Zain KSA

Telecom – Industrial
ZAINKSA AB: Saudi Arabia
03 November 2020

الراجحي المالية
Al Rajhi Capital

US$1.750bn	48%	US$30.06mn
Market cap	Free float	Avg. daily volume

Target price	12.00	-3.2% over current
Current price	12.40	as at 3/11/2020

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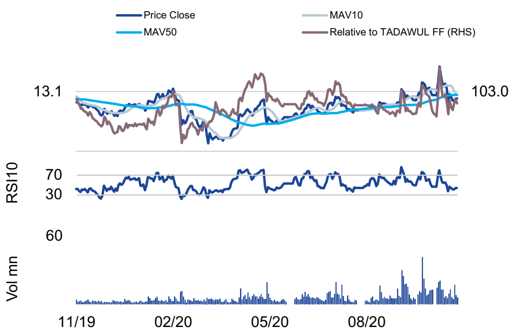
Existing rating

Underweight	**Neutral**	Overweight

Performance



Earnings

(SARmn)	2019	2020e	2021e
Revenue	8,386	7,995	8,474
Y-o-Y	11.4%	-4.7%	6.0%
Gross profit	5,969	5,574	5,593
Gross margin	71.2%	69.7%	66.0%
EBITDA	3,823	3,559	3,424
EBITDA margin	45.6%	44.5%	40.4%
DPS (SAR)	0	0	0
EV/EBITDA	6.4x	6.9x	7.2x

Source: Company data, Al Rajhi Capital

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Neutral: Revise TP to SAR12/sh.

Q3 top-line came broadly in-line with our expectation, although net profit beat our estimate, aided by one-off gain through the refinancing deal. After a successful rights issue, we now model debt to be lower by SAR4.5bn, which is likely to lower interest expense by ~SAR220mn annually. The company has a few positive triggers but we do not expect a material turnaround in the near term. Post results and lowering debt level after rights issue, we raise our TP slightly to SAR12.0 per share (SAR11.5 per share earlier, after adjusting for capital cut) based on 6.6x EV/EBITDA. We also revise our rating to Neutral (Underweight earlier) based on the current upside.

Figure 1 Zain KSA Q3 2020 results

(SAR mn)	Q3 2020	Q3 2019	Y-o-Y	Q2 2020	Q-o-Q	ARC est	vs ARC
Revenue	**1,928**	**2,008**	**-4.0%**	**1,889**	**2.1%**	**1,888**	**2.1%**
Gross profit	1,266	1,495	-15.3%	1,355	-6.6%	1,376	-8.0%
Gross margin	65.7%	74.5%		71.7%		72.9%	
Operating profit	138	376	-63.3%	297	-53.5%	271	-49.0%
Operating margin	7.2%	18.7%		15.7%		14.3%	
Net profit	**60**	**121**	**-50.4%**	**59**	**1.7%**	**37**	61.4%
Net margin	3.1%	6.0%		3.1%		2.0%	

Source: Company data, Al Rajhi Capital

Q3 results: Top-line came at ~SAR1,928mn, down 4% y-o-y (vs. 6% drop expected), primarily due to due to lower Umrah and Hajj visitors, MTR and business activity. Further, gross margin dropped to 65.7% from 71.7% last quarter, missing our estimate of 72.9%, likely due to lower than expected benefits from the reversal of past provisions for royalty fees during the quarter. In addition, the company witnessed a SAR55mn y-o-y jump in D&A on higher capex, partially offsetting a decline in operating expenses, leading to a further miss at the operating level. Post refinancing of the Murabaha agreement, the company recorded a one-time gain of SAR136mn on MFA modification under IFRS9 accounting treatment, helping the company to post SAR60mn net profit, above our expectation of SAR37mn in Q3.

Capital restructuring: Post 23% cut in the capital recently, the company's board approved a capital hike (from SAR4.48bn to SAR8.98bn) through the right use worth 450mn shares. As of 29 Oct 2020, the right issue was 86.76% subscribed with the remaining shares are being reoffered to institutional investors on 3-4 Nov 2020. The company plans to use the proceeds to partially repay dues (SAR1.67bn) owed to its Parent Company, Zain Group, and Murabaha facility (SAR2.77bn), implying lower interest expenses and thereby better increase the scope for dividend going forward. The company has recently refinanced its Murabaha facility at better commercial terms. Under the agreement, the Murabaha facility, which earlier valued at SAR5.9bn with a maturity date of 2023 is now extended up to SAR6bn till 2025. We believe that this refinance will not only benefit the company through lower interest rates but also provides additional liquidity, which could be used to fund its capex plan.

Near term drivers

- Given the relatively higher weight of iOS in KSA (25% of smartphones in KSA higher than the world average), we believe the key trigger for 5G in KSA is the introduction of Apple 5G iPhones. 5G launch is positive for the Saudi Telecom Sector and Zain KSA in particular as customers are likely to migrate towards higher package bundles given the difference in speeds recorded for 5G over 4G (14x; source: OpenSignal).
- The company may have an edge over Mobily in 5G based on network coverage data. However, we believe that STC is likely to be best positioned among the three operators.
- 4Q will be the last quarter for any reversals of provision due to a change in royalty fees from 2018. There may be a one-off profit in Q4 2020.
- Even after lowering liabilities using the proceeds from the rights issue, the company remains highly leveraged. Total net debt is likely to remain at an elevated level (SAR12bn) for 2020 while total liabilities including IFRS lease liabilities would be SAR13.6bn. This excludes the current portion of these payables to MoF along with the accrued interest that are recorded under trade and other payables (altogether around SAR19bn).
- Given the higher leverage position of the company, we don't see any possibility of dividends in the near to medium term.

Valuation and risks. Factoring in the rights issue, our adjusted TP stood at SAR11.5 per share. Post the Q3 results, we slightly raise our 1-year forward-looking target price to SAR12.0/sh. for the company, which is arrived using only EV/EBITDA (and not DCF), based on 6.6x multiple. This is because the DCF is very susceptible to changes in WACC given high debt. Based on our revised target price, we have a Neutral rating on the stock.

Upside risks to our valuation include faster adoption of 5G, successful rights issue with a substantial cash infusion, an increase in data prices, faster than expected top-line growth, lower capex spends, a waiver from Zakat liabilities, decline in SAIBOR. Downside risks are impairment of receivables, higher than expected capex, further decline in prices, and an increase in SAIBOR.

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"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.

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