0	0
Net profit available to shareholders	-2,278	-3,099	-2,314	-1,172	-171
Dividends	0	0	0	0	0
Transfer to Capital Reserve	0	0	0	0	0
	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	21.9	7.0
P/B (x)	1.0	1.3	1.8	2.2	2.3
EV/Sales (x)	43.6	7.7	4.7	3.5	2.9
EV/EBITDA (x)	NA	NA	80.6	18.3	11.1
EV/EBIT (x)	NA	NA	NA	NA	39.5
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



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



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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