TELECOM | MARCH 2019

ZAIN KSA

NCB Capital الأهلي كابيتال

OVERWEIGHT
CURRENT PRICE SAR9.8

UPSIDE +16.3%
TARGET PRICE SAR11.4

RATING CHANGE

Promising turnaround story

We upgrade Zain to overweight with a TP of SAR11.4. We believe Zain's turnaround story is materializing, driven by 1) reduction of royalty fees, 2) royalty fees reversal and 3) tower sale. This will be further supported by Zain's inclusion in EM indices. We expect Zain to report a net income of SAR592mn in 2019f growing by 78.1% yoy. We expect a CAGR growth in sales of 3.4% between 2018-2022f, with a CAGR 1.2% growth in net income during the same period. The stock is trading at 2019f PE and EV/EBITDA of 9.0x and 3.8x, lower than the peer group average of 15.4x and 6.1x respectively.

- **New services to support top-line growth:** We expect Zain's revenues to grow 4.2% yoy in 2019 to SAR7.8bn. This compares to a growth of 3.1% in 2018 and 5.5% in 2017. We believe the growth will be driven by 1) growth in enterprise segment supported by government projects, 2) change in the client mix toward post-paid customers which represent 40% of the total customer base, 3) growth in FTTH, and 4) introducing new services. According to management, Zain expects to benefit from Dawiyat (FTTH infrastructure partner) to reach 180,000 homes. The company is also introducing new products such as cloud services, e-pay services and specialized new packages for Hajj and Umrah visitors. These factors are expected to offset the decline in mobile users in Saudi. Based on CITC Q3 18 data, mobile subscribers declined 3.5% yoy to 42.5mn, with a penetration rate of 131%.

- **Tower sale is key to reducing debt levels:** Zain's BoD approved the sale and leaseback of its 8,100 towers to IHS for a total value of SAR2.43bn. The lease period is 15 years with an option to extend it for an additional 5 years. The offer also includes building 1,500 towers over the next 6 years. The average price/tower is US$80,000 which is lower than the last 4-year average of US$121,000. Proceeds from the transaction will be used to reduce debt levels, which currently stand at SAR10.2bn. We have not incorporated this transaction in our models as Zain awaits regulatory approvals and details about the leasing terms are not yet available. Although the debt level is expected to decline after the transaction is completed, the impact in the P&L is expected to be limited as the decline in financing charges will be offset by higher lease back expenses for the towers.

Summary Financials

SRmn	2018	2019f	2020f	2021f	2022f	CAGR (%)
Revenues	7,531	7,844	8,094	8,353	8,595	3.4%
Gross Income	5,425	5,827	6,012	5,710	5,877	2.0%
Gross margin (%)	*72.0%*	*74.3%*	*74.3%*	*68.4%*	*68.4%*	
Operating Income	1,219	1,507	1,460	1,000	993	(5.0)%
Operating margin (%)	*16.2%*	*19.2%*	*18.0%*	*12.0%*	*11.6%*	
Net income	332	592	649	301	349	1.2%
Net margin (%)	*4.4%*	*7.5%*	*8.0%*	*3.6%*	*4.1%*	
EPS (SAR)	0.57	1.01	1.11	0.52	0.60	1.2%

Source: Company, NCBC Research estimates

STOCK DETAILS

M52-week range H/L (SAR)	10/6
Market cap ($mn)	1,429
Shares outstanding (mn)	584
Listed on exchanges	TADAWUL

Price perform (%)	1m	3m	12m
Absolute	4.7	47.7	40.3
Rel. to market	5.4	39.1	24.1

Avg daily turnover (mn)	SAR	US$
3m	58.4	15.6
12m	32.1	8.6

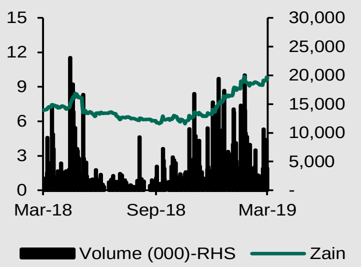
Reuters code	7030.SE
Bloomberg code	ZAINKSA AB
	www.sa.zain.com

VALUATION MULTIPLES

	18	19f	20f
PE (x)	16.1	9.0	8.3
PB (x)	1.3	1.2	1.0
EV/EBITDA (x)	4.7	3.8	3.5
Div Yield (%)	0.0	0.0	0.0

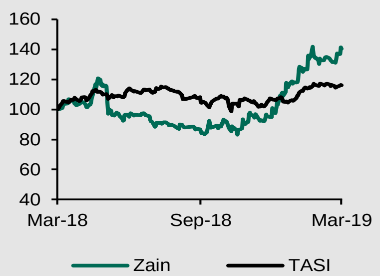
Source: NCBC Research estimates

SHARE PRICE PERFORMANCE



Source: Tadawul

RELATIVE PERFORMANCE



Source: Tadawul

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- **An overview of royalty fee revision:** Saudi telecom operators (STC, Mobily and Zain) signed agreements with the Ministry of Finance (MoF), the Ministry of Communication and Information Technology (MCIT) and CITC to settle the outstanding dispute related to royalty fees charged during 2009 to 2017 in addition to the amounts paid in 9M 18. The agreements aim to support the telecommunications sector and to stimulate investment in infrastructure, in-line with the National Transition Program (NTP) and Vision 2030. According to the agreements, royalties will be unified at a rate of 10% of net revenues, compared to 15% for voice, 8% for data and 10% for landline revenues. In return, companies will invest in their networks over the next 3 years. However, the details were not disclosed.
- **Royalty fee revision expected to be a game changer:** The impact of change in royalty fee will vary across companies, with Zain being the main beneficiary with an estimated cost reduction of SAR293mn/annually and a provision reversal of SAR1.7bn over 3 years. Actually, Zain reversed SAR300mn in 2018 with the outstanding amount of SAR1.4bn to be revised in 2019-2020, subject to meeting certain undisclosed requirements set in the agreement within 3 years. We believe this is a game changer for Zain, expanding its gross margins to 74.3% in 2019-2020 from 65.6% in 2017, based on a conservative reversal estimate of SAR1.3bn. The ability of the company to meet the requirements will further support margins in 2019-2020.
- **Inclusion to EM indices to drive the stock:** The Saudi market has been added to the MSCI and FTSE indices, with the first tranche for FTSE and MSCI expected in March 2019 and June 2019, respectively. Zain is expected to be added only to FTSE index with an expected weight of 0.4% and an inflow of SAR90mn. Although the estimated flow is limited, we expect the stock to be positively impacted supported mainly by 1) the attractive turnaround story and 2) the fact that the other two players in the sector (STC and Mobily) are included in both FTSE and MSCI indices with strong inflows.
- **5G to be launched in 2019f**: Zain, along with other Saudi telecom operators are expected to launch 5G services in 2019f. We believe the launch of the service and expanding the coverage is part of the agreement with government authorities. However, we believe a gradual ramp-up of the service. We expect Zain's capex/sales ratio to be 20%, lower than adjusted capex of 10% in 2018.
- **Net income to grow 78.1% yoy in 2019f to SAR592mn:** The change in royalty fees and the related reversals, along with top-line growth and lower debt levels are expected to support Zain's earnings. We expect Zain to report net income of SAR592mn in 2019f growing by 78.1% yoy. In 2020, net income is estimated to grow by 9.6%. However, net income is expected to decline to SAR301mn in 2021 as the reversal period is concluded. Zain's ability to further control its costs will be the main growth driver going forward.

Financials

Exhibit 1: Changes to estimates

In SR mn, unless otherwise stated

		Old 2019f	New 2019f	% Chg	% Gr	Old 2020f	New 2020f	% Chg	% Gr
Revenue		7,316	7,844	7.2%	4.2%	7,525	8,094	7.6%	3.2%
Gross Profit		4,968	5,827	17.3%	7.4%	5,129	6,012	17.2%	3.2%
EBITDA		2,612	3,336	27.7%	10.9%	2,759	3,428	24.2%	2.8%
EBIT		841	1,507	79.1%	23.6%	877	1,460	66.4%	(3.1)%
Net Profit		(73)	592	NM	78.1%	10	649	NM	9.6%
Price target	SAR					6.9	11.4	65.8%	

Source: NCBC Research estimates.

Exhibit 2: Income Statement

In SR million, unless otherwise stated

	2018	2019f	2020f	2021f	2022f	2023f
Revenues	**7,531**	**7,844**	**8,094**	**8,353**	**8,595**	**8,827**
% change	*3.1%*	*4.2%*	*3.2%*	*3.2%*	*2.9%*	*2.7%*
Cost of services	(2,106)	(2,017)	(2,081)	(2,643)	(2,718)	(2,787)
Gross profit	**5,425**	**5,827**	**6,012**	**5,710**	**5,877**	**6,041**
Gross margin (%)	*72.0%*	*74.3%*	*74.3%*	*68.4%*	*68.4%*	*68.4%*
Operating expenses	(2,415)	(2,491)	(2,584)	(2,596)	(2,653)	(2,726)
EBITDA	**3,009**	**3,336**	**3,428**	**3,114**	**3,224**	**3,315**
EBITDA margin (%)	*40.0%*	*42.5%*	*42.4%*	*37.3%*	*37.5%*	*37.6%*
Dep. & Amortization	(1,790)	(1,828)	(1,968)	(2,114)	(2,231)	(2,329)
EBIT	1,219	1,507	1,460	1,000	993	986
EBIT margin (%)	*16.2%*	*19.2%*	*18.0%*	*12.0%*	*11.6%*	*11.2%*
Financing costs	(931)	(960)	(865)	(752)	(690)	(592)
Other inc./expenses, net	44	44	54	53	45	34
Pre-tax profit	332	592	649	301	349	428
Tax (Zakat)	0	0	0	0	0	0
Net income	**332**	**592**	**649**	**301**	**349**	**428**
% change	*2,780.3%*	*78.1%*	*9.6%*	*(53.6)%*	*15.8%*	*22.8%*
Net margin (%)	*4.4%*	*7.5%*	*8.0%*	*3.6%*	*4.1%*	*4.9%*
EPS (SAR)	**0.57**	**1.01**	**1.11**	**0.52**	**0.60**	**0.73**

Source: NCBC Research estimates

Exhibit 3: Balance Sheet

In SR million, unless otherwise stated

	2018	2019f	2020f	2021f	2022f	2023f
Cash & cash equivalents	1,417	1,735	1,716	1,445	1,105	1,171
Other current assets	2,528	2,172	2,225	2,551	2,608	2,660
Total current assets	3,945	3,907	3,941	3,997	3,713	3,830
Net fixed assets	6,123	6,542	6,883	7,146	7,361	7,548
Other assets - license fees	14,505	13,988	13,471	12,954	12,437	11,920
Other assets – other licenses	119	176	247	336	448	588
Total non-current assets	22,379	22,226	22,011	21,735	21,432	21,131
Total assets	**26,323**	**26,134**	**25,953**	**25,731**	**25,145**	**24,961**
Current portion of long term borrowing	2,527	800	800	596	745	656
Other current liabilities	4,825	4,516	4,496	5,313	5,251	5,391
Total current liabilities	7,352	5,316	5,296	5,909	5,996	6,046
Long-term borrowings	7,668	8,406	7,606	6,479	5,465	4,809
Due to related party	5,457	5,943	6,584	7,111	7,111	7,111
Employee end of service benefits	93	82	72	64	56	49
Total non-current liabilities	14,959	16,213	15,403	14,268	13,246	12,583
Total liabilities	**22,311**	**21,530**	**20,700**	**20,177**	**19,242**	**18,630**
Share capital	5,837	5,837	5,837	5,837	5,837	5,837
Reserves & surplus	(1,803)	(1,212)	(563)	(262)	87	515
Shareholders' funds	4,012	4,604	5,253	5,554	5,903	6,331
Total equity & liabilities	**26,323**	**26,134**	**25,953**	**25,731**	**25,145**	**24,961**

Source: NCBC Research estimates

Exhibit 4: Cash Flow Statement

In SR million, unless otherwise stated

	2018	2019f	2020f	2021f	2022f	2023f
Cash flow from op. (a)	1,836	3,942	3,399	3,650	3,142	3,430
Cash flow from inv.(b)	(1,520)	(1,676)	(1,753)	(1,838)	(1,928)	(2,027)
NOPLAT	1,219	1,507	1,460	1,000	993	986
WC	300	(242)	(73)	491	(119)	88
CAPEX	(743)	(1,569)	(1,619)	(1,671)	(1,719)	(1,765)
Depreciation	1,790	1,828	1,968	2,114	2,231	2,329
Free cash flow	2,566	1,525	1,737	1,934	1,386	1,637
Cash flow from fin.(c)	(15)	(1,948)	(1,665)	(2,083)	(1,555)	(1,337)
Net chg. in cash (a+b+c)	302	318	(18)	(271)	(341)	66
Cash at start of the year	1,116	1,417	1,735	1,716	1,445	1,105
Cash at end of the year	1,417	1,735	1,716	1,445	1,105	1,171

Source: NCBC Research estimates

Exhibit 5: Key Ratios

Per share, unless otherwise stated

	2018	2019f	2020f	2021f	2022f	2023f
EPS	0.6	1.0	1.1	0.5	0.6	0.7
FCF per share	2.6	3.0	3.3	2.8	2.8	2.1
Div per share	0.0	0.0	0.0	0.0	0.0	0.0
Book value per share	6.9	7.9	9.0	9.5	10.1	10.8
Valuation ratios (x)						
P/E	16.1	9.0	8.3	17.8	15.4	12.5
P/FCF	3.5	3.1	2.8	3.3	3.3	4.4
P/BV	1.3	1.2	1.0	1.0	0.9	0.8
EV/sales	1.9	1.6	1.5	1.3	1.2	1.1
EV/EBITDA	4.7	3.8	3.5	3.5	3.2	2.9
Div yield (%)	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Profitability ratios (%)						
Gross margins	72.0%	74.3%	74.3%	68.4%	68.4%	68.4%
Operating margin	16.2%	19.2%	18.0%	12.0%	11.6%	11.2%
EBITDA margins	40.0%	42.5%	42.4%	37.3%	37.5%	37.6%
Net profit margins	4.4%	7.5%	8.0%	3.6%	4.1%	4.9%
ROE	8.8%	13.7%	13.2%	5.6%	6.1%	7.0%
ROA	1.3%	2.3%	2.5%	1.2%	1.4%	1.7%
Liquidity ratios						
Current ratio	0.5	0.7	0.7	0.7	0.6	0.6
Quick Ratio	0.5	0.7	0.7	0.6	0.6	0.6
Operating ratios (days)						
Inventory	39	39	39	39	39	39
Receivables outstanding	53	50	49	48	47	46
Trade and other payables outstanding	711	681	651	621	591	590
Operating cycle	92	89	88	87	86	85
Cash cycle	(619)	(593)	(564)	(535)	(506)	(506)
Leverage Ratios						
Debt/Equity	2.5	2.0	1.6	1.3	1.1	0.9
Net Debt/ EBITDA	2.9	2.2	2.0	1.8	1.6	1.3
Interest Coverage ratio	1.3	1.6	1.7	1.3	1.4	1.7

Source: NCBC Research estimates

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