الراجحي المالية
Al Rajhi Capital

Research Department
Pritish K. Devassy, CFA
Tel +966 11 2119370, devassyp@alrajhi-capital.com

Key themes

Post analysis of Q1 financial statements, we revise our models. In 1Q, Mobily has seen improvement in underlying costs and is likely to improve earnings gradually. On STC, despite higher dividends, valuations are rich in our view.

What do we think?

Stock	Rating	Price Target
STC	Neutral	SAR93.0
Mobily	Neutral	SAR21.5

Saudi Arabian Telecoms

Revisiting valuations

The Saudi telecoms sector has seen quite a few regulatory (reversal of royalties) and accounting changes (IFRS 9, 15, 16) that have led to revisions of EBITDA and net profit numbers and thereby questions on sustainable level of earnings. There are also questions about high accounts receivables, payables and creation of newer liabilities due to IFRS changes which we attempt to address in our report. In short, none of these changes affect our valuation but among the multiple changes, we have seen lower costs for Mobily while costs for Zain have come higher than expected. Given the thin base, the earnings and thereby stock price is likely to remain volatile. Sector growth may be unlikely to revise upwards because of already high penetration and firm regulatory control over prices. There could be headwinds in the near term (higher promotional activities witnessed in mid Q2). Post Q1 results, we revise our estimates upward for Mobily and lower for STC. STC's higher dividends in 2018 and foreign inflows have resulted in the stock rallying sharply. In the near future, there could be ample supply of stock given Govt's high ownership in STC. We have a revised TP of SAR21.5/share for Mobily (prev. 17.5) and SAR93/share for STC (prev. 98).

1Q19 thoughts and outlook: Impact of reversal of royalty fee, IFRS 16 impact and high top-line y-o-y growth were the key notables in 1Q19 results.

- All the companies reported healthy top-line growth rates coming from a low base with STC up 8.4% y-o-y as compared to Mobily's 13.0% and Zain's 24.2%. Q1 of 2018 being the first quarter post VAT, saw active promotions as there was pre-purchasing in Q4 2017 which led to high growth in 1Q19 on an annual basis. On a q-o-q basis, the top-line growth was 2.5% for STC, 1.2% for Mobily, 2.3% for Zain.

- While the new calculation for royalty fees was expected to deliver a negative set of results for Mobily and a positive set for Zain, it was the other way round with better than expected results for Mobily and a lower gross margin for Zain KSA. This was because of higher underlying costs for Zain KSA and improvement in costs for Mobily. STC had a royalty reversal benefit in 2018 and previously disclosed in its last analyst call that the company does not expect any major benefit from this reversal. In our view this is ironical because the company had a net benefit of around SAR580mn in 2018. Anyhow the impact in 1Q19 came close to management guidance. We believe the calculations are more complex and the existing level of gross margins could be more or less maintained.

- IFRS 16 was another surprise with a no or marginal impact on bottom-line while one would have expected a negative impact because of depreciation + interest costs being generally higher than rental leases in such a conversion from operating lease to capital lease, initially. Zain and Mobily both reported no material change on I/S because of IFRS 16. However, despite the increase in depreciation for Mobily, net D&A came much lower than our expectation leading to the beat in earnings. While the net changes from IFRS 16 would boost EBITDA, and thereby Enterprise value on same EBITDA, it should increase lease liabilities and thereby adjust EV accordingly.

Please see penultimate page for additional important disclosures. Al Rajhi Capital (Al Rajhi) is a foreign broker-dealer unregistered in the USA. Al Rajhi research is prepared by research analysts who are not registered in the USA. Al Rajhi research is distributed in the USA pursuant to Rule 15a-6 of the Securities Exchange Act of 1934 solely by Rosenblatt Securities, an SEC registered and FINRA-member broker-dealer.

- The key driver for the sector continues to be data pricing and promotional offers. Pricing is tightly controlled by the regulator and hence a material increase is not easy in our view. Weaker than expected results of Zain have likely spurred the company to go for another round of pricing promotion in this quarter and was followed by Mobily and could weaken earnings for the sector. In our view, pricing offers and promotions are utilized more by prepaid subscribers and as number of post-paid subscribers grow, the fleeting effect of promotions could gradually decline.

- Though there is some growth expected from business segment, we are less positive on the enterprise segment given possibility of receivables issues, high capex and low margin. We also believe even FTTH does not have capability to materially swing topline (currently single digit of revenues as per our assumptions).

- On the positive side of things, rate of decline in expats could decline as already a large chunk of expats have already left. Lifting of ban on VoIP, being in existence for more than one and half year could also lower the cannibalization on an annual basis especially now as data contributes to a large part of earnings for companies.

- Unlike most telecom companies globally, working capital and other liabilities have been unusually high for those in Saudi. For example, apart from debt of SAR12.9bn, Mobily has A/R of SAR2.9bn and A/P of SAR4.9bn. Not only this there are liabilities such as provisions, employee termination benefits, others, accrued expenses, IFRS 16 etc. which total to around SAR3.2bn. Previously, for arriving at our valuations, we used to deduct these liabilities from our EV assuming these liabilities at market value currently. However now we adjust the working capital liabilities with working capital assets and apply a 50% factor given that these liabilities would be not be reversed immediately.

Mobily: Upgrade on better costs, free cash flows, revisiting liabilities

Better than expected results: While we expected losses for 1Q19 based on prior disclosure of annual impact of higher provisions of SAR450mn- SAR600mn (SAR 112mn per quarter at the lower end of the range) based on accounting for lower past royalty fees, the company surprised the street by reporting profits. Apart from this fee for the past, there was an expected increase in royalty fee for the current period, at around SAR40mn per quarter – so the net addition in costs was likely to have been at least SAR150mn. The financial statements appear to show that these costs have been fully absorbed by increase in top-line. However we believe this was because of lower rental expense due to IFRS 16. The company reported lower expense of SAR120mn in cost of goods sold (and another 30mn below gross profit line in SG&A).

Depreciation and SG&A puzzle: While the above should have ideally lowered net income because of IFRS 16 shuffle from rental cost to depreciation and interest expenses, we saw only an increase of 30mn in depreciation (vs. usual run-rate) which led to the beat in bottom-line. Not only this SG&A was mentioned to decline by SAR30mn but came SAR90mn below usual run rate. *So in a nutshell, depreciation as well as SG&A have dropped mainly leading to beat. If IFRS16 were not implemented the cost savings would have been even more evident.* If this is to continue, the base of earnings is likely to be higher. But as we have seen in the past, there is bound to be volatility in SG&A and we expect the costs to increase slightly. However we expect D&A to gradually revise lower in the coming years.

Figure 1 Mobily – impact of IFRS-16

(SARmn)	As reported	Adjustment IFRS 16	Amounts without adoption of IFRS 16
Revenue	**3,201**	-	**3,201**
Cost of sales	**(1,362)**	(120)	**(1,482)**
Gross profit	**1,839**	(120)	**1,719**
Selling and marketing	**(275)**	(14)	**(289)**
General and administrative	**(324)**	(16)	**(341)**
Impairment loss on accounts receivable	**23**	-	**23**
Depreciation and amortization	**(969)**	118	**(851)**
Impairment loss on property and equipment	**(27)**	-	**(27)**
Other income	**11**	-	**11**
Operating profit	**277**	(32)	**245**
Share in results of joint venture	**(0)**	-	**(0)**
Finance expenses	**(212)**	34	**(178)**
Finance income	**11**	-	**11**
Profit before zakat	**76**	2	**78**
Zakat	**(9)**	-	**(9)**
Profit for the period	**67**	2	**69**

Source: Company data, Al Rajhi Capital

If the depreciation costs were lower at the same rate as of STC /Zain that is 13-15% of sales as compared to 30% of sales, there would be a SAR1.9bn increase in profit for Mobily. This implies that depreciation could decline in the future leading to bottom-line increasing. We believe that the depreciation has been high because of legacy assets and once these are depreciated, we would see lower depreciation of newer assets. Currently capex/sales is lower at around 24% and is expected to stay high in the near term as per the company.

More than debt: We had major concerns earlier on the level of liabilities which was actually not considered as debt thereby leading to our not so favourable view on the stock. For example, apart from the debt of SAR12.9bn, there are liabilities worth SAR9bn that is Mobily is not paying financing expenses on. With an approx. FCF of SAR1.7bn, if the company had to pay for these liabilities before paying for debt it would take another 5 years for them to start reducing debt. Previously in our valuations, we deducted most of these liabilities at book value after all these are liabilities to be paid. However, we now change our valuation methodology for these liabilities because:

1) Most of these liabilities are staying at the same level for years without any interest component

2) Some of these liabilities can be offset by some assets. For example, in Q1 Mobily offset some part of its part of accounts receivables with accrued expenses.

3) Most liabilities are being rolled over by newer contracts. For example, we believe accrued expenses are mostly related to do with capex expenses. Hence once the payment is made for the current year, given that there is new capex coming up, the accrued expenses continue to remain broadly unchanged. Thus in this context, it would be better to not account for these liabilities as on current date of balance sheet but assume it runs into perpetuity and account only for change in these liabilities (which is unchanged in our valuation).

In our revised methodology, we take a midway path between fully recognizing liabilities and not recognizing liabilities. We categorize into two segments as seen below in the tables and apply a 50% weightage to one category (after offsetting these revised liabilities with their respective counterpart assets. e.g., accounts payables with receivables, prepaid assets with accrued expenses) while taking the full liabilities in the second set. This is because there is no interest associated for only the first category.

Figure 2 Net liabilities (at half book value) in our valuations

(SARmn)	1Q19
Liabilities other than debt	
A/cs payable	4,909
Accrued expenses and others	3,604
Total	**8,514**
Offsetting assets	
A/cs receivable	2,858
Prepaid expenses	1,009
Total	**3,867**
Net liabilities	**4,647**
Net liabilities taken at 50% of total	**2,324**

Source: Company data, Al Rajhi Capital

Figure 3 Other liabilities taken at full book value

(SARmn)	1Q19
Lease liabilities (IFRS-16)	1,801
Employee termination benfits	415
Others	595
Provision	416
Total	**3,226**

Source: Company data, Al Rajhi Capital

No change in sector growth potential: To be sure, we do not expect a material change in outlook but forecast a moderate improvement in costs (and a structural improvement in D&A). We are not as negative on the cost front especially on royalties, as we were previously. We forecast a 6% top-line growth estimate for 2019 (because of lower base and price increase by around mid-2018) and 3% growth for 2020 and slight improvement in margins.

We still do not expect dividends for the company for another 2-3 years. However, we note that in another two years' debt could be reduced by SAR1.7-2.5bn depending on how much is used to pay off the current and other liabilities, which would lower net debt/ EBITDA and Debt/Asset levels to reasonable levels of 30% before the board could decide on dividends in our view. Currently as per our calculations, liabilities would need to be lower by SAR5.2bn for D/A to reach 30% and FCF is around SAR1.7bn, which is the basis for our estimate of 2-3 years to start paying dividends.

Figure 4 Mobily's DCF valuation model

(SARmn)		2019E	2020E	2021E	2022E	2023E	2024E	2025E
Pre-tax operating profit		951	1,067	1,344	1,505	1,667	1,829	1,991
Non-cash charges/taxes		20	15	-19	-42	-66	-88	-105
Post-tax operating profit		**971**	**1,082**	**1,325**	**1,463**	**1,601**	**1,741**	**1,886**
Add: Depreciation & amortisation		3,853	3,791	3,730	3,670	3,612	3,556	3,501
Change in working capital		(88)	(24)	(12)	(12)	(12)	(12)	(12)
Less: Capex		(3,018)	(2,979)	(3,039)	(2,965)	(2,749)	(2,524)	(2,431)
Free Cash Flow to Firm		**1,718**	**1,869**	**2,004**	**2,157**	**2,452**	**2,761**	**2,944**
			9%	**7%**	**8%**	**14%**	**13%**	**7%**
Discount factor		*0.94*	*0.86*	*0.78*	*0.71*	*0.64*	*0.58*	*0.53*
PV of Free Cash Flows		1,622	1,606	1,565	1,530	1,581	1,607	1,548
Sum of present values of FCFs		**11,060**						
Terminal value as per DCF								
Long term growth rate	2.0%							
Free cash flow (t+1)	3,003							
Terminal value	34,380							
Present value of terminal value	**18,077**							
Value of the equity								
Appraised value of the enterprise	29,137							
Add:								
Value of associates and non-core assets	8							
Cash	1,837							
Less:								
Debt	(12,877)							
Minorities	-							
zakat and tax related	(73)							
Other pending payables	(2,324)							
Provisions	(3,226)							
Appraised value of the equity	**12,482**							
Number of shares (mn)	770							
Appraised share price (end of year)	**16.2**							
12 month forward	**18.2**							

Source: Company data, Al Rajhi Capital

More details on 1Q

- Revenue of SAR3,201mn (+13.0% y-o-y) came in line with our estimate. Growth was driven by 1) continued growth in subscriber base and improvement of subscriber mix 2) growth in data revenues 3) increase in wholesale revenues 4) and expansion in business unit revenues.
- There was a positive impact of SAR150mn (Cost of sales: SAR120mn, Selling general and marketing: SAR30mn) on EBITDA due to adoption of IFRS-16 (conversion of operating lease into financial lease). As such, EBITDA increased 23% to SAR1,272mn. Excluding this impact, adjusted EBITDA reached SAR1,122mn, an increase of 8.3% y-o-y.
- On a pre-IFRS16 basis, financial expenses decreased 5% y-o-y to SAR178mn, driven by debt reduction. However, post-IFRS16, financial expenses increased 12.9% y-o-y to SAR212mn, primarily due to creation of lease liabilities.
- Net income came in at SAR 67mn (ahead of our estimate of SAR138mn loss), compared to losses of SAR 93mn in Q1-18. On a q-o-q basis, net income declined 16.2%, as Q4 2018 recorded a reversal in provisions related to government fee. However, the net effect of the IFRS-16 impact was negligible as reduction in opex was offset by increase in D&A and finance expenses.
- Capex to revenue stood at 24%, with a total of capex of SAR782mn. Excluding spectrum, capex to revenue stands at 23% with a capex of SAR736mn. The company is expected to maintain high capex intensity (top of the range compared to the sector benchmark) to support modernisation project and increase capacity to absorb additional traffic.

- EBITDA-Capex (Free cash flow) increased to SAR490mn vs. SAR222mn a year ago. This is driven by improvement in top-line growth and continued efficiency in operational cost management, implementation of IFRS 16 and a spectrum capex of SAR310mn in 1Q18.
- At a pre-IFRS level, net debt to EBITDA improved to 2.45x in Q1 2019 from 3.29x in Q1 2018 and 2.49x in Q4 2018. Net debt stood at SAR11.3bn, a reduction of ~1.0bn during the last 12 months.
- Mobily also saw a sharp reduction in receivables and in accrued expense and liabilities in the quarter. This is primarily driven by the company reaching settlement with the STC. For many years, the company has been continuing business without paying each other so the net position is balanced.

Figure 5 Mobily Q1 results

(SAR mn)	Q1 2018	Q4 2018	Q1 2019	% chg y-o-y	% chg q-o-q	ARC est
Revenue	2,833	3,162	3,201	13.0%	1.2%	3,182
Gross profit	1,663	1,386	1,839	10.6%	32.7%	1,814
Gross profit margin	58.7%	43.8%	57.5%			57.0%
Operating profit	101	267	277	174.3%	3.7%	44
Operating profit margin	3.6%	8.4%	8.7%			1.4%
Net profit	(93)	80	67	NM	-16.2%	(138)
Net profit margin	-3.3%	2.5%	2.1%			-4.3%

Source: Company data, Al Rajhi Capital

Valuation: For our price target, we use an equal mix of DCF (SAR18.2/share) and EV/EBITDA (SAR24.8/share, based on 7x multiple, unchanged) methods and arrive at a revised target price of SAR21.5/share with a Neutral rating. In a nutshell, the company has a visibility of only moderate top-line y-o-y growth for the next 2 years and EBITDA margin is more likely at the higher end for a telecom company (vs. globally). While FCF is reasonably healthy, so are the liabilities.

Risks: Upside risks to our valuation are improved gross margins, improving receivables, with no bad debts, faster than expected top-line growth, lower pricing competition. Downside risks are impairment of receivables, higher than expected capex, further decline in prices, write down of goodwill, unfavourable decision on pending litigations, increase in SAIBOR. We expect lower regulatory challenges going forward.

Figure 6 Income statement

Income statement (SARmn)	12/17A	12/18A	12/19E	12/20E	12/21E
Revenue	11,351	11,865	12,577	12,954	13,213
Cost of services	-4,821	-5,283	-5,383	-5,635	-5,748
Gross profit	6,530	6,582	7,194	7,319	7,465
SG&A	-2,918	-2,145	-2,390	-2,461	-2,392
EBITDA	3,612	4,437	4,804	4,858	5,074
D&A	-3,626	-3,928	-3,853	-3,791	-3,730
Operating profit	-14	509	951	1,067	1,344
Finance cost	-678	-799	-837	-764	-696
Other expenses (net)	45	129	66	67	68
Profit before tax	-648	-161	181	370	717
Tax	-61	38	-35	-37	-72
Minority interest	-	-	-	-	-
Net profit	-709	-123	146	333	645

Source: Company data, Al Rajhi Capital

STC

Good 1Q19 numbers: In 1Q19, STC outperformed expectations with a 8% y-o-y growth in top-line (due to low base) which translated to a commensurate beat at the bottom-line. As guided in STC's last analyst conference call, the company did not have a material impact of either reversal of royalty provisions or increase in royalty fee. The key deviations from our estimate were SAR150mn increase in early retirement expenses and improvement in SG&A expenses which was likely to due to IFRS 16, which was mostly offset by increased depreciation and finance costs as per our understanding. Net-net the company seems to be broadly unchanged post the recent set of changes, which leads us to lower our estimates as we expected a higher reversal of royalty fee previously.

The stock has surged from SAR83/share to SAR105/share in 6 months mainly because of 1) increased dividend, implying dividend yield of around 6% 2) foreign inflows 3) expectations of higher reversal fee, which though has not materialized in our view (but in-line with management guidance). However, while we believe that the company has the ability to maintain high level of dividends (SAR5/share in 2019) given its cash position, the valuations are expensive currently.

Higher capacity to pay dividends but STC to focus on growth: In line with the dividend policy for next three years (minimum quarterly payment of SAR1 per share) starting from the Q4 2018, STC announced a DPS of SAR1 per share for Q1 2019. Further, the company also initiated first USD5bn denominated Sukuk issuance programme which we believe reflects the intention of Govt owned enterprises to raise dollar denominated sukuks that would help the FX reserves and establish the yield curve in Saudi. Recently, first tranche of Sukuk worth USD1.25bn was completed. For now, we believe proceeds from Sukuks will be used to pay outstanding dividends of SAR3/share for 2018 amounting to SAR6bn.

Though the company has capacity to increase dividends despite the agreement to invest SAR6.6bn for exclusive rights to broadcast football matches by General sports authority, we believe the company is keen on looking for investments to boost growth.

One off gains from Uber – Careem deal expected: Also in Q1, STC signed an agreement with Uber to sell its 8.83% stake in Careem (accounted as an associate under equity method) for a sales consideration of SAR1.03bn (US$274mn). The sales consideration consists of cash and Uber's convertible notes. The sale which is subjected to regulatory approval could generate a gain of SAR653mn (~USD174mn) which could be reflected within 12 months as STC has reclassified as assets held for sale as at 31 March 2019. The deal is expected to be completed and final impact recorded upon completion of the regulatory procedures (source: company filings).

Valuation: As for valuation metrics, we use a mix of DCF (FCF) and relative valuation (7.5x EV/EBITDA up from 6.5x historical average and better than 7x valuation assigned to Mobily because of lower taxes/zakat rate). Given stable capital structure and stability in financial performance along with modest growth rates, both valuation methods yield similar valuation estimates. For FCF, our cost of equity is 11.25% and WACC is 11%. Our target price is SAR93/sh., average of DCF (SAR92/sh.) and relative valuation methods (SAR94/sh.). We expect SAR5/share in 2019 as dividends.

Risks: Upside risks to our estimates are from higher than expected revenues from its newer investments, tower sale/sharing, lower than expected cost of early retirement, hike in quarterly dividends and improvement in valuation of subsidiaries. Downside risks are from unfavourable regulatory changes, aggressive competition leading to lower than expected ARPUs and acquisitions at expensive valuations.

Figure 7 STC Q1 results

(SAR mn)	Q1 2018	Q4 2018	Q1 2019	% chg y-o-y	% chg q-o-q	ARC est
Revenue	12,349	13,062	13,386	8.4%	2.5%	12,634
Gross profit	6,935	8,632	7,903	14.0%	-8.4%	7,454
Gross profit margin	56.2%	66.1%	59.0%			59.0%
Operating profit	2,632	3,476	3,275	24.4%	-5.8%	2,930
Operating profit margin	21.3%	26.6%	24.5%			23.2%
Net profit	2,588	3,106	2,750	6.3%	-11.5%	2,657
Net profit margin	21.0%	23.8%	20.5%			21.0%

Source: Company data, Al Rajhi Capital

Figure 8 Income statement

Income statement (SARmn)	12/17A	12/18A	12/19E	12/20E	12/21E
Revenue	50,689	52,068	53,526	54,596	55,688
Cost of services	-22,106	-21,503	-22,481	-22,985	-23,500
Gross profit	28,583	30,565	31,045	31,611	32,188
SG&A	-10,153	-10,708	-10,223	-10,537	-10,804
EBITDA	18,431	19,857	20,822	21,074	21,384
D&A	-7,445	-7,601	-8,089	-8,361	-8,534
Operating profit	10,986	12,256	12,732	12,713	12,850
Finance cost	-354	-399	-756	-981	-981
Other expenses (net)	357	-18	22	369	410
Profit before tax	10,989	11,840	11,998	12,102	12,280
Tax	-721	-749	-768	-775	-786
Minority interest	-253	-301	-296	-302	-308
Net profit	10,016	10,790	10,934	11,026	11,186

Source: Company data, Al Rajhi Capital

Zain KSA

We do not cover Zain KSA and have suspended last quarter due to our Shariah board classification as non-Shariah compliant. However we do still track company's performance. Zain KSA's net profit of SAR129mn missed our estimate of SAR194mn and consensus estimate of SAR169mn. The miss in bottom line was mainly driven by lower than expected gross margins (70.7% actual vs 76.3% estimate) even as top-line growth was strong. We believe that the top-line growth was likely due to the positive impact from higher data prices and the low base effect in Q1 2018 where the pricing was low as a result of aggressive promotions. There are few positives for the company as the expat exodus has bottomed-out and any increase in pricing should benefit the company in terms of higher top-line growth. Further, the tower sale agreement with IHS Holdings is likely to help achieve significant savings in the capex and the company will use the proceeds to reduce the debt. Moreover, this will enable the company to focus on creating 5G network and building 1,500 sites in next 6 years. However, that being said, the profitability remains weak for the company even after strong top-line performance, benefit from reversal of provisions and positive impact from IFRS-16 adoption.

- Revenue of SAR2,093mn (+24.2% y-o-y) came higher than our expectation of SAR2,026mn, mainly driven by broad based growth across all segments, especially B2B, Consumer and Data revenue. There was a support from aggressive promotions and low pricing contributing to the low base in Q1 2018. ARPU increased from SAR68 in Q1-18 to SAR72 in Q1-19 with customer base reaching 8.2mn (post-paid contribution of more than 50%). The company has a lowest market share in the B2B solutions and it is growing at a healthy rate.

- Gross margin of 70.7% in Q1 2019 remains at an elevated level, though came much lower than our expectation of 76.3%, despite the marginal difference between actual reversal and our estimate. We have factored in a provision reversal of SAR117mn, while the actual reversal was slightly lower at SAR107mn. Sequentially, gross margin is down from 89% in Q4 2018 as the previous quarter incorporated higher reversals.

- EBITDA increased to SAR955mn, up 67% y-o-y, with ~46% EBITDA margin as compared to ~34% last year. There was a benefit to the tune of SAR136mn on EBITDA due to the adoption of IFRS-16 (effective Jan 1, 2019), which mandates reclassification of lease from operating leases to financial leases. Excluding this effect, EBITDA margin would have been ~39% with a 43% y-o-y growth. Excluding the effect of IFRS-16 and reversal of provisions (SAR107mn), EBITDA would have grown by 25% y-o-y.

- Capex is at SAR840mn, which included SAR571mn from new spectrum as compared to SAR841mn, that included SAR705mn of spectrum.

- Financing costs increased to SAR266mn in Q1 2019 from SAR250mn in Q1 2018, which included an additional impact of SAR21mn from IFRS-16.

- Net income came in at SAR129mn (SAR77mn loss in Q1 2028), which missed our estimate of SAR194mn and consensus estimate of SAR169mn. The positives for the company was the strong top-line growth of ~24%. Further, this the third consecutive quarter that the Zain KSA has posted profits. Although, the impact of IFRS-16 has as little positive impact of SAR12mn on the bottom-line.

Figure 9 Zain Q1 2019 results

(SAR mn)	Q1 2018	Q4 2018	Q1 2019	% chg y-o-y	% chg q-o-q	ARC est
Revenue	1,685	2,046	2,093	24.2%	2.3%	2,026
Gross profit	1,117	1,824	1,480	32.5%	-18.9%	1,545
Gross profit margin	66.3%	89.1%	70.7%			76.3%
Operating profit	143	628	382	167.1%	-39.2%	434
Operating profit margin	8.5%	30.7%	18.3%			21.4%
Net profit	(77)	399	129	NM	-67.7%	194
Net profit margin	-4.6%	19.5%	6.2%			9.6%

Source: Company data, Al Rajhi Capital

IMPORTANT DISCLOSURES FOR U.S. PERSONS

This research report was prepared by Al Rajhi Capital (Al Rajhi), a company authorized to engage in securities activities in Saudi Arabia. Al Rajhi is not a registered broker-dealer in the United States and, therefore, is not subject to U.S. rules regarding the preparation of research reports and the independence of research analysts. This research report is provided for distribution to “major U.S. institutional investors” in reliance on the exemption from registration provided by Rule 15a-6 of the U.S. Securities Exchange Act of 1934, as amended (the “Exchange Act”).

Any U.S. recipient of this research report wishing to effect any transaction to buy or sell securities or related financial instruments based on the information provided in this research report should do so only through Rosenblatt Securities Inc, 40 Wall Street 59th Floor, New York NY 10005, a registered broker dealer in the United States. Under no circumstances should any recipient of this research report effect any transaction to buy or sell securities or related financial instruments through Al Rajhi. Rosenblatt Securities Inc. accepts responsibility for the contents of this research report, subject to the terms set out below, to the extent that it is delivered to a U.S. person other than a major U.S. institutional investor.

The analyst whose name appears in this research report is not registered or qualified as a research analyst with the Financial Industry Regulatory Authority (“FINRA”) and may not be an associated person of Rosenblatt Securities Inc. and, therefore, may not be subject to applicable restrictions under FINRA Rules on communications with a subject company, public appearances and trading securities held by a research analyst account.

Ownership and Material Conflicts of Interest

Rosenblatt Securities Inc. or its affiliates does not ‘beneficially own,’ as determined in accordance with Section 13(d) of the Exchange Act, 1% or more of any of the equity securities mentioned in the report. Rosenblatt Securities Inc, its affiliates and/or their respective officers, directors or employees may have interests, or long or short positions, and may at any time make purchases or sales as a principal or agent of the securities referred to herein. Rosenblatt Securities Inc. is not aware of any material conflict of interest as of the date of this publication.

Compensation and Investment Banking Activities

Rosenblatt Securities Inc. or any affiliate has not managed or co-managed a public offering of securities for the subject company in the past 12 months, nor received compensation for investment banking services from the subject company in the past 12 months, neither does it or any affiliate expect to receive, or intends to seek compensation for investment banking services from the subject company in the next 3 months.

Additional Disclosures

This research report is for distribution only under such circumstances as may be permitted by applicable law. This research report has no regard to the specific investment objectives, financial situation or particular needs of any specific recipient, even if sent only to a single recipient. This research report is not guaranteed to be a complete statement or summary of any securities, markets, reports or developments referred to in this research report. Neither Al Rajhi nor any of its directors, officers, employees or agents shall have any liability, however arising, for any error, inaccuracy or incompleteness of fact or opinion in this research report or lack of care in this research report’s preparation or publication, or any losses or damages which may arise from the use of this research report.

Al Rajhi may rely on information barriers, such as “Chinese Walls” to control the flow of information within the areas, units, divisions, groups, or affiliates of Al Rajhi.

Investing in any non-U.S. securities or related financial instruments (including ADRs) discussed in this research report may present certain risks. The securities of non-U.S. issuers may not be registered with, or be subject to the regulations of, the U.S. Securities and Exchange Commission. Information on such non-U.S. securities or related financial instruments may be limited. Foreign companies may not be subject to audit and reporting standards and regulatory requirements comparable to those in effect within the United States.

The value of any investment or income from any securities or related financial instruments discussed in this research report denominated in a currency other than U.S. dollars is subject to exchange rate fluctuations that may have a positive or adverse effect on the value of or income from such securities or related financial instruments.

Past performance is not necessarily a guide to future performance and no representation or warranty, express or implied, is made by Al Rajhi with respect to future performance. Income from investments may fluctuate. The price or value of the investments to which this research report relates, either directly or indirectly, may fall or rise against the interest of investors. Any recommendation or opinion contained in this research report may become outdated as a consequence of changes in the environment in which the issuer of the securities under analysis operates, in addition to changes in the estimates and forecasts, assumptions and valuation methodology used herein.

No part of the content of this research report may be copied, forwarded or duplicated in any form or by any means without the prior consent of Al Rajhi and Al Rajhi accepts no liability whatsoever for the actions of third parties in this respect. This research document has been prepared by Al Rajhi Capital Company (“Al Rajhi Capital”) of Riyadh, Saudi Arabia. It has been prepared for the general use of Al Rajhi Capital’s clients and may not be redistributed, retransmitted or disclosed, in whole or in part, or in any form or manner, without the express written consent of Al Rajhi Capital. Receipt and review of this research document constitute your agreement not to redistribute, retransmit, or disclose to others the contents, opinions, conclusion, or information contained in this document prior to public disclosure of such information by Al Rajhi Capital. The information contained was obtained from various public sources believed to be reliable but we do not guarantee its accuracy. Al Rajhi Capital makes no representations or warranties (express or implied) regarding the data and information provided and Al Rajhi Capital does not represent that the information content of this document is complete, or free from any error, not misleading, or fit for any particular purpose. This research document provides general information only. Neither the information nor any opinion expressed constitutes an offer or an invitation to make an offer, to buy or sell any securities or other investment products related to such securities or investments. It is not intended to provide personal investment advice and it does not take into account the specific investment objectives, financial situation and the particular needs of any specific person who may receive this document.

Investors should seek financial, legal or tax advice regarding the appropriateness of investing in any securities, other investment or investment strategies discussed or recommended in this document and should understand that statements regarding future prospects may not be realized. Investors should note that income from such securities or other investments, if any, may fluctuate and that the price or value of such securities and investments may rise or fall. Fluctuations in exchange rates could have adverse effects on the value of or price of, or income derived from, certain investments. Accordingly, investors may receive back less than originally invested. Al Rajhi Capital or its officers or one or more of its affiliates (including research analysts) may have a financial interest in securities of the issuer(s) or related investments, including long or short positions in securities, warrants, futures, options, derivatives, or other financial instruments. Al Rajhi Capital or its affiliates may from time to time perform investment banking or other services for, solicit investment banking or other business from, any company mentioned in this research document. Al Rajhi Capital, together with its affiliates and employees, shall not be liable for any direct, indirect or consequential loss or damages that may arise, directly or indirectly, from any use of the information contained in this research document.

This research document and any recommendations contained are subject to change without prior notice. Al Rajhi Capital assumes no responsibility to update the information in this research document. Neither the whole nor any part of this research document may be altered, duplicated, transmitted or distributed in any form or by any means. This research document is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction where such distribution, publication, availability or use would be contrary to law or which would subject Al Rajhi Capital or any of its affiliates to any registration or licensing requirement within such jurisdiction.

Disclaimer and additional disclosures for Equity Research

Disclaimer

This research document has been prepared by Al Rajhi Capital Company ("Al Rajhi Capital") of Riyadh, Saudi Arabia. It has been prepared for the general use of Al Rajhi Capital's clients and may not be redistributed, retransmitted or disclosed, in whole or in part, or in any form or manner, without the express written consent of Al Rajhi Capital. Receipt and review of this research document constitute your agreement not to redistribute, retransmit, or disclose to others the contents, opinions, conclusion, or information contained in this document prior to public disclosure of such information by Al Rajhi Capital. The information contained was obtained from various public sources believed to be reliable but we do not guarantee its accuracy. Al Rajhi Capital makes no representations or warranties (express or implied) regarding the data and information provided and Al Rajhi Capital does not represent that the information content of this document is complete, or free from any error, not misleading, or fit for any particular purpose. This research document provides general information only. Neither the information nor any opinion expressed constitutes an offer or an invitation to make an offer, to buy or sell any securities or other investment products related to such securities or investments. It is not intended to provide personal investment advice and it does not take into account the specific investment objectives, financial situation and the particular needs of any specific person who may receive this document.

Investors should seek financial, legal or tax advice regarding the appropriateness of investing in any securities, other investment or investment strategies discussed or recommended in this document and should understand that statements regarding future prospects may not be realized. Investors should note that income from such securities or other investments, if any, may fluctuate and that the price or value of such securities and investments may rise or fall. Fluctuations in exchange rates could have adverse effects on the value of or price of, or income derived from, certain investments. Accordingly, investors may receive back less than originally invested. Al Rajhi Capital or its officers or one or more of its affiliates (including research analysts) may have a financial interest in securities of the issuer(s) or related investments, including long or short positions in securities, warrants, futures, options, derivatives, or other financial instruments. Al Rajhi Capital or its affiliates may from time to time perform investment banking or other services for, solicit investment banking or other business from, any company mentioned in this research document. Al Rajhi Capital, together with its affiliates and employees, shall not be liable for any direct, indirect or consequential loss or damages that may arise, directly or indirectly, from any use of the information contained in this research document.

This research document and any recommendations contained are subject to change without prior notice. Al Rajhi Capital assumes no responsibility to update the information in this research document. Neither the whole nor any part of this research document may be altered, duplicated, transmitted or distributed in any form or by any means. This research document is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction where such distribution, publication, availability or use would be contrary to law or which would subject Al Rajhi Capital or any of its affiliates to any registration or licensing requirement within such jurisdiction.

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 10% above the current share price, and we expect the share price to reach the target on a 12 month time horizon.

"Neutral": We expect the share price to settle at a level between 10% below the current share price and 10% above the current share price on a 12 month time horizon.

"Underweight": Our target price is more than 10% below the current share price, and we expect the share price to reach the target on a 12 month time horizon.

"Target price": We estimate target 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.

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

Mazen AlSudairi
Head of Research
Tel : +966 1 211 9449
Email: alsudairim@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

Al Rajhi Capital is licensed by the Saudi Arabian Capital Market Authority, License No. 07068/37.