Mobile Telecommunication Co. (ZAIN KSA)

Event Update - Capital Reduction

ALJAZIRA CAPITAL الجزيرة للأسواق المالية

Zain KSA to cut capital by 23% instead of 28% announced earlier, due to enhanced ability to reduce accumulated losses and improvement in the company's operations

Zain KSA's board of directors amended recommendation to reduce capital from SAR 5.8bn to SAR 4.5bn, representing a decrease of ~23%, to wipe out majority of accumulated losses. Earlier in February 2020, the board had recommended ~28% decrease of in the capital. Post the capital cut, the company will issue rights worth a total of SAR 4.5bn, increasing the capital from SAR 4.5bn to SAR 9.0bn.

As of June 2020, Zain KSA reduced its accumulated losses to SAR 1.4bn (24.7% of total capital) from SAR 1.5bn (25.7%) as of March 2020. The proposed capital cut coupled with the company's improved profitability (recorded net profit for last eight quarters consecutively), would completely erase accumulated losses from the balance sheet, while capital raised through the rights issue will be used to reduce debt. This will help the company in terms of interest savings. Possibility of dividend distribution to shareholders post rights issue can also be anticipated.

Table 1

(In SARmn)	Current (as of June 2020)	After capital reduction	Post rights issue
Share capital	5,837	4,487	8,987
Accumulated losses	-1,444	-94	0
Equity	4,189	4,189	8,595
Debt	13,420	13,420	13,420
Cash	1,094	1,094	5,500
D/E	3.2	3.2	1.6

Source: Company filings, Aljazira Capital

rights should improve Zain KSA's leverage ratio from 3.2x as of June 2020 to 1.6x, even if the additional capital is not used to repay debt.

In case of debt repayment from the new capital, we consider three scenarios:

Scenario 1: Debt repayment of SAR 1,500mn

Scenario 2: Debt repayment of SAR 3,000mn

Scenario 3: Debt repayment of SAR 4,500mn

Table 2

(In SARmn)	Scenario 1 Debt repayment of SAR 1,500mn	Scenario 2 Debt repayment of SAR 3,000mn	Scenario 3 Debt repayment of SAR 4,500mn
Share capital	8,987	8,987	8,987
Accumulated losses	0	0	0
Equity	8,595	8,595	8,595
Debt	11,920	10,420	8,920
Cash	4,000	2,500	1,000
D/E	**1.4**	**1.2**	**1.0**
Finance cost (annualised)	759	663	568
Interest rate	6.36%	6.36%	6.36%
Savings in finance cost	248	344	439

Source: Company filings, Aljazira Capital

by improving leverage ratio from 3.2x to 1.0–1.4x and reducing annual finance cost by SAR 248–439mn.

Moreover, improved financial ratios and the capacity to generate higher profit would allow Zain KSA to borrow at lower interest rates. For H1-20, Zain KSA's annualized interest charges stood at ~6.4% of average total debt, approximately 550bps above the six-month SAIBOR. We expect a decline of 150–250bps in interest rates after debt reduction. This will further ease finance cost for the company.

Neutral

Target Price (SAR)	**12.4**
Upside / (Downside)*	**5.8%**

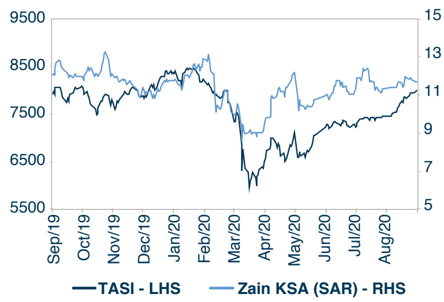
Source: Tadawul *prices as of 30th of August 2020

Key Market Data

Market Cap(mn)	6,841
YTD%	-0.2%
52 week (High)/(Low)	13.38/8.35
Share Outstanding (mn)	583.7

Source: Company reports, Aljazira Capital

Price Performance



Source: Tadawul, Aljazira Capital

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Table 3

(In SARmn)	Scenario 1 Debt repayment of SAR 1,500mn	Scenario 2 Debt repayment of SAR 3,000mn	Scenario 3 Debt repayment of SAR 4,500mn
Share capital	8,987	8,987	8,987
Accumulated losses	0	0	0
Equity	8,595	8,595	8,595
Debt	11,920	10,420	8,920
D/E	1.4	1.2	1.0
Reduction in interest rate	150bps	200bps	250bps
Interest rate	4.9%	4.4%	3.9%
Finance cost	584	458	348
Savings in finance cost	423	548	659

Source: Company filings, Aljazira Capital

Assuming 150bps, 200bps and 250bps reduction in the above-mentioned Scenarios 1, 2 and 3, respectively, would result in savings of SAR 423–659mn in finance cost. This may effectively increase the company's net profit (FY19: SAR 485mn) by ~1.8–2.3x. With the number of shares increasing from 584mn to 873mn (~1.5x), the capital restructuring exercise may turn EPS accretive for shareholders.

Table4

(In SARmn)	Scenario 1 Debt repayment of SAR 1,500mn	Scenario 2 Debt repayment of SAR 3,000mn	Scenario 3 Debt repayment of SAR 4,500mn
Actual net profit	485	485	485
No. of shares	584	584	584
EPS (SAR)	0.83	0.83	0.83
Savings in finance cost	423	548	659
Net profit post savings	892	1,013	1,120
No. of shares	873	873	873
Effective EPS (SAR)	**1.02**	**1.16**	**1.28**
Incremental EPS	0.19	0.33	0.45

Source: Company filings, Aljazira Capital

AJC view: Zain KSA's decision to decrease the amount of capital cut (from 28% to 23% of capital) indicates the management's confidence on consistently delivering the profits and improved operating conditions of the company. We believe that the proposed restructuring of capital was an essential step for the company to improve its financial health. Zain KSA's bottom-line is expected to benefit from the lower finance cost. Moreover, a strong balance sheet would support the high level of capex (H1-20: SAR 1.9bn) anticipated in the next 2–3 years as the company continues to invest in network infrastructure and the 5G rollout. Zain KSA is currently trading at a PE ratio of 14.1x on FY19 EPS. If valued at the same multiple (14.1x) to an effective EPS range of SAR 1.02-1.28, the share price would range from **SAR 14.4–18.1/ share**.

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RATING TERMINOLOGY

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.

Disclaimer