

Zain KSA (ZAINKSA AB)

Neutral

Price: SR18.94

27 Nov 2014

Price Target: SR10.50

PT End Date: 31 Dec 2015

No impact on market value from recommendation to reduce share capital - focus to remain on data, n/w

Zain KSA's BoD has proposed reducing its share capital by 46% to write-off ~SR5.0bn of accumulated losses up to 30 Sep-14. In our view, the proposal does not impact Zain KSA's market value though its share price is likely to technically rebase higher on lower shares – we calculate a rebased share price of SR16.5 based on a current share price of SR8.9. If the proposed capital reduction is approved, our current Dec-15 PT of SR10.5 technically rebases to SR19.4. We remain Neutral on Zain KSA.

- **BoD recommends reducing share capital by 46%.** The main reason for the proposed capital reduction is to write-off ~SR5.0bn of accumulated losses up to 30 Sep-14. As a result, the current share capital of SR10.8bn will reduce to SR5.8bn while total shareholders' equity (3Q14: SR5.8bn) will not be impacted.
- **No affect on market value - share price will technically rebase higher on lower shares.** While the proposed share capital reduction does not affect the market value of Zain KSA (ie, no impact on market cap of USD2.6bn), the outstanding shares will reduce to 584m from 1,080m as a result of the share capital reduction (the percentage shareholding will not change). Therefore, Zain KSA's share price is likely to technically rebase higher. We calculate the current share price of SR8.9 will technically increase to SR16.5. If the proposed capital reduction is approved, our current Dec-15 PT of SR10.5 technically rebases to SR19.4 on the lower number of shares.
- **Zain KSA reports unanticipated challenges weighed on ops performance - likely priced-in.** These challenges include: a) price competition, b) higher international termination charges, c) new regulatory restrictions imposed on prepaid customers (eg, free international roaming), d) labor market reforms, and e) reduction in Hajj quotas. Regulatory restrictions on prepaid and labor market reforms have impacted Zain KSA more than its competitors due to the higher proportion of revenues from these segments.
- **Data, network capability among key areas of focus.** Zain KSA's key areas of focus to improve its performance have included: a) focusing on higher margin service, eg data, b) increasing the capacity and coverage of network infrastructure, c) refresh its brand, d) introducing a refreshed store format, e) expanding sales reach by increasing number of PoS, f) restructuring the Murabaha Facility with a reduction in financing charges, and g) appointing a new management team. In our view, Zain KSA is likely to continue to focus on the data segment and increasing its network capabilities. We find it reassuring that Zain KSA is not aggressively focusing on gaining customer market share which could potentially have indicated further risk of price competition.
- **Await date of EGM to approve share capital reduction proposal.** The BoD has made the capital reduction proposal to its EGM. If the shareholders approve the capital reduction, the capital reduction will apply to all shareholders registered at the close of trading on the day of the EGM. The date of the EGM is currently tbc and the proposed capital reduction is subject to obtaining all necessary regulatory and shareholder approvals.

Table 1: Zain KSA - Analysis of proposed capital reduction on share price and Dec-15 PT

	Current capital structure	Post capital reduction
Dec-15 PT (SR/sh)	10.5	19.4
Share Price (SR/sh)	8.9	16.5
Number of Shares (m)	1,080	584
Market Value (SR m)	9,656	9,656
Par Value (SR/sh)	10.0	10.0
Share Capital (SR m)	10,801	5,837
3Q14 Retained Earnings (SR m)	-4,964	0

Source: J.P. Morgan estimates, Company data.

Investment Thesis

Zain KSA is a one-country operator in Saudi Arabia. Following Zain KSA's balance sheet restructuring, we believe Zain KSA is likely to re-focus on the growth opportunities in the Saudi telecom market. Our rating for Zain KSA is Neutral on limited valuation support.

Valuation

Our target price for Dec-15 of SR10.50 is derived from the average of our DCF-based valuations and multiples based valuations. We then use relative valuation multiples and historical trading ranges as reference. We use in our DCF valuations risk-adjusted weighted average cost of capital (WACC) of 11.1% and a terminal growth rate of 2%. The DCF valuations discount our forecast cash flows until year-end 2022, back to 2015. In our multiples-based valuation, we use a 2015E EV/EBITDA of 10.0x.

Risks to Rating and Price Target

The key risks that, in our view, could keep our target price and rating from being achieved include the following: Key regulatory risks include licensing, termination fees and access to infrastructure. If the company has international operations these could be exposed to political risks depending on the stability of the country of operation. As part of normal business practice, the company invests in innovative but often still unproven technologies and services. This can lead to low visibility of new revenue streams. Changes in the economic environment are likely to have an impact on our financial forecasts. Our company forecasts already factor in reasonable levels of competition. However, less rational or irrational competition could impact our growth and margin forecasts more than expected. Depending on the degree of foreign exchange risk, fluctuations of foreign currencies can have a meaningful impact on our earnings forecasts.

Following Zain KSA's balance sheet restructuring, we anticipate Zain KSA to focus on its network investment and growth opportunities. Zain KSA could also potentially benefit from faster-than-expected recovery in top-line growth along with EBITDA margin improvement. However, high than expected network investments could lead to downside risks to our FCF forecasts and margin expectations. An additional up-/down-side risk is the potential launch of MVNOs in Saudi Arabia.

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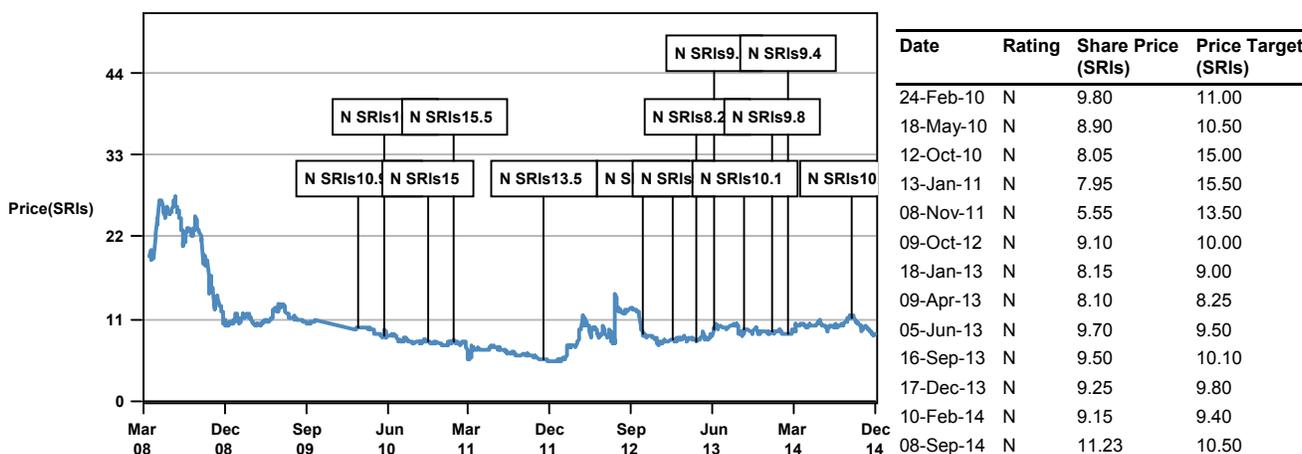
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Zain KSA (7030.SE, ZAINKSA AB) Price Chart



Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends. Initiated coverage Feb 24, 2010.

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