August 5, 2019

ZAIN KSA
Company Update

Rating	Buy
12- Month Target Price	SAR 15.00

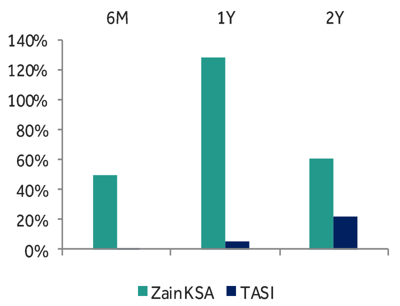
Price as on Aug-05, 2019	SAR 13.98
Upside to Target Price	7.3%
Expected Dividend Yield	0.0%
Expected Total Return	7.3%

Market Data

52 Week H/L	SAR 14.46/5.77
Market Capitalization	SAR 8,161 mln
Shares Outstanding	584 mln
Free Float	51.8%
12-Month ADTV	4,320,202
Bloomberg Code	ZAINKSA AB

1-Year Price Performance

Source: Bloomberg



Prosperity with better conditions

Investment thesis:

After many years of struggles, we expect Zain KSA to stay in the green from here on. Achieving net profit for the fourth quarter in a row, in addition to achieving the highest half-year revenue of SAR 4.2 billion on increased demand of services, which gives us confidence. Changes in the regulatory environment have been beneficial while the Company's debt and accumulated losses have been declining. The Company is working towards being a telecom operator not a developer of infrastructure. This is evidenced by their efforts to sell its telecom towers, which is still on the table and its proceeds would help reduce debt. The capital restructuring process is still pending approval with CMA and could provide further upside. It continues to invest in infrastructure and has announced its readiness to launch the fifth generation services during the 3Q of this year.

Risks:

Risks to our thesis include higher management fees to Zain group, elevated cost of the fifth generation service and failure of capital restructuring and tower sale.

Financials and Forecasts

	2018	2019E	2020E	2021E
Income Statement (SAR mln)				
Revenue	7,531	7,769	7,956	8,256
Gross Profit	5,425	6,178	6,345	5,820
EBITDA	3,009	3,287	3,377	3,128
EBIT	1,219	1,523	1,541	1,217
Net Income	332	589	622	284
EPS	0.57	1.01	1.07	0.49
Balance sheet (SAR mln)				
Assets:				
Total Current Assets	3,945	5,199	5,350	5,980
Total Non-Current Assets	22,379	22,114	21,394	20,642
Total Assets	26,323	27,313	26,744	26,622
Liabilities:				
Total Current Liabilities	7,352	7,751	4,648	5,429
Total Non-Current Liabilities	14,959	14,937	16,848	15,662
Total Liabilities	22,311	22,687	21,496	21,090
Equity:				
Total Equity	4,012	4,626	5,248	5,532
Total Equity and Liabilities	26,323	27,313	26,744	26,622
Key Ratios				
Gross Margin	72%	80%	80%	71%
EBIT Margin	16%	20%	19%	15%
EBITDA Margin	40%	42%	42%	38%
Net Margin	4%	8%	8%	3%
EV/EBITDA	7.9x	7.3x	6.8x	6.8x
P/FCF	1.5x	3.1x	1.5x	4.6x

Source: Riyad Capital, Company Reports

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Telecom Sector Advancing

The Saudi telecom sector occupies an important position in the Kingdom as it is a key element in the Kingdom's Vision 2030. According to the latest report by CITC, the telecom sector regulator in the Kingdom, the number of mobile subscriptions reached 41.6 million in 1Q2019 compared to 41.3 million at the end of 2018. We expect an increase to 41.7 million by end of 2019.

Table 1: Number of Subscribers In The Sector (mln)

Million	2015	2016	2017	2018	2019E
Post-paid Subscriptions	7.9	8.8	10.1	12.89	12.93
Pre-Paid Subscriptions	44.9	39.1	30.1	28.42	28.77
Total Subscriptions	**52.8**	**47.9**	**40.2**	**41.3**	**41.7**

Source: Riyad Capital, CITC Reports

We believe there are three major factors which influence growth in the telecom sector:

Number of Subscribers
A growing population in the Kingdom and the high proportion of youth are factors that raise attractiveness of the telecommunications sector. Demand depends mainly on the population, which grew by 2% in 2018 to reach 33.41 million and is expected to reach 33.74 million by the end of 2019. Recently, the sector has been affected by economic variables such as application of VAT last year as well as expats leaving the country.

Table 2: Population & Number of Subscribers (mln)

Million	2015	2016	2017	2018	2019E
Population	31.52	31.74	32.61	33.41	33.74
Number of subscribers	52.8	47.9	40.2	41.3	41.7
Mobile Penetration %	**168%**	**151%**	**123%**	**124%**	**124%**

Source: Riyad Capital, CITC Reports, GASTAT

Regulations and Policies
The CITC has removed many of the obstacles faced by telecom operators in the Kingdom by a number of measures including extending licenses as well as a unified license to provide all telecommunications services (including fixed telecommunications services for voice and data calls). In addition, spectrum availability has been enhanced through auctions to meet the growing demand for mobile Internet services. The Kingdom has succeeded in increasing spectrum allocations to raise the average mobile Internet speed from 9.2 Mbps by the end of September 2017 to 37.5 Mbps at the end of May 2019. It is believed that KSA ranks 2nd in G20 countries in terms of allocation of globally identified frequency bands for providing public mobile telecommunication services. Moreover, reducing the MTR rate and reducing commercial fees from 15% to 10% to help companies develop their infrastructure have been other important steps that will help in realizing Vision 2030.

Technological innovation
Saudi Arabia is taking proactive steps to speed up the adoption of 5G network and has been given a high priority. Tests have been successfully conducted in a number of places and it is expected that commercial launch in Saudi Arabia will happen later this year.

Zain KSA History

Zain KSA is the third operator in the country and provides mobile and internet services. In 2007, Zain KSA was established by Zain Kuwait which formed a consortium that was awarded the third mobile operator license at a cost of SAR 23 billion nearly twice the amount of second operator (Mobily's) license. In 2008, Zain started its operation and was listed at Tadawul with a capital of SAR 14 billion (which currently stands at SAR 5.8 billion).

Recent events

- A Unified License was granted that allows them to offer all telecommunication services, including fixed line services
- The Company became a subsidiary of Mobile Telecommunications Company K.S.C.P. Kuwait.
- The Company signed an agreement with the Ministry of Finance, the Ministry of Communications and Information Technology and the Communications and Information Technology Commission, which includes the consolidation of the annual royalty for commercial service and the settlement of disputed amounts for the period from 2009 to 2017. This benefits the Company to the tune of SAR 1.7 billion over 3 years.
- Acquisition of additional spectrum in the 3.5 GHz frequency bands
- Signed a new SAR 2.25 billion Islamic Murabaha facility agreement to refinance its existing commercial loan with better terms.

2Q Results

- Zain recorded topline of SAR 2.1 billion (+11 Y/Y, -2% Q/Q), due to seasonality effect of Ramadan.
- Gross margin improved by +300 bps Q/Q, on the back of SAR 129 million reversal in commercial fees.
- EBIT has reach SAR 374 million compared to SAR 382 million in 1Q19, mainly due to the additional spending in technology and marketing. As a result, EBITDA also declined by -6% Q/Q.
- Zain posted 2Q19 earnings at SAR 130 million (+1% Q/Q), close to market expectations of SAR 127 million as an additional income of SAR 8 million was accrued from a government project.

Future Strategy

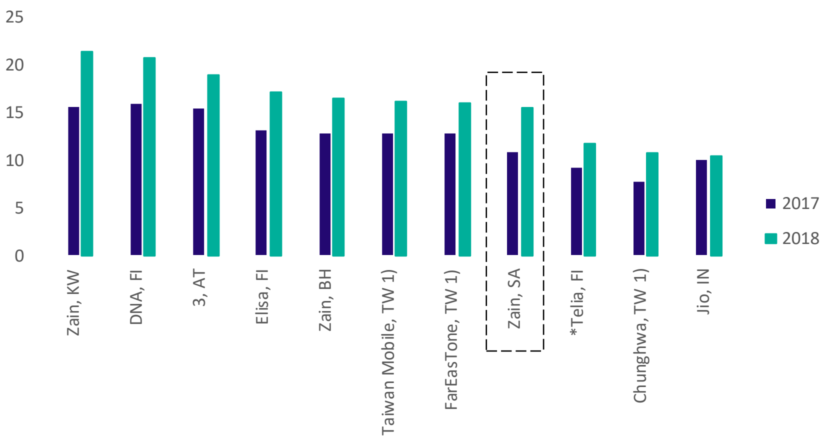
Zain is now in the growth phase, as it experienced rapid topline growth. The Company reached breakeven in 2017 with its first operating profit of SAR 786 million followed by its first net profit of SAR 332 million in 2018. Zain KSA is expected to continue making profits going forward. Regulatory changes have proved advantageous to the Company such as extension of its license that has long burdened the company as well as the granting of a Unified License where it can offer all telecommunication services including fixed services. MTR rate reduction in addition to rationalization of commercial fees from 15% to 10% have been the other positive developments for the Company. The Company announced reversals of SAR 1.7 billion over 3 years of which SAR 300 million was reversed in 2018 and the remaining amount of SAR 1.4 billion would be reversed in 2019 and 2020.

The sale of its telecom towers was planned but could not go through. However, it is still possible in the event another buyer is found in accordance with regulatory requirements or the previous buyer fulfill the requirements. The process of capital restructuring is still on the table, which can increase the company's attractiveness even further. The Company recently announced that its 5G technology has become available at Neom Bay Airport.

ARPU growth

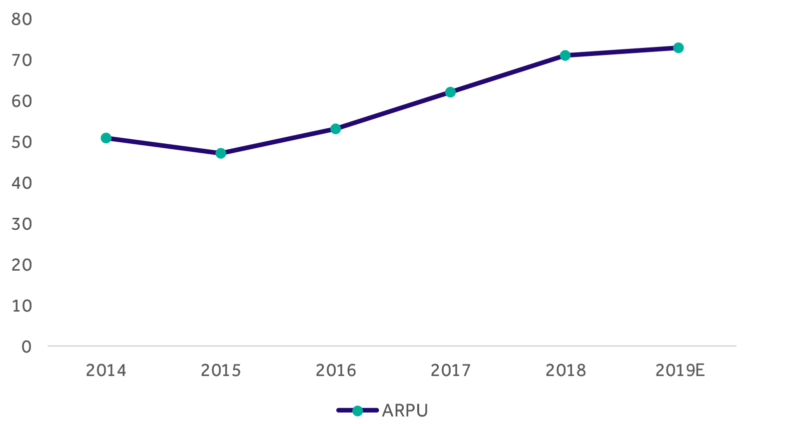
Zain's average data usage per SIM per month has increased by +44% to reach 15.5 GB in 2018 compared to 10.8 GB in 2017 becoming one of the top 11 operators in the globe that have the highest mobile data consumption per SIM. Total mobile data traffic also increased on annual basis. However, the total mobile service revenue per GB has declined Y/Y because of high competition but comparing the number of GB with ARPU, we can see that Zain has been able to grow its ARPU on yearly basis from SAR 62 to SAR 71.

Exhibit 1: GB per reported SIM per month



Source: Tefficient Report

Exhibit 2: ARPU Growth



Source: Riyad Capital, Company Reports

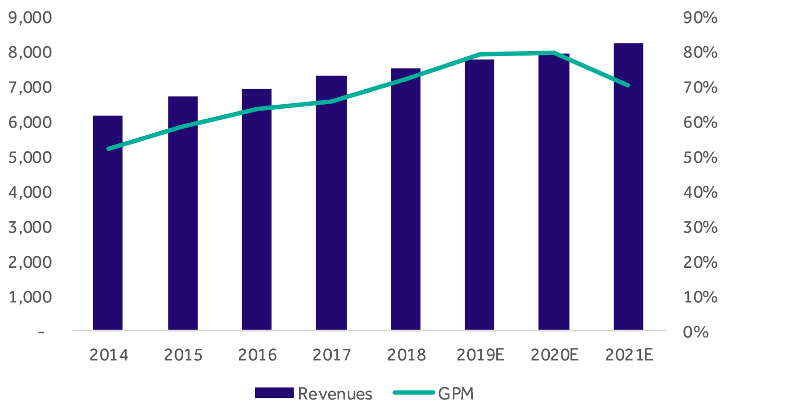
Stability of Subscriber base

The subscriber base is one of the most important assets of telecom companies. Zain managed to maintain its base which has reached 8.3 million by end of 2Q19. It has also been able to change its mix of prepaid and postpaid subscribers to more postpaid customers due to its efforts.

Topline going up and margins expanding

The company has consistently achieved annual growth in its revenues despite competition, market share and market conditions. Zain achieved revenues of SAR 7.5 billion last year and we expect it to reach SAR 7.7 billion in 2019. On the other hand, the Company registered a strong gross margin that reached 72% last year and is expected to increase further for the next two years on back of provisions reversals.

Exhibit 3: Revenues and Margins Grow Over the Years

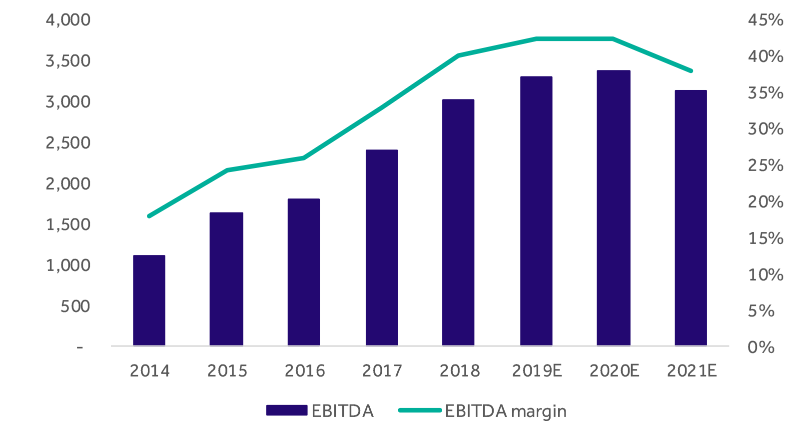


Source: Riyad Capital, Company Reports

EBITDA margin reaches 40%

We see improvement in EBITDA for Zain. It has reached SAR 3 billion in 2018 and this shows us the company's operational efficiency and financial soundness. EBITDA margin reached 40% and we expect it to reach 42% in 2019 due to the improvement of gross profit on the back of an increase in topline and the impact of the reversals on cost of sale, in addition to implementation of IFRS 16.

Exhibit 4: EBITDA & EBITDA Margin Over the Years

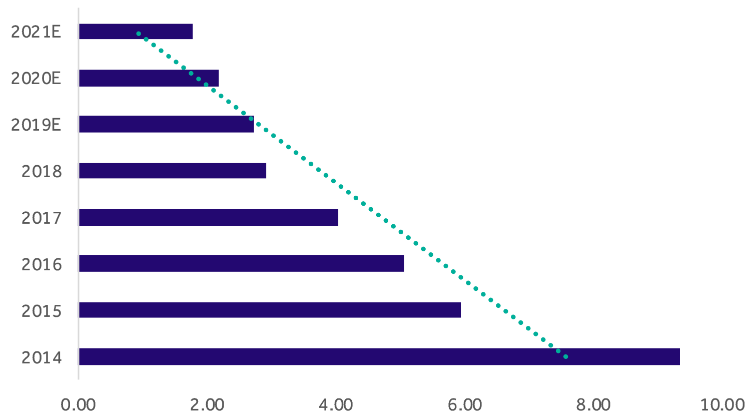


Source: Riyad Capital, Company Reports

Net debt to EBITDA to reach 2.6x by 2019-end

The telecoms sector is one of the sectors with high capital expenditure. Debt has always weighed heavily on Zain due to the high cost of its license. As the company tried to grow despite the high cost of financing and its small market share in the telecom sector, it increased pressure on margins. Zain KSA was able to reduce its Net Debt to EBITDA to reach 2.92x by 2018-end, which we expect to come down further to 2.64x by end of this year. Declining Net debt to EBITDA shows how the company has grown over time and also its ability to handle its debt burden.

Exhibit 5: Net debt to EBITDA shrinking

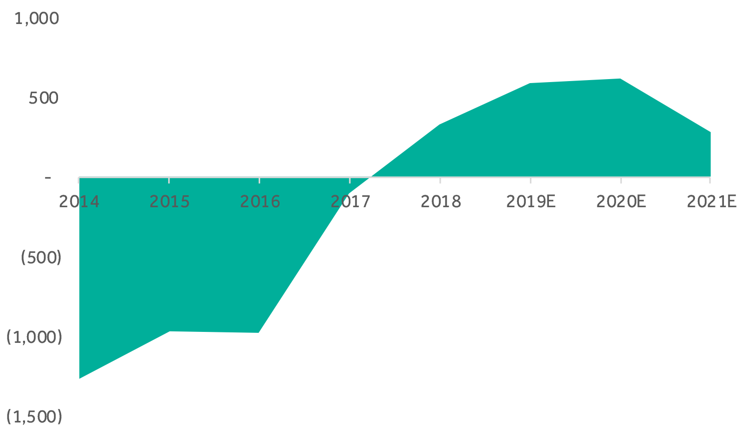


Source: Riyad Capital, Company Reports

Positive bottomline expected to continue

Zain was able to finally achieve a net profit at the end of the previous year of SAR 332 million. The Company was able to turn around from a loss making Company to a profit making one due to increasing demand for its products and services in addition to MTR rate reduction and rationalization of commercial fees from 15% to 10%.

Exhibit 6: Achieving a net profit



Source: Riyad Capital, Company Reports

Valuations

We have valued Zain KSA on the basis of Discounted Cash Flows (DCF) and EV/EBITDA multiple. We blended the two valuation methods and based 80% of our fair price on DCF and 20% on EV/EBITDA. We arrive at a fair value of SAR 15.10. Thus, we raise our target price from SAR 11.50 to SAR 15.00 and revert to a Buy recommendation.

Zain Valuation (SAR)

Valuation method	Fair Price	Weight	
DCF	14.35	80%	11.56
EV/EBITDA	17.72	20%	3.54
Fair Price (SAR)			**15.10**

Source: Riyad Capital

1-Discounted Cash Flows (SAR 14.35)

Using the Discounted Cash Flow Model, we assumed a risk-free rate of 4.06% and used 1.028 as a 2-year weekly beta obtained from Bloomberg. Cost of debt is at 9% reflecting the higher cost of funding for Zain, while long-term growth is assumed at 1%. We arrive at a Weighted Average Cost of Capital of 9%. Using the DCF method, we arrive at a fair value of SAR 14.35. Our assumptions are illustrated below:

Discounted Cash Flow (DCF) Valuation

Assumptions	
Risk free rate	4.06%
Beta	1.028
Equity risk premium	4%
Cost of equity	8%
Cost of debt	9%
Terminal growth rate	1%
Average Equity Weight	34%
Average Debt Weight	66%
WACC	**9%**

Assumptions	
Enterprise value	
DCF calculation as of	
NPV of explicit period	7,893
NPV of terminal value	16,437
Enterprise value	24,330
Net Debt	15,954
Equity value	8,376
Target price	**SAR 14.35**

Assumptions	2019	2020	2021	2022
EBITDA	3,287	3,377	3,128	3,140
Capex	(1,437)	(1,114)	(1,156)	(1,169)
Change in NWC	856	3,253	(151)	(315)
FCF	2,706	5,517	1,822	1,656
PV		**5,070**	**1,538**	**1,285**
Terminal Value				**21,180**
PV Of TV				**16,437**

Source: Riyad Capital

2- EV/EBITDA multiple (SAR 17.72)

We have used EV/EBITDA multiple as it takes into account the growth rate, risk, and the management team ability. We have used four regional telecom operators as we believe this provides an appropriate comparison and not local competitors. These comparable companies are not the top operators in their respective countries in which they operate.

The average EV/EBITDA of comparable companies comes to 3.15x. Zain KSA's EBITDA per share for 2019 is expected to be SAR 5.63. Thus, we arrive at a fair value of SAR 17.72 per share.

EV/EBITDA

Company	EV/EBITDA
OOREDOO KK	3.02
VIVA KK	4.26
ZAINBH BI	2.38
ORDS OM	2.93
Average	3.15
ZAIN's Forward EBITDA per share	5.63
Fair price (SAR)	**17.72**

Source: Riyad Capital, Bloomberg

Stock Rating

Buy	Neutral	Sell	Not Rated
Expected Total Return Greater than +15%	Expected Total Return between -15% and +15%	Expected Total Return less than -15%	Under Review/ Restricted

* The expected percentage returns are indicative, stock recommendations also incorporate relevant qualitative factors
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