Mobile Telecommunication Company (ZAIN KSA)

Investment Update

الجزيرة كابيتال
ALJAZIRA CAPITAL الجزيرة للأسواق المالية

Mobile Telecommunication Co. Saudi Arabia (Zain KSA): Tower deal to strengthen the balance sheet; gross margin to remain under pressure.

Zain KSA posted strong results in Q2-22 with net income surging more than 3x to SAR 134mn, led by a healthy topline and lower depreciation charges owing to tower deal. The revenue growth was robust at 16.4% Y/Y driven by B2B and 5G growth, further supported by recovery in Consumers segment and return of demand for visitors' packages due to easing of travel restrictions. However, Zain KSA's gross margin contracted 970bps Y/Y to 56.7%. Based on our revised assumption to accommodate latest changes and performance, we maintain a "Neutral" rating on Zain KSA but lower TP to SAR 13.5/share.

- **Sale of tower assets will enhance liquidity, lower depreciation charges:** Zain KSA is expected to complete the sale of its tower assets at in agreed valuation of SAR 3.0bn. As the company will keep 20% of ownership of its towers, proceedings from the deal to Zain KSA are estimated at SAR 2.4bn, with a net gain of around SAR1.0bn. We assumed a balanced approach towards the use of the proceeding which will enable the company to repay outstanding debts and liabilities (borrowings of SAR 6.2bn, expected payments to the Ministry of finance of >SAR 500mn per year, as well as SAR 1.5bn due to related parties), and continue to maintain CAPEX at 13-15% of revenue over the next few years. With this approach, the company will be able to repay most its existing liabilities over next five years, while continuing to invest in growth opportunities. Additionally, it provides scope for dividend payments with improved profitability in future. The sale of assets will also lower depreciation related to these assets (benefit of ~SAR 93mn Y/Y in Q2-22, as per management). However, amortization expenses are likely to be charged once the assets are leased back.
- **Revenue growth expected to be strong in FY22:** Zain KSA seems to regain the lost ground during the pandemic with number expats and visitors helping the company's growth. In Q2-22, the number of subscribers stood at 8.9mn, which had fallen to the low of 7.0mn during the pandemic. Additionally, Zain KSA's 5G revenue is also picking up as the large investment done by the company is starting to pay off. In Q2-22, 5G contribution to total revenue stood at above 7%. The company is witnessing strong demand in 5G home services. Zain KSA has signed an agreement with two MVNOs and share of revenue from these agreements are expected to reflect from Q3-22 financials. Furthermore, growing active user base of Tamam and growth in B2B segment are also expected to add to the company's revenue. We forecast topline growth of 12.1% Y/Y in FY22 to SAR 8,857mn.
- **Gross margins likely to remain under pressure:** Despite the robust growth in revenue Zain KSA has witnessed significant pressure on gross margins in past three quarters. Increase in contribution from low-margin visitors' packages and handset sales likely to have impacted the margin. Further shifts in revenue mix due to ongoing growth in the B2B segment also exerts margin pressure. We expect this pressure to continue and forecast goss margins at 56.7% in FY22 and 56.9% in FY23. Nevertheless, growing demand for the company's 5G services may help improving ARPU and support margins to some extent.

AJC view and valuation: We believe that upfront availability of cash is the key takeaway from Zain KSA's tower agreement. Lower depreciation charges are likely to be offset in the future by amortization charges and lease payments once the company leases back the tower assets. The company's topline is recovering well from the impact of the pandemic and is expected to deliver strong growth this year. However, contraction of gross margin is a concern for the company. We value ZAIN KSA with 50% weightage each to EV/EBITDA (5.7x based on FY23 estimates) and P/E (16.1x based on FY23 estimates) valuation to arrive at a TP of **SAR 13.5/share** and "**Neutral**" recommendation.

Neutral

Target Price (SAR)	**13.5**
Upside / (Downside)	**13.8%**

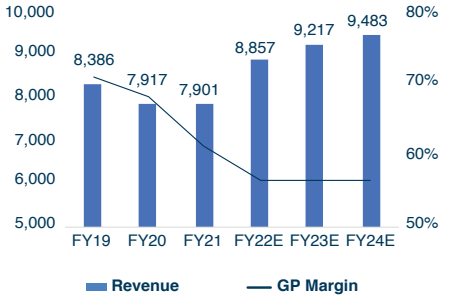
Source: Tadawul *prices as of 8th of August 2022

Key Financials

SARmn (unless specified)	FY20	FY21	FY22E*	FY23E
Revenues	7,917	7,901	8,857	9,217
Growth %	-5.6%	-0.2%	12.1%	4.1%
Net Income	260	214	460	793
Growth %	-46.4%	-17.6%	114.9%	72.3%
EPS	0.38	0.24	0.51	0.88

Source: Company reports, Aljazira Capital; *FY22 estimates do not include expected one-off gain from the tower deal

Revenue and Gross Margin



Source: AlJazira Capital, Company reports

Key Ratios

	FY20	FY21	FY22E*	FY23E
Gross Margin	68.8%	61.8%	56.7%	56.9%
Net Margin	3.3%	2.7%	5.2%	8.6%
P/E (x)	35.9	High	23.1	13.4
P/B (x)	1.4	1.2	1.0	0.9
EV/EBITDA (x)	3.9	5.6	4.5	4.2
Dividend Yield	0.0%	0.0%	0.0%	0.0%

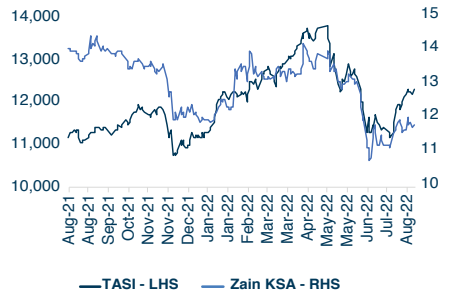
Source: Company reports, Aljazira Capital; *FY22 estimates do not include expected one-off gain from the tower deal

Key Market Data

Market Cap (SAR bn)	10.7
YTD%	-2.0%
52-week (High)/(Low)	14.64/10.58
Share Outstanding (mn)	899

Source: Company reports, Aljazira Capital

Price Performance



Source: Tadawul, Aljazira Capital

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Key Financial Data

Amount in SAR mn , unless otherwise specified	FY19	FY20	FY21	FY22E	FY23E	FY24E
Income Statement						
Revenue	8,386	7,917	7,901	8,857	9,217	9,483
% Y/Y Growth	*11.4%*	*-5.6%*	*-0.2%*	*12.1%*	*4.1%*	*2.9%*
Cost of Services	(2,418)	(2,472)	(3,016)	(3,834)	(3,971)	(4,077)
Gross Profit	**5,969**	**5,445**	**4,885**	**5,022**	**5,246**	**5,406**
% Y/Y Growth	*10.0%*	*-8.8%*	*-10.3%*	*2.8%*	*4.5%*	*3.0%*
Operating and administrative expenses	(1,899)	(1,763)	(1,749)	(1,819)	(1,988)	(2,052)
EBITDA	**3,823**	**3,441**	**3,128**	**3,203**	**3,258**	**3,354**
Depreciation and amortization	(2,312)	(2,439)	(2,430)	(2,059)	(1,983)	(2,064)
Operating Profit	**1,511**	**1,002**	**699**	**1,145**	**1,275**	**1,289**
% Y/Y Growth	*23.9%*	*-33.7%*	*-30.3%*	*63.9%*	*11.4%*	*1.1%*
Finance Charges	(1,045)	(898)	(489)	(518)	(433)	(332)
Net Income before Zakat	**467**	**104**	**210**	**627**	**842**	**958**
Zakat	(19)	(20)	(17)	(47)	(62)	(70)
Net Income	**485**	**260**	**214**	**460**	**793**	**901**
% Y/Y Growth	*46.0%*	*-46.4%*	*-17.6%*	*114.9%*	*72.3%*	*13.5%*
Balance Sheet						
Current Assets						
Cash and Cash equivalents	4,824	1,103	512	3,166	2,507	1,962
Other current assets	2,247	2,280	3,269	2,940	3,058	3,146
Total Current Assets	**7,072**	**3,383**	**3,781**	**6,106**	**5,566**	**5,107**
Non Current Assets						
Property and equipment	6,080	6,857	6,640	5,461	5,605	5,769
Intangible assets,net	16,216	16,280	15,561	15,058	14,546	14,028
Total Non Current Assets	**24,334**	**24,775**	**24,096**	**21,368**	**21,075**	**20,725**
Total Assets	**31,405**	**28,158**	**27,877**	**27,474**	**26,640**	**25,832**
Liabilities						
Total Current Liabilities	**4,576**	**9,099**	**10,300**	**7,350**	**7,533**	**7,629**
Total Non-Current Liabilities	**22,726**	**10,330**	**8,538**	**9,547**	**7,737**	**5,932**
Shareholders' equity:						
Share Capital	5,837	8,987	8,987	8,987	8,987	8,987
Retained earnings	(1,608)	(54)	139	1,515	2,308	3,209
Total Equity	**4,103**	**8,729**	**9,040**	**10,577**	**11,371**	**12,271**
Total Liabilities and Equity	**31,405**	**28,158**	**27,877**	**27,474**	**26,640**	**25,832**
Key ratios						
Gross Margin	71.2%	68.8%	61.8%	56.7%	56.9%	57.0%
Operating Margin	18.0%	12.7%	8.8%	12.9%	13.8%	13.6%
EBITDA Margin	45.6%	43.5%	39.6%	36.2%	35.3%	35.4%
Net Margin	5.8%	3.3%	2.7%	5.2%	8.6%	9.5%
ROE	11.8%	3.0%	2.4%	4.4%	7.0%	7.3%
ROA	1.5%	0.9%	0.8%	1.7%	3.0%	3.5%
Market/ Valuation ratios						
Book Value Per Share (BVPS)	7.0	9.7	10.1	11.8	12.7	13.7
PE (x)	16.4	35.9	50.5	23.1	13.4	11.8
PB (x)	1.7	1.4	1.2	1.0	0.9	0.9
EV/EBITDA (x)	3.5	3.9	5.6	4.5	4.2	3.9
EPS	0.72	0.38	0.24	0.51	0.88	1.00
No. of shares (Mn)	677	687	899	899	899	899

Source: Company financials, AlJazira research; FY22 estimates do not include expected one-off gain from the tower deal

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RESEARCH DIVISION

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1. Overweight: This rating implies that the stock is currently trading at a discount to its 12 months price target. Stocks rated "Overweight" will typically provide an upside potential of over 10% from the current price levels over next twelve months.
2. Underweight: This rating implies that the stock is currently trading at a premium to its 12 months price target. Stocks rated "Underweight" would typically decline by over 10% from the current price levels over next twelve months.
3. Neutral: The rating implies that the stock is trading in the proximate range of its 12 months price target. Stocks rated "Neutral" is expected to stagnate within +/- 10% range from the current price levels over next twelve months.
4. Suspension of rating or rating on hold (SR/RH): This basically implies suspension of a rating pending further analysis of a material change in the fundamentals of the company.

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