# Omantel Co.– Event Note

September 6th, 2018

Omantel held a conference in which it reiterated the importance of the reasons behind investing in Zain Kuwait and highlighted some key points as follow:

- Local market saturation and maturity expected because of entry of the 3rd mobile operator, the new Access and Interconnection regulation, increases in royalty and withholding taxes and the continued investment in new telecom technologies were some of the reason behind investing in Zain. Moreover, OTEL is fully engaged with Zain Group to leverage Omantel Investments in submarine cable systems/hosting solutions for the benefit of the both companies.

- Oman telecom industry experienced the following:
  - Voice market is slowing, potential remains in broadband.
  - Mobile sector is facing de-growth since 3Q'17 both in terms of revenues and subscribers. The company estimates revenues of both OTEL and ORDS to be around OMR 556mn in 2018 compared with OMR 569 for 2017 and number of subscribers to touch 6.6mn compared with 6.94mn for 2017.
  - Historical competitive advantages are eroding with new competition emerging along with increasing input costs.
  - 160% penetration of sim cards.
  - Telecom companies almost pay 50% tax (including royalty)

- *<u>Royalty fee on Fixed Line services is calculated at 7% basis while on Mobile services is at 12%.</u>* The company said that lower calculation on fixed service was based on its understanding and communication with the TRA. This resulted in cost saving of about OMR 3.4mn based on 1H'18 fixed revenues. The company expects further OMR 5mn saving for the 2H'18.

- *<u>Delays in getting Zain synergy benefits due to regulatory issues</u>*. We estimated this to happen taking into account the complexity of the procedures and process in different countries. The company earlier said that synergies will take full effect starting 2019 and expected 80% of the annual targeted synergies of USD 80mn to be in 2018 but likely to achieve 40 - 55% only. We have already assumed in our model that the positive impact will take place from 2019, as the current scenario is:
  - As per the company, the successful renegotiations with key vendors achieving discount of around 20% on unit price on main network equipment resulted in almost USD 15mn CAPEX saving for 2018. CAPEX to revenue ratio went down from the highest from 20% to 11% in 2Q'18. However, for the remaining part of the year, it is expected to be around 18 -20%
  - Expected wholesale synergies of around USD 30-35mn for 2018.
  - *Bahrain:* Integration to the interconnection wholesale business line is active. The market contribution is small.
  - *Saudi (the promising market):* Delay in materializing the benefit to 2Q19 due to legal and commercial issues.
  - *Jordan and Sudan:* The interconnection synergies to start by 4Q'18.

- Dividends from Zain stood at USD 110mn and was paid in April this year.

- Wholesale contributes about 18% of the total revenue, most of which is international. Wholesale business include renting towers to other operators and submarine business. The company targets to raise it to 22% over the years.

- *No updates on the entry of the 3rd mobile operator and on terms related to new access and interconnection charges.* Still the entry of the 3rd mobile operator is unknown by the local players. We believe that high penetration rate, stiff competition and overall reduction in spending behavior are factors that might delay the commencement of the 3rd operator to year 2020. However, in case of entry, pressures will be seen mostly on ARPUs, which we expect will reduce our TP by 10 – 15%. With regard to the new access and interconnection regulation which allows complete availability of an operator's infrastructure to competitors at cost-plus basis, we expect better commercial terms in favor of OTEL and ORDS to be resulted out of the current discussions with the TRA.

- *More concentration on high yield services and products compared with hubbing and handset sales which provide low margins.* The company said earlier in the conference call that its hubbing business is shifted to OZtel (SPV), thus no further royalty charges to be paid on this line of business.

- In 1H'18, the financial statements of the parent (legal entity) did not include the SPV business, it was consolidated at the group level. Thus, part of the cost of funding and revenue (in shape of dividends) is under the SPV accounts and not shown in the parent company accounts.

- *The mobile license renewal cost to be clarified in 2H'18*. As we said earlier, OTEL unlike ORDS did not pay significant amount on the earlier mobile license as the cost related to it was merely OMR 0.5mn. We expect the upcoming one to be in range of OMR 50 – 60mn considering what ORDS paid earlier and have already assumed the same in our model.

## Upcoming Triggers

Overall, we expect better 2H'18 results taking into account factors like 1) better performance of Zain on partial recovery of some key markets and expected sale of telecom towers and 2) lower cost of funding paid by OTEL as the costly bridge loan was closed in April 2018.

**What is happening with Zain?**

- *Better liquidity and cost saving.* In June this year, Zain KSA successfully refinanced and extended the maturity date of its existing syndicated SAR 5.9bn Murabaha facility for five years. Moreover, Zain Kuwait has completed a five-year, USD700mn revolving credit facility with a number of regional and international banks. The aim is to refinance USD800mn revolving syndicated loan completed in 2014.

- *Zain KSA will be part of Zain Group consolidated results starting 3Q'18***.** As Zain Kuwait acquired additional member seat in Zain Saudi Board of directors, it allows the company to consolidate Zain KSA results. This will smooth the accounting and strengthen the Group's financial indicators on various levels like revenue and EBITDA and other keys indicators except for net income as Zain Group's ownership in Zain KSA will not change. Zain Group EBIDTA will increase by USD 500mn to USD 600mn by end of 2018. This will result in lower net debt to EBITDA ratio despite ZAIN KSA loan.

- *Closing the Tower sale in 2H'18 to support 2018 results*. This could generate around USD 500mn to USD 600mn.

- *Expecting lesser inflation impact in South Sudan to help the financials.*

- Zain Group likely to continue paying dividends at level of 30 to 35 Fils/share indicating stability of income. Bearing in mind that Zain last year got USD 800mn from OTEL because of sale of treasury shares.

- Zain might soon expect VAT which will impact revenue.

**Better 2H'18 is seen for OTEL on:**

- *Relatively lower cost of funding.* OTEL closed its costly bridge loan in April 2018. The total interest cost related to Zain Group acquisition for the period ended 30 June 2018 is OMR 29.7mn which is expected to be lower in 2H'18 considering also the lack of one-off costs of about OMR 5.2mn.
- *Focusing on higher operating margin products.* In 1H'18, Hubbing and Handsets business played higher role in the revenue mix. Those line of business provide lower operating margin compared with other lines. We expect the company to concentrate more in other high yield products such as wholesale and fixed income lines. The company expects operating margin to be near to 36% for 2H'18.

## Outlook

So far, the story of OTEL is going in sync with our positive view on the stock. Despite the lack of immediate triggers, we believe the stock will recover in the medium to long term level considering the above-mentioned drivers and current attractive multiples.  In our view the stock is not dividend story any more as it is a growth one.

At current levels, OTEL **P/Bv is below one** and its P/E of 6.87x is below the regional telecom sector average of 9.82x. We keep our **BUY** recommendation of the stock with TP of **OMR 0.953/share**, an upside of 21.6%. Further details can be found in our latest Oman Telecom Report

***Note:*** *Used sources of this note include OTEL investor and conference call, Zain conference call and U Capital.*

P.O.BOX 1137, PC 111 – CPO, Sultanate of Oman I CR No. 1279406 I Tel: +968 2494 9000 I Fax: +968 2494 9099 I Email: info@u-capital.net I Web: www.u-capital.net

## Recommendation

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|---|---|
| BUY | Greater than 20% |
| ACCUMULATE | Between +10% and +20% |
| HOLD | Between +10% and -10% |
| REDUCE | Between -10% and -20% |
| SELL | Lower than -20% |

**Ubhar Capital SAOC (U Capital)**

Website:
PO Box 1137
PC 111, Sultanate of Oman
Tel: +968 2494 9000
Fax: +968 2494 9099
Email: research@u-capital.net