July 19, 2017

riyad capital الرياض المالية

Rating	Buy
12- Month Target Price	SAR 14.00

Mobile Telecommunication Company (Zain)

Transfer of Coverage

New Zain

A new chapter for Zain has begun. Business improvement in the past three years (6% CAGR in revenue), gross margin at 67% and first quarterly net profit in the previous quarter are indicators. However, the Company stands at a crossroads that may lead to different paths. We are optimistic on this front. The company will have to decide on carving out its towers as well as capital restructuring that may include debt-equity swap and capital increase. Following the announcement regarding the intention of capital restructuring, stock price fell from its 52 weeks high of SAR 11.45 to SAR 9.15 reacting to expected EPS dilution. The sector is heading to an increasing competition as fundamentals are changing. Revenue mix, low data prices and post-paid market share are the current challenges facing operators. We continue with our Buy recommendation. We are raising target price from SAR 13.00 to SAR 14.00. We have not accounted for capital restructuring or tower sales due to lack of clarity.

A better story could evolve

We expect towers sale to take place during 2017 at an expected value of SAR 1.9 billion. MTR still remains at relatively elevated levels, which could lead to further reduction, benefiting Zain the most. Capital restructuring is expected to dilute EPS. On the other hand, this could result in better net profits as debt levels and finance charges will decline benefitting in the long-term. Total banks debt of SAR 14 billion is expected to decline as cash flow from operations improve and capex spending declines in coming years. These developments are expected to signal a bright future for the company that has suffered from highly leveraged balance sheet.

Increasing ARPU backing bottom line

Revenue in 1Q2017 has stood at new levels of SAR 1.9 billion, leading ARPU to SAR 63, +22% higher than the two year quarterly average. Zain successfully increased post-paid representation in subscriber base to 17% in 2016 compare to 1% in 2013. The Company has shifted its focus towards customer experience leading to better pricing. New strategy has paid-off well in 1Q2017 and expected to drive revenue in the coming years at a CAGR of 6% by 2020-end.

Long-term bet

We expect a net profit of SAR 209 million in 2017 at a net margin of 3%. Bottom line is expected to grow at a CAGR of 14% reaching SAR 313 million in 2020. Since 2015, working capital has contributed to FCF due to effective management. Supplier payout pace is expected to increase but changes in working capital remains positive; we remain alert to this. Free cash flow is expected to grow at CAGR of 10% by 2020-end. We maintain our Buy recommendation, increasing the target price to SAR 14.00 but may revisit our recommendation if management announces capital restructuring. Nevertheless, we are optimistic that the benefits of restructuring will outweigh EPS dilution. We find the new Zain as a good long-term bet.

Expected Total Return	
Price as on July-18, 2017	SAR 9.23
Upside to Target Price	51.7%
Expected Dividend Yield	0.0%
Expected Total Return	51.7%

Market Data	
52 Week H/L	SAR 11.45 /6.30
Market Capitalization	SAR 5,388 mln
Shares Outstanding	583.7 mln
Free Float	51.84%
12-Month ADTV	4,027,969
Bloomberg code	ZAINKSA AB

1-Year Price Performance

Source: Bloomberg

FY2017E (SAR mln)	
Revenue	7,689
Gross profit	5,105
Operating profit	1,087
Net profit	209
EPS (SAR)	0.36

Key Financial Figures

FY Dec31 (SAR mln)	2016A	2017E	2018E
Revenue	6,927	7,689	8,150
Gross Profit	4,401	5,105	5,297
EBITDA	1,795	2,696	2,817
Net Profit	(980)	209	269
EPS (SAR)	(1.68)	0.36	0.46

Key Financial Ratios

FY Dec31	2016A	2017E	2018E
Gross Margin	63.5%	66.4%	65.0%
EBIT Margin	-0.8%	14.1%	13.0%
NIM	-14.1%	2.7%	3.3%
EV/EBITDA	11.3x	7.7x	7.0x
P/FCF	9.04x	3.63x	2.97x

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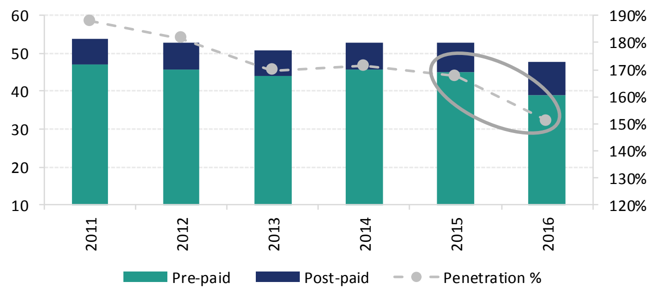
Sector Update

Tough 2016

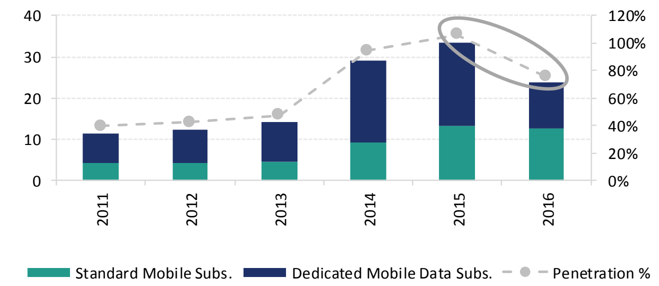
In 2016 telecom sector witnessed dramatic changes. In the first quarter, CITC announced the second MTR reduction on mobile and land line, which changed pricing strategy for all three operators. Following the MTR reduction, biometric verification policy took place, leading market penetration rate to decline from 168% in 2015 to 151% in 2016. In October 2016, a high order granted all three operators a unified license and useful life extension of 15 years. The order had a positive impact on Mobily and STC, however, for Zain it was a lifeline.

Exhibit 1: Mobile Subscriber Base (mln)



Source: CITC Publication

Exhibit 2: Mobile Broadband Services (mln)



Source: CITC Publication

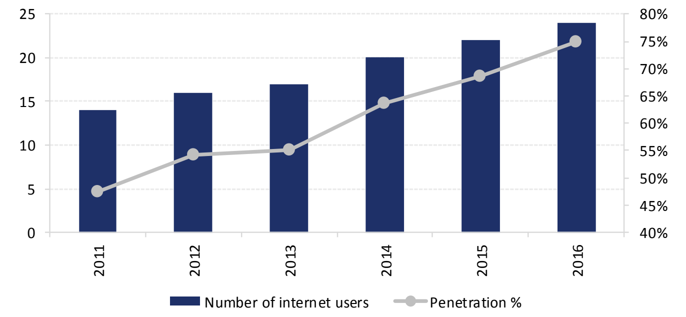
Market is maturing

Telecom sector is considered mature and defensive. The sector has witnessed significant structural changes that have led to a rise in operational and financial risk. It is also a time of major economic change in the country as Vision 2030 is implemented. Economic slowdown has weakened purchasing power, which is expected to remain this year. The internet user mix has supported telecom sector to be resilient relative to other sectors.

Strong data growth and contribution to revenue mix in the future would intensify pressure on margins as operators seek to move beyond a defensive image. They face a significant challenge when emphasizing growth opportunities. Rapid growth in data traffic is being accompanied by lower margins that has led CITC to suspend unlimited offers for pre-paid subscribers. Investors are looking for more details and insight into the industry’s margin mix particularly from mobile segment future growth. The pressure on margins looks set to increase in the foreseeable future as data services require more capex that would eat into margins compared to legacy services such as voice and SMS. Currently margins are considered high as market conditions are defending margins by limiting data use. However that may not be sustainable.

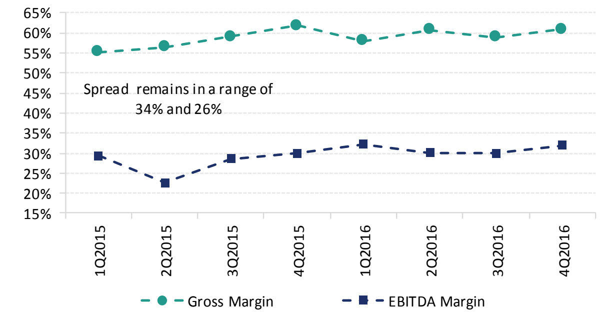
Evidently, the two market leaders are exploring options to carve out passive infrastructure to enhance margins. Furthermore, STC has shifted part of its focus towards STC venture, as they increased their investment in rid-hailing Company, Careem.

Exhibit 3: Rapid Increase in Penetration Rate of Internet Users (mln)



Source: CITC Publication

Exhibit 4: Sector Gross Margin vs EBITDA Margin



Source: Riyad Capital

The Saudi Vision 2030 has created an opportunity for sector players as the government has recognized that sector contribution in non-oil GDP is vital, making the B2B segment attractive. We believe that STC is a major player with strong financial position and outstanding record would be the greatest beneficiary of such initiative. However, Mobily and Zain have been granted a unified license that gives them the opportunity to expand in the market.

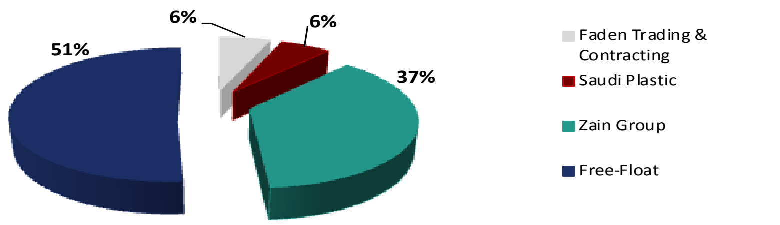
Future Outlook

The recent telecom evolution has increased the risk of losing subscribers. An embedded SIM "Soft SIM" (the next step in evolution) is one which is physically integrated into the device. Soft SIMs will ease switching from one operator to another, and intensify competition. On the other hand, advances in the telecom sector have led to the explosion of Big Data Analytics creating solution for telecom operator's fear including customer switching risk and operational efficiency. Telecom operators receive enormous amount of data regarding client behavior, this would make operators shift from reactive to proactive position regarding providing service to its clients. Operators will be able to anticipate client needs and reduce churn rate. On the operational level, operators will be able to improve efficiency and reduce expenses. From an investment perspective operator will be able to optimize CAPEX investment decisions leading to higher return on investment.

Zain's Story

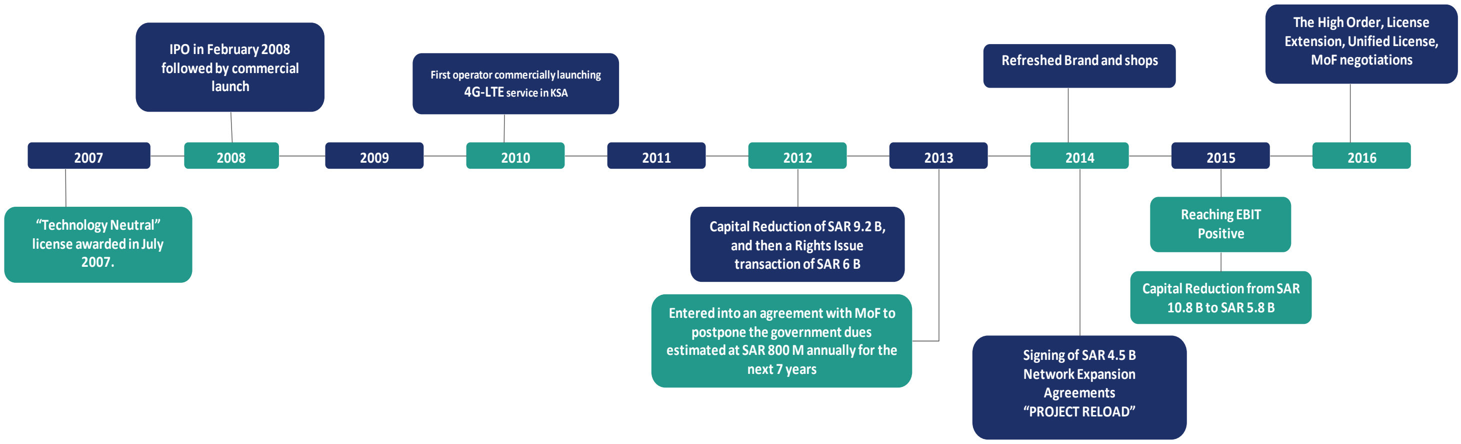
Zain KSA is the third operator in the country and provides mobile and internet services. In 2007, Zain KSA was established by Zain Kuwait which formed a consortium that was awarded the third mobile operator at a license cost of SAR 23 billion nearly twice the amount of second operator, Mobily's license.

Exhibit 5: Major Shareholders



Source: Tadawul

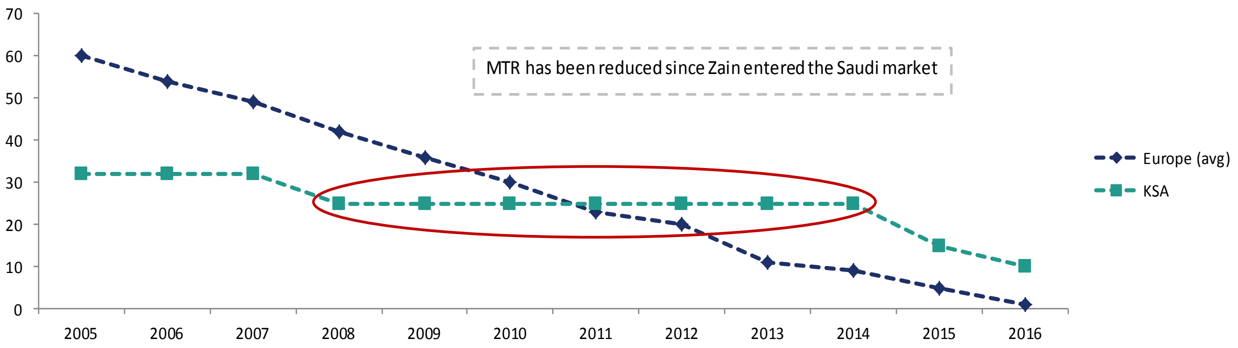
In 2008, Zain started its operation and was listed in the Tadawul with a capital of SAR 14 billion (currently at SAR 5.8 billion). So far Zain KSA's major shareholders have maintained their shareholding. Zain Group remains the largest shareholder with a possibility to increase its holding if debt-equity SWAP comes through. In the last decade, Zain KSA witnessed changes in top management more than once.



Upside risks

Although CITC has reduced MTR by 60% since 2015, yet it is relatively high. Thus, we can expect a further reduction. Zain was the greatest beneficiary as it is a net payer while STC is a net receiver given its market share and Mobily more or less neutral. MTR changes have allowed Zain to adopt low price strategy leading to significant improvement in market share. We expect CITC to reduce MTR fees reaching to international standard, which would have a positive impact on Zain.

Exhibit 6: Saudi vs European MTR Average Halala/Minute



Source: Zain

Tower sales leaseback transaction can improve financial position as it's expected to generate SAR 1.9 billion. Such transaction would allow Zain to repay significant amount of debt, which would translate positively on the bottom line. On the operational side, tower sale model is helpful as lease contract will have long life, allowing management to better predict future operating expenses. Zain has nearly eight thousands towers in its portfolio.

Downside risk

The bubble size indicate the magnitude of risk impact

Avoiding disengagement from the change in customers' mindset is a burden on management. Telecom operators must understand and respond to fast-changing customer expectations and behavior. Operators have to be innovative starting with the overall business model and down to modeling packages and customer service in a way that does not compromise quality for prices or vice versa. Furthermore, Zain must develop a connectivity plan for new areas of growth to decide what's better, to develop capabilities or partner with infrastructure provider.

Since the announcement of the unified license, word has spread on a possible granting of a unified license to Etihad Atheeb, which raises a concern on the possibility of acquisition by a foreign telecom operator making competition more intense. On the other hand, the regulator might change royalty fees imposed on operators; however, we do not expect such a change in the foreseeable future.

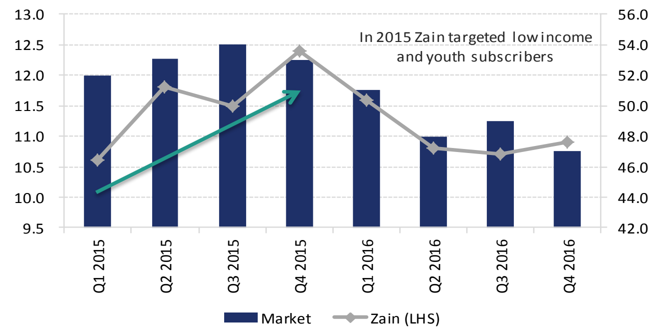
As competition among telecom operators gets more intense, spectrum allocation value increases. Spectrum allows operator to increase market share and maintain or improve quality. Anther industry specific risk that we believe is vital for Zain is vendor concentration risk. Lack of vendors could raise an operational and financial risk as vendor would have the power over pricing and payment terms, causing quality and free cash flow to be in jeopardy. Consumers set high expectations for quality while they are price-sensitive; making quality-price tradeoff is an important factor in a low switching cost industry.

Zain's leverage position and accumulated losses are a major financial risk. Although, recently free cash flow has turned positive, yet it is considered weak. Equity dilution is expected to be the first step in a capital restructure plan. Zain will most likely offset accumulated losses by capital followed by capital issuance to fulfil the need of cash and MOF debt-equity swap. Such dilution will significantly harm current shareholders, especially if proper approval allows for the inclusion of the SAR 5.5 billion shareholders' advances, either fully or partially, in the swap transaction.

Zain in the game

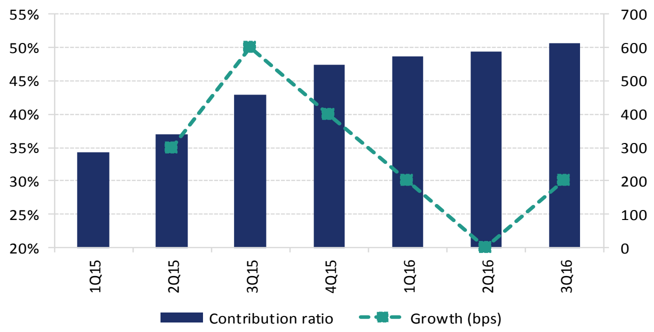
In the recent past Zain strategy has been revolving around increasing market share, growing data share in revenue and providing the best offer and experience in the digital segment. That strategy has paid-off, operational performance since 2015 has surpassed our expectations. Targeting low income and youth through lowering prices proved to be successful strategy, as market subscriber base has improved leading market share to increase from 18% to 23%. Changing MTR prices, a key policy to control competition, by CITC has also supported company strategy.

Exhibit 7: Zain Subscriber Base vs Market (mln)



Source: Tadawul, CITC Publications

Exhibit 8: Data Share in ARPU



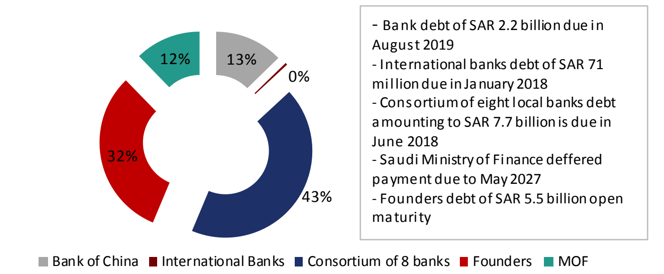
Source: Zain

In the foreseeable future, we find telecom operators, including Zain, focusing on increasing data contribution to revenue; Zain touched the 50% level in 3Q2016. The current financial benefit of increasing data contribution in revenue mix is improving gross margin, which is the back bone of company's profitability. Gross margin is expected to level off by the beginning of 2018 as more data consumption will pressure margin as well as increase CAPEX requirement. The Saudi economy is transforming to digital economy, capitalizing on unified license and NTP and by forming partnership with FTTH infrastructure owner would be a game changer for the sector and a starting point for sustainable growth in Zain's topline. According to CITC governor the estimated spending in telecom and IT-services would grow to SAR 138 billion in 2017 compare to SAR 130 billion in 2016, spending would include both government and private sector. Zain must be able to work with public and private sector towards dissemination of broadband services and corresponding platforms including cloud computing. Such initiative would make an attractive opportunity for B2B segment to contribute in topline.

Debt is the focal point in risk assessment

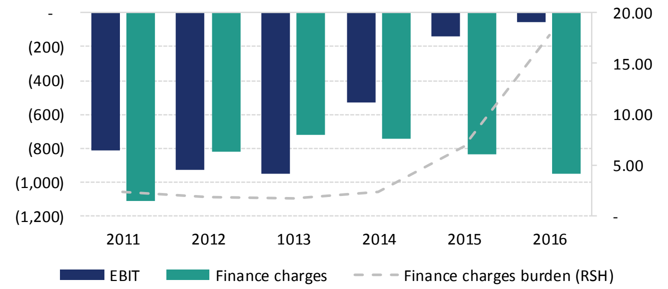
Zain growth has been stunted by the price of its telecom license which forced the company to tap debt market aggressively, leading to leveraged financial position. The price was expensive as mobile penetration rate grew from 117% in 2007 to 162% in 2009. CITC statistics for 2008 shows mobile market revenue stood at SAR 39 billion while broadband subscribers surged 48% in 2009 compared to 2008. Market statistics led third operator license to stand at SAR 23 billion, twice the price of Mobily's license. A sound capital structure for telecom operators is crucial as industry requires high CAPEX spending while competition narrows margins. Zain's profitability was and still remains harmed by finance charges. The burden (EBT/EBIT) increased from 2.38 times in 2014 to 17.86 times in 2016, due to improvement in operating profit (standing near to positive territory) and constant growth in financial charges. Total debt as of 1Q2017, excluding shareholders advances, stands at SAR 14 billion.

Exhibit 9: Zain's Debt Structure



Source: Zain Financials

Exhibit 10: Financial Charges Harm Profitability (SAR mln)



Source: Zain Financials

Two solutions in the pipe line

There are two solutions we anticipate to take place during 2017. First, tower sale is expected during the second half of the year, it is expected to generate cash in a range between SAR 1.8 billion to SAR 2.0 billion. Transaction proceeds could be used to partially repay syndicated Murabha facility amounting SAR 7.7 billion (as of 1Q17). We estimate the impact by tower sale to lower finance charges in the range of 30% to 50% as debt base will decline vastly.

Table 1: Ministry of Finance Debt to Equity Swap (SAR mln)

Estimated share price	9.0	9.5	10.0	10.5	11.0	11.5	12.0	12.5	13.0
MOF Loan	2,185	2,185	2,185	2,185	2,185	2,185	2,185	2,185	2,185
No. of shares before conversion	584	584	584	584	584	584	584	584	584
No. of shares converted	243	230	218	208	199	190	182	175	168
No. of shares post-issuance	826	814	802	792	782	774	766	758	752
Percentage of dilution	**71%**	**72%**	**73%**	**74%**	**75%**	**75%**	**76%**	**77%**	**78%**

Source: Riyad Capital estimates

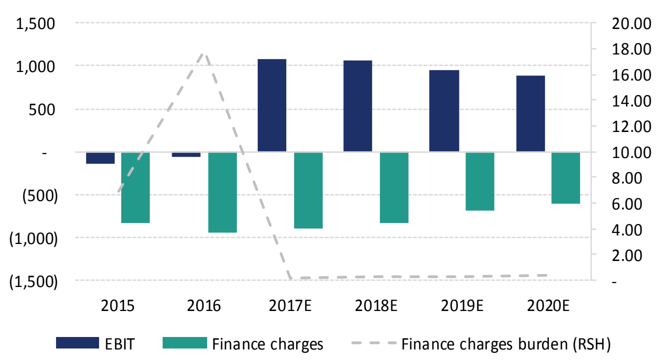
Secondly, we expect debt equity swap transaction in which Ministry of Finance will swap a cumulative amount of debt, which stands at SAR 2.2 billion (as of 1Q2017) to equity. We believe Zain needs to be convincing that this swap may generate returns exceeding the associated risks. We expect the transaction to follow a capital reduction allowing MOF to avoid dilution effect. We can come up with three major positives impact if successful swap comes through:

1. Finance charges will decline, as government charges Zain SAIBOR+agreed margin, although margin is considered relatively low compared to commercial financing.
2. Net debt to forward EBITDA for 2017 falling from 4.0x to 3.0x compared to last year's 6.0x to 4.7x (assuming net debt as of 1Q2017).
3. Management ability to renegotiate cost of debt and covenants with other lenders. More flexible covenants would enhance business management.

Zain's effort bearing fruit

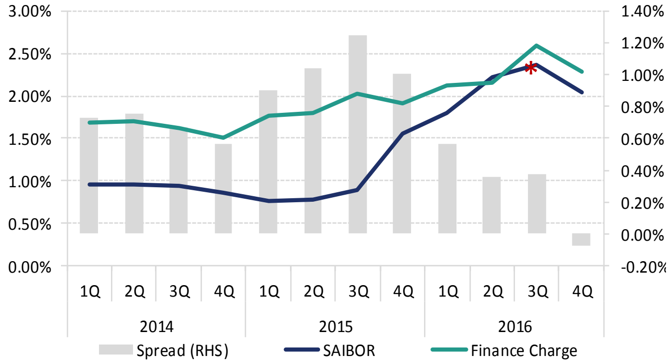
In the past years and since 2014 finance charges coverage ratio has been improving as it increased by 65bps reaching 1.88x in 2016. Improvement is expected to continue regardless of the outcome of either tower sales or debt equity swap. We estimate coverage ratio to continue improving on the back of elevated EBITDA levels and marginal decrease in cost of debt accompanied by debt base as cash flow from operation increases. During 3Q2016, management reacted to SAIBOR increases by replacing debt of SAR 2.25 billion from SAIBOR to LIBOR leading to savings of SAR 175 million over three years.

Exhibit 11: Declining Finance Charges Reduce Burden (SAR mln)



Source: Zain Financials, RC Estimates

Exhibit 12: Management React to Increasing SAIBOR



Source: Zain Financials, RC Estimates

We project finance charges as a percentage of EBITDA to decline from 53% in 2016 to 33% in 2017 reaching 22% in 2020 (not accounting for tower sales and debt-equity swap). As illustrated in exhibit 11, finance charges burden touched a high in 2016 as the company has minimized operating losses. However 2016 was an inflection point, as we expect burden below 1x going forward.

Cost of debt could be renegotiated

Zain successfully grew its topline and controlled its direct costs in the past three year, leading gross profit to increase at a 3-year CAGR of 17%, the improvement pushed gross margins to reach a record high of 64% in 2016 from 52% in 2014. Gross profit reflects business nature and company strategy, limiting the extent to which the company can manage direct costs. Therefore, an improvement is essential for Zain to turn its bottom line to the black.

Table 2: Improving Credit Ratios

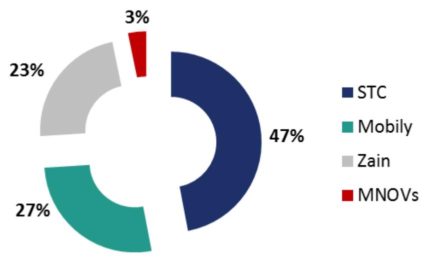
Key debt ratio	2014	2015	2016	2017E	2018E	2019E	2020E
EBITA margin	7%	13%	12%	22%	20%	18%	17%
Coverage ratio using EBITA	0.60	1.03	0.90	1.85	1.98	2.22	2.41
FFO to finance charges	1.09	2.48	3.04	3.25	3.69	4.31	5.17
CFO to debt *	0.02	0.13	0.21	0.25	0.32	0.39	0.58
Debt to EBITDA *	10.80	7.27	6.23	3.49	2.73	2.13	1.49
Debt to capital *	68%	72%	76%	71%	65%	58%	47%

Source: Company Reports, RC Estimates

**Debt amount includes government accruals and excludes shareholder's advances*

As illustrated in the table above, the dual effect of increasing gross profit and controlling opex led to an improvement in major credit ratios. EBITA, rather than EBITDA, is used in the analysis to capture the industry nature requirement of high capex spending. Both EBITA margin and coverage ratio entered a new level in 2015 that is expected to further improve. In 2017 we expect company to record operating profit and increase its EBITA margin and coverage ratio to 22% and 1.85x respectively. Intensive market competition is expected to impact EBITA margin going forward as it would lead to an increase in operating expenses.

Both cash flow ratios have been improving since 2013 when net cash flow from operations turned positive. In 2015, CFO touched a record high of SAR 1.5 billion massively reducing debt repayment risks. Following 2016, Zain made unprecedented principle repayment amounting to SAR 824 million. Funds from operations coverage ratio and CFO to debt are expected to improve going forward to 2020. Debt to EBITDA and debt to capital are expected to improve as well. Debt to capital ratio improvement is crucial for the company's valuation and it will be discussed later under the valuation part.



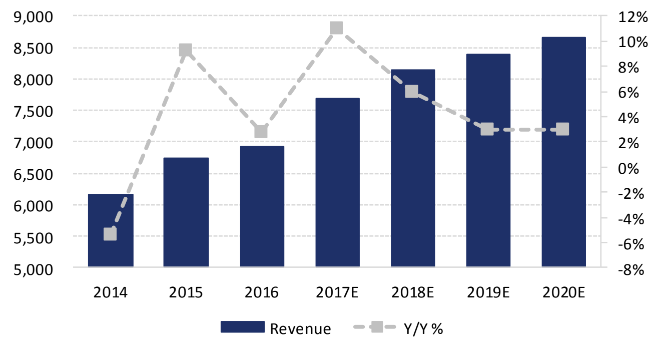
STC remains the dominant player with pricing power
**Market share estimates by RC*

Financial Analysis

Revenue at new levels

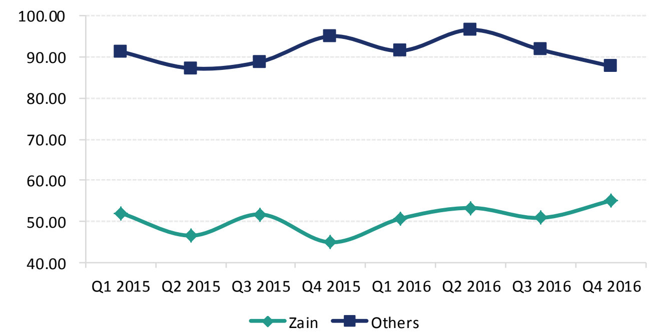
In the past three years Zain strategy focused on expanding market share by lowering prices and enhancing network to improve quality. It was successful as market share reached 23%. Going forward, Zain's strategy is focusing on customer experience and enhancing value added service, prices increased to peer levels (no more 30% discount to market). Zain's focus on high margin revenue stream (post-paid subscribers) is improving ARPU. Post-paid subscribers in 2013 represented 1% of total subscribers, by 2016-end post-paid representation stood at 17%. Going forward, competition on post-paid among all three operators will be more intense.

Exhibit 13: Revenue Growth at CAGR of 6% (SAR mln)



Source: Zain Financials, RC Estimates

Exhibit 14: Zain ARPU vs Others (SAR)



Source: Zain Financials, RC Estimates
STC and Mobily's number of subscribers are estimated by RC

In 1Q17, Zain recorded a new revenue level at SAR 1.9 billion up +9% Y/Y and +7% Q/Q at a tough time for the sector. ARPU stood at SAR 63 compare to SAR 55 last quarter and SAR 51 in 1Q16. Major drivers of this rise in topline consist of:

- Increasing high quality (post-paid) share in revenue;
- Improving quality of service as Zain invested catch-up capex nearly SAR 4.5 billion in the past four years;
- Expansion in retail footprint with more than 300 shops in the kingdom.

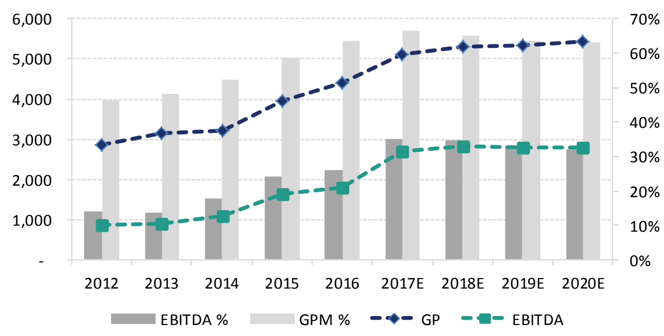
We expect current strategy and drivers to continue driving revenue growth at a CAGR of 6% for the period 2016 – 2020, leading revenue to SAR 8.6 billion. MTR is expected to decline further, allowing Zain services to be more competitive. A continuous change in revenue mix is a major risk factor that we must keep an eye on. STC is a dominant player with the highest market share in post-paid segment. CITC rules against having a dominant player could force STC to give up some of its market share through further decrease in MTR prices by CITC. Currently, STC's focus on new innovative B2B services supports our theory.

Although Zain has a unified license, we do not expect new service such as FTTH or land line to see the light in 2017 and 2018 due to its financial position. Better utilization of unified license could start in 2019 once capital restructuring is over and mobile market share reaches management's target. This is a risk associated with Zain being the last entrant for new services; however, market penetration of FTTH is less than 10% for 2016-end. For the coming few years, management is able to capitalize on current network to provide high speed internet at competitive price that would minimize FTTH impact on topline and market share.

Improved margins

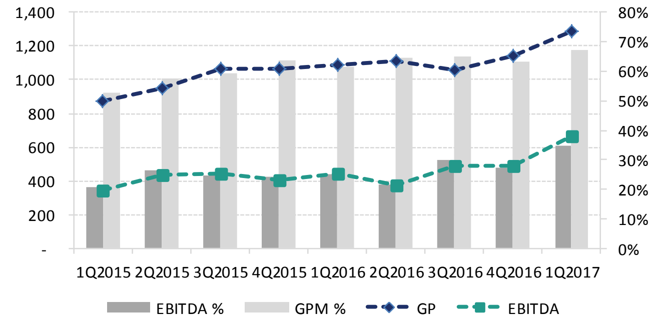
In the past five years Zain managed to grow revenue by a CAGR of 3% and decrease cost of service by a CAGR of 7% leading gross margin to stand at 64% in 2016 compare to 46% in 2012. Efficient management for variable cost has led the robust growth in gross margins. Access charges, roaming, commission and others have witnessed a decline by a CAGR of 11% in the period 2012-2016, its representation of revenue stood at 17% in 2016 versus 32% in 2012.

Exhibit 15: Margins Expected to Remain Flat (SAR mln)



Source: Zain Financials, RC Estimates

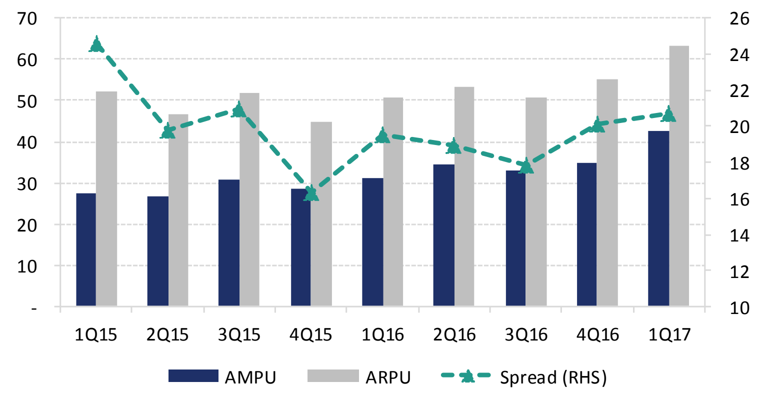
Exhibit 16: Gross and EBITDA Margins at Record High (SAR mln)



Source: Zain Financials, RC Estimates

Since 1Q2015, CITC has reduced MTR by 60%, strong tool to control market competition. This reduction allowed management to improve profitability and its market share by being cost efficient and allowing the start of its low price strategy, which has made Zain products more competitive. As a result gross margins have shown a robust improvement since 1Q15 until 1Q17 increasing from 53% to 67%, we expect a correction taking margin back toward 63% by 2020.

Exhibit 17: High ARPU, Controlled Spreads Boost AMPU (SAR)



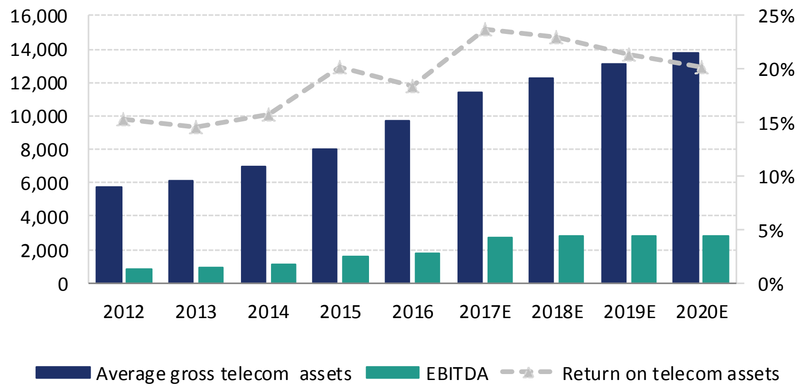
Source: Zain Financials

In the past nine quarters subscriber base remained in a range between minimum of 10.1 million (in 1Q2017) and maximum of 12.4 million. We justify robust increase in 1Q17 ARPU by the significant decline in subscriber base on the back of biometric verification process. ARPU has grown by an average of +3% on a quarterly basis for the past nine quarters leading average margin per user (AMPU) to stand at SAR 42.6 in 1Q17, 1.55x of 1Q15. During 2017 we have noticed increases in Zain product price and management focus shifted from a low price strategy to customer experience by providing high quality service.

Profitability ratios

Since 2014, Zain has started to catch-up on capex spending as the company funding ability has improved. Increasing gross capex has limited the substantial improvement in EBITDA when assessing return on telecom assets as a measure of profitability, during the period 2014-2016. In the past five years gross telecom assets grew by a CAGR of 14% seeking better coverage, higher quality of service and compensating increasing data traffic in the country. We expect such a growth to level off in 2016-2017, as capex intensity ratio touched its peak at 42% in 2016 compared to 22% in 2015 and 11% in 2014. Intensity ratio is estimated to stand at 13% for 2017 and remain in a range of 10% to 13% for the coming three years. As a result return on telecom assets is expected to stand at its peak in 2017 increasing from 16% to 24% followed by a period of decline to stand at 20% in 2020. EBITDA is estimated to grow by a CAGR of 12% for the period 2016-2020 compared to a CAGR of 20% in the past five years.

Exhibit 18: EBITDA Boosted Return on Telecom Assets (SAR mln)



Source: Zain Financials, RC Estimates

Bottom line turned to black

In 1Q17, Zain recorded it first net profit since inception, SAR 45.5 million mainly driven by increasing contribution of high margin revenue stream including post-paid line and data revenue. Cost optimization program, whose main objective is to minimize expenses that are not related to revenue generation, started to reflect on financial performance. We expect net losses to be in the past, net income of SAR 209 million is expected for the current year at a net margin of 3%. Going forward we expect Zain to renegotiate its financing with major lenders seeking a lower cost of debt, which will have significant impact on net income. It's worth noting that finance charges are expected to erode 83% of EBIT in 2017.

Table 3: Income Statement Key Financial Figures (SAR mln)

Income Statement	2014	2015	2016	2017E	2018E	2019E	2020E
Revenue	6,170	6,741	6,927	7,689	8,150	8,394	8,646
Gross profit	3,223	3,951	4,401	5,105	5,297	5,330	5,447
EBIT	(534)	(141)	(55)	1,087	1,058	952	882
Finance charges	745	838	953	897	826	690	608
Net Income	**(1,270)**	**(972)**	**(980)**	**209**	**269**	**300**	**313**

Source: Company Reports, RC estimates

Cash flows entering a new norm

Looking at Zain's cash flow statement, we noticed a turning point in 2015 as net cash flow from operation entered a new phase. Net cash flow from operation in 2015 stood at SAR 1.6 billion compare to SAR 287 million in 2014 and negative balance in 2012 amounting to SAR (1.1) billion. Both adjusted operating income and better working capital management have offset the massive burden on finance charges paid every year.

Table 4: Cash Flow Key Financial Figures (SAR mln)

Cash Flow Statement	2012	2013	2014	2015	2016
Adjusted operating income	975	975	1,077	1,716	1,830
Changes in working capital	(1,595)	(220)	(267)	364	1,071
Cash flow from operation	(621)	755	810	2,080	2,901
Finance charges paid	(529)	(526)	(523)	(512)	(536)
Net cash flow from operation	**(1,150)**	**229**	**287**	**1,568**	**2,365**

Source: Company Reports

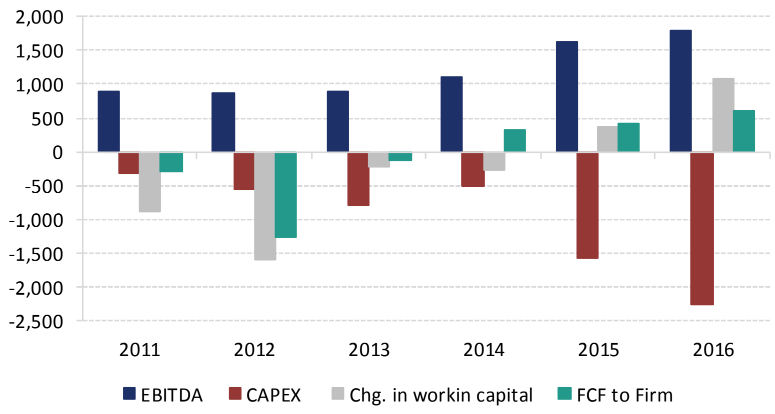
Zain's continuous improvement in core business operation has accelerated. A combined effect of margin inclining and turning working capital spending to positive have boosted cash flow generation. In 2015, gross margin stood at 59% compare to 52% leading adjusted operating income to save SAR 638 million in cash, growth of +59% Y/Y.

Heavy capex spending has not harmed working capital as management relied on its largest shareholder relationship with vendors to negotiate payment structure. Delaying payables have contributed to positive changes in working capital than true cash inflows by increasing deferred revenue or decreasing receivable and inventory balances. Delayed accruals have increased its contribution in 2016 to 56% of total cash inflows compare to 18% in 2015. It's worth noting that accruals represented 57% of positive net change in working capital in 2015 and 84% in 2016. However, we expect repayment to take a new pace as capex spending decline.

Working capital is vital to Zain's value

Historically, Zain has recorded negative free cash flow up until 2014, which has now changed. This change was largely due to improving EBITDA and effective working capital management. In conclusion, working capital management is creating a temporary value for equity holders with a probable positive impact through limiting dilution when debt-equity swap transaction takes place.

Exhibit 19: Improving Free Cash Flow (SAR mln)



Source: Zain Financials

Valuation and Recommendation

Zain operational performance has exceeded our expectation by recording a net profit in 1Q17 instead of an expected net loss. We have assessed the drivers that led to the profit and we estimate losses to be in the past now. We use a risk free rate of 3%, ten-year Saudi sovereign bond yield, and a beta of 1.25. Cost of debt is at 7%, reflecting the higher cost of funding for Zain while long term growth is assumed at 1%. We have included a company specific risk of 5% to the cost of equity for an expected capital restructuring that may lead to dilution. Using a debt to equity of 81:19, we arrive at a fair value of SAR 13.69 for Zain.

Table 5: Discounted Cash Flow Valuation

Assumptions	
Risk-free rate	3%
Risk premium	12%
Beta	1.25
Cost of equity	19%
Cost of debt	7%
Debt weight	81%
Equity weight	19%
WACC	9%
Long term growth rate	1%

Assumption, SAR mln		2018E	2019E	2020E
EBIT		1,058	952	882
Depreciation & Amortization		1,759	1,828	1,899
Change in workinig capital		185	150	317
Capital expenditure		(1,182)	(1,049)	(1,124)
Free cash flow to firm		1,821	1,880	1,974
Present value of FCFF		**1,667**	**1,576**	**1,514**
PV of terminal value	18,549			
Enterprise value	23,305			
Net debt	14,388			
Equity value	7,989			
Fair Value per share (SAR)				13.69

Source: Riyad Capital

We assign a Buy rating at a target price of SAR 14 with an upside of 51.7%**.** In our forecast we have not accounted for possible major events with regard to tower sales and capital restructuring that could include a debt-equity swap and capital increase which will dilute EPS.

The following table illustrates the sensitivity of target price to changes in WACC and terminal growth rate.

Table 6: Sensitivity Analysis of WACC and Terminal Growth Rate

	Terminal Growth Rate									
WACC	0.2%	0.4%	0.6%	0.8%	1.0%	1.2%	1.4%	1.6%	1.8%	2.0%
8.6%	13.50	14.33	15.21	16.12	17.09	18.11	19.19	20.33	21.53	22.81
8.8%	12.57	13.36	14.19	15.06	15.97	16.94	17.95	19.03	20.16	21.36
9.0%	11.68	12.43	13.22	14.04	14.91	15.82	16.79	17.80	18.87	20.00
9.2%	10.65	11.36	12.10	12.87	13.69	14.54	15.44	16.38	17.38	18.43
9.4%	10.02	10.70	11.41	12.16	12.94	13.76	14.62	15.53	16.48	17.49
9.6%	9.24	9.89	10.57	11.28	12.02	12.80	13.62	14.48	15.38	16.33
9.8%	8.49	9.11	9.76	10.44	11.15	11.89	12.67	13.48	14.34	15.23
10.0%	7.78	8.37	8.99	9.64	10.31	11.02	11.76	12.53	13.34	14.19

Source: Riyad Capital

It is important to note that we may revisit our Buy recommendation and target price based on the possible capital restructuring as and when it is revealed. We are optimistic that restructuring would improve financial position and bottom line as management seeks to lower debt burden.

Summary Financials

Table 7: Zain Summary Financials

Income Statement (SAR mln)	2015	2016	2017E	2018E	2019E	2020E
Revenue	6,741	6,927	7,689	8,150	8,394	8,646
Cost of sales	2,790	2,526	2,583	2,852	3,064	3,199
Gross profit	**3,951**	**4,401**	**5,105**	**5,297**	**5,330**	**5,447**
Distribution and marketing exp.	2,047	2,366	2,176	2,241	2,304	2,412
General and administrative exp.	275	240	234	239	246	253
EBITDA	**1,629**	**1,795**	**2,696**	**2,817**	**2,780**	**2,781**
Depreciation and amortization exp	1,770	1,850	1,609	1,759	1,828	1,899
Operating income	**(141)**	**(55)**	**1,087**	**1,058**	**952**	**882**
Finance charges	838	953	897	826	690	608
Net income / loss	**(972)**	**(980)**	**209**	**269**	**300**	**313**
EPS (LPS)	(1.67)	(1.68)	0.36	0.46	0.51	0.54

Balance Sheet (SAR mln)	2015	2016	2017E	2018E	2019E	2020E
Assets						
Cash and cash equivalents	1,378	919	559	467	501	642
Account receivable, net	1,093	1,109	1,089	1,025	909	833
Inventory, net	104	42	84	44	58	49
Prepayments and other assets	1,521	1,243	886	893	838	868
Total current assets	**4,096**	**3,312**	**2,617**	**2,428**	**2,306**	**2,393**
Property and equipment, net	5,007	7,006	6,971	6,768	6,359	5,906
Intangible assets, net	16,813	16,196	16,028	15,654	15,284	14,962
Other non-current assets	132	96	77	81	84	86
Total non-current assets	**21,952**	**23,298**	**23,077**	**22,504**	**21,727**	**20,954**
Total assets	**26,048**	**26,611**	**25,694**	**24,932**	**24,034**	**23,347**
Liabilities & Equity						
Long term loans - current	2,450	1,797	1,000	1,000	1,000	1,000
Note payable	330	450	461	489	504	519
Account payable	286	714	661	516	385	482
Due to related parties	3	3	4	4	5	5
Deferred revenue	732	529	538	570	588	605
Accrued expenses and other liab.	2,698	3,147	2,657	2,605	2,538	2,506
Total current liabilities	**6,498**	**6,640**	**5,321**	**5,184**	**5,019**	**5,116**
Long term loans	8,616	8,245	7,371	5,585	3,785	1,985
Advances from shareholders	3,967	4,569	5,255	5,885	6,474	6,991
Due to related parties	835	885	961	1,042	1,125	1,211
Other non-current liabilities	1,508	2,619	2,922	3,097	3,190	3,286
Derivatives financial instruments	7	4	-	-	-	-
Provision for EOSB	66	74	77	81	84	86
Total non-current liabilities	**14,998**	**16,396**	**16,585**	**15,691**	**14,658**	**13,560**
Total liabilities	**21,497**	**23,036**	**21,906**	**20,875**	**19,677**	**18,677**
Capital	5,837	5,837	5,837	5,837	5,837	5,837
Hedging Reserves	(7)	(4)	-	-	-	-
Accumulated deficit	(1,278)	(2,258)	(2,049)	(1,780)	(1,481)	(1,167)
Total Shareholders Equity	4,552	3,575	3,788	4,057	4,357	4,670
Total Liab & Equity	**26,048**	**26,611**	**25,694**	**24,932**	**24,034**	**23,347**

Source: Company Reports, Riyad Capital

Ratios	2016	2017E	2018E	2019E	2020E
Growth (YoY)					
Revenue	2.7%	11.0%	6.0%	3.0%	3.0%
Gross Profit	11.4%	16.0%	3.8%	0.6%	2.2%
EBITDA	10.2%	50.2%	4.5%	-1.3%	0.0%
EBIT	-	-	-2.7%	-10.0%	-7.3%
Finance charges	13.7%	-5.9%	-7.9%	-16.5%	-11.9%
Net Income	NM	NM	28.5%	11.5%	4.6%
Profitability					
Revenue / IC (x)	0.37x	0.43x	0.48x	0.52x	0.57x
ROIC	-5.2%	1.2%	1.6%	1.9%	2.1%
ROE	-24.1%	5.7%	6.9%	7.1%	6.9%
EBITDA margin	25.9%	35.1%	34.6%	33.1%	32.2%
NIM	-14.1%	2.7%	3.3%	3.6%	3.6%
Net debt/EBITDA	5.1x	2.9x	2.2x	1.5x	0.8x
Others					
EV/EBITDA	11.3x	7.7x	7.0x	6.7x	6.2x
EV/IC	1.1x	1.2x	1.2x	1.2x	1.1x
FCF yield	3%	7%	9%	10%	11%
EPS(SAR)	(1.68)	0.36	0.46	0.51	0.54
P/E	-	25.9x	20.1x	18.0x	17.3x
P/B	1.5x	1.4x	1.3x	1.2x	1.2x

Relative Stock Price Performance

Stock Rating

Buy	Neutral	Sell	Not Rated
Expected Total Return Greater than 15%	Expected Total Return between -15% and +15%	Expected Total Return less than -15%	Under Review/ Restricted

** The expected percentage returns are indicative, stock recommendations also incorporate relevant qualitative factors*

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