شركة الساحل للتنمية والاستثمار ش.م.ك (مقفلة)
COAST INVESTMENT & DEVELOPMENT CO. K.S.C (CLOSED)

Zain Post-Transaction

Deal Analysis...

KUWAIT | Feb 22nd, 2010

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Coast Investment & Development Company, Coast Investment Fund and Coast clients own shares of Mobile Telecommunication Company (Zain)

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Bharti Airtel deal with Zain's Africa assets

Zain's profitability have decrease since 2005 onwards, after their major acquisition on Celtel for a deal worth USD 3.36 billion. Celtel owned mobile operating licenses in 15 countries in Africa, which required also heavy capital expenditure that were spent to on Africa , which was in the region of USD 5.5 billion.
On January 2010, Zain received an offer from Bharti Airtel to acquire Zain Africa assets (except Morocco and Sudan) for USD 10.7 billion.

In this report, we will demonstrate in the impact of this transaction if it went through, how will it affect the future of the company, and what is the financial implications of such transaction.

Zain Africa

After Zain acquired Celtel in May 2005, their revenues grow tremendously. From KWD 0.32 million in 2004 to KWD 2 billion in 2008. The additional client base from Celtel contributed significantly to the increase in revenue. Yet, the growth in Zain`s net profit didn't match the growth in revenue. The reason behind it is the increase in General & Administrative (G&A) expense and the Interest Expense. G&A expenses increase was due to the increase in staff after the acquisition and the concentrated spending on marketing and advertising campaigns to accommodate for the rebranding the regional corporate image of the company.

The presence of Zain in Africa is associated with its long-term strategic goal of positioning Zain as global player and also the potential growth of the markets in Africa was an important factor in taking the decision to step into Africa and compete with other multinational telecom corporations. Consequently there is a high risk involved with this future growth opportunity. That is why there was a difference of opinions between shareholders of the company and whether the company is able to succeed in turning African assets into cash generating assets.

Table 2 shows the geographical distribution of the income statement of Zain for the period of 9 months ended September 2009. It is apparent that Iraq, Sudan and Kuwait has the highest gross profit margin among Zains' subsidiaries with 78.2% for Iraq, 75.8% for Sudan and 75.4% from Kuwait, while in terms of net profit margin Kuwait, Sudan and Jordan represent the highest with 42%,40% and 36% respectively.

Table 1: Zain Active Subscribers '000 (September 2009)

Country	Q3 2009	Q3 2008	Growth %	Population	Mobile Subscribers	Penetration Rate[1]
Bahrain	693	603	14.9%	791	1,400	177.0%
Iraq	10,063	8,522	18.1%	30,747	20,000	65.0%
Jordan	2,625	2,253	16.5%	6,316	5,314	84.1%
Kuwait	1,808	1,711	5.7%	2,985	2,907	97.4%
Lebanon	1,273	761	67.3%	4,224	1,430	33.9%
KSA	4,401	966	355.6%	25,721	36,000	140%
Palestine	1,731	-	-	4,013	1,153	28.7%
Sudan	7,335	4,530	61.9%	39,154	11,186	28.6%
Middle East	**29,929**	**19,346**	**54.7%**			
Burkina Faso	1,444	1,236	16.8%	15,757	2,553	16.2%
Chad	1,194	880	35.7%	11,274	1,809	16.0%
Congo B	1,415	1,246	13.6%	3,683	1,807	49.1%
DRC	3,569	3,023	18.1%	66,020	9,263	14.0%
Gabon	870	761	14.3%	1,475	1,300	88.1%
Ghana	1,208	0		23,837	11,570	48.5%
Kenya	2,191	2,558	-14.3%	39,802	16,234	40.8%
Madagascar	1,425	1,087	31.1%	19,625	4,835	24.6%
Malawi	1,711	1,170	46.2%	15,263	1,781	11.7%
Niger	1,432	948	51.1%	15,290	1,677	11.0%
Nigeria	14,936	15,905	-6.1%	154,729	62,988	40.7%
Sierra Leone	555	444	25.0%	5,696	1,009	17.7%
Tanzania	4,764	3,285	45.0%	43,739	14,723	33.7%
Uganda	2,243	1,865	20.3%	32,710	8,555	26.2%
Zambia	2,940	2,520	16.7%	12,935	3,539	27.4%
Total Africa	**41,897**	**36,928**	**13.5%**			
Zain Group	**71,826**	**56,274**	**27.6%**			

Source: Zain Q3 2009 earning press release, CIA Factbook
[1] Penetration rate as of December 2008

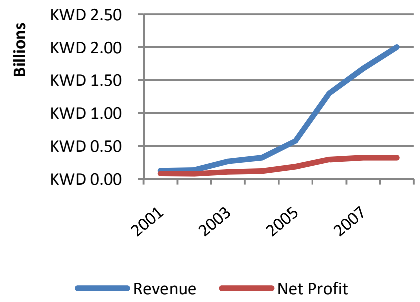
Africa got the lowest margins with 69.5% gross profit margin and a humble 5.3% in net profit margin. This shows that African assets is still not matured yet, and from Table 1 ,it is noticeable that most to countries Zain had in Africa had lower than 50% penetration rate which justifies their ambition to get into the African market to gain exposure on their potential upside. It's a question of how long can Zain bear capital expenditure without getting any significant return.

Table 2: Q3 2009 Earnings for Zain's subsidiaries

Subsidiary	Revenue	Net Profit	EBITDA[1]
Kuwait	264.6	112.3	139.0
Jordan	158.7	54.9	73.9
Bahrain	55.3	13.1	17.7
Lebanon	18.6	4.3	4.4
Sudan	207.3	84.1	104.5
Iraq	286.8	85.9	141.4
Africa	788.2	25.3	208.7
Unallocated	0	(184.2)	(32.4)
Total	1779.6	195.7	657.2

Source: Zain third quarter 2009 financial statement

Figure 1: Zain Earnings Growth



Source: Zain annual reports.

Zain Post-Africa

Zain has a total of 71.8 million subscriber as of September 2009, and will be left with 29.9 million subscriber. Africa had the highest contribution to the revenue in the 3rd quarter of 2009 with a 44% share followed by Iraq and Kuwait with 16% and 15% respectively. Following Zain's Africa assets sale, Kuwait and Iraq will still maintain their position as the top contributors to the revenue and will be joined by Sudan with 21%.

Exhibit 1: Zain Q3 2009 net profit distribution

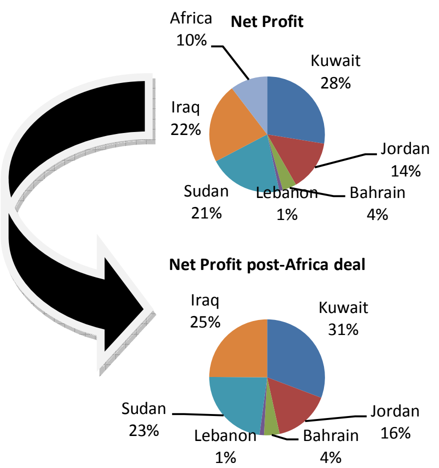
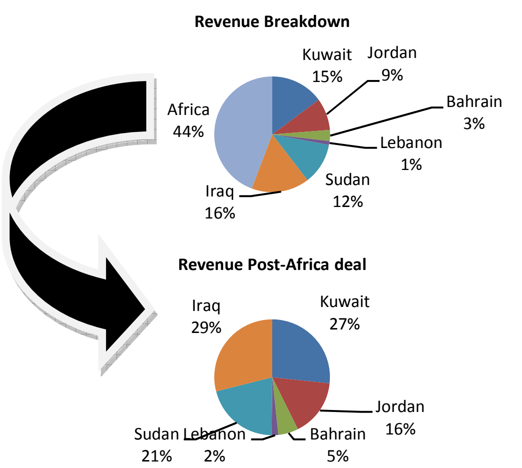


Exhibit 2: Zain Q3 2009 revenue distribution



Source: Zain O3 2009 financial statement

In terms of net profit, Kuwait has the highest contribution as of September 2009 with 28%, followed by Iraq 22% and Sudan with 21%.

If Zains' African assets where to be sold, it won't affect much their net income. As a matter of fact it might even earn higher net income and higher margins as their G&A will decrease significantly after selling off African operations.

As for the cash earned from selling their African assets which is agreed to be USD 10.7 billion (equivalent to KWD 3.08 billion), management have several alternative as what do with this cash.

[1] EBITDA is estimated.

Earnings

The profit from that potential transaction is KWD 3.1 billion, after deducting the expenses Zain incurred , net profit from the deal will be KWD 1.01 billion, assuming that all the deal have been financed through equity. The IRR of the investment in Africa would be 11.4%.

Table 3: Return from Zain Africa investment

	KWD million	Note
Acquisitions	(1,300)	Including Celtel , Nigeria and Ghana. 39% of Sudan (Mobitel) is not deducted from this amount
Capital Expenditure	(1,602)	Sum of all capital expenditure endured by Zain from 2005 to 2009
Net Profit	108	
Add: Depreciation	702	
Bharti Offer	3,103	USD 10.7 billion converted to KWD using 0.290 KWD/USD
Profit from Africa	1,011	
EPS (KWD)	0.236	EPS is from only the proceeds from Zain Africa deal.

Dividends

The expected net profit available for shareholders of the parent company for the year 2009 is between KWD 270-320 million and a cash balance of KWD 310-330 million, which will allow Zain to distribute cash dividends between 70%-75% per share (equivalent to KWD 0.070-0.075). As per the agreement between Zain and Bharti Airtel, the transaction will occur during the 2nd quarter of 2010, which means that there will be excess cash in Zain's books, the possible scenarios are either reinvest the cash , distribute it as cash dividends or a combination of both. These scenarios depends on the future strategic outlook of Zain's board of directors. The timing of the second dividends can be during the year, since the law doesn't prohibit distributing dividends several times during the year , Table 4 demonstrates the possible scenarios.

Table 4: Zain's expected dividends

Strategy	Expected Dividends 2009	Expected Dividends 2010	Total Dividends
Major expansion	0.070	0.070	0.140
Reinvest in pre-existing sectors	0.073	0.115	0.188
No reinvestment	0.075	0.235	0.310

Capital

The right to decrease Zain's paid-up capital is also probable after the transaction. Yet again, this depends on the new strategy of the board of directors. Whatever the percentage decrease is, the cash payback per share will always equal the par value of KWD 0.100 per share. It can be added to the Table 4: Zain's expected dividends table to calculate the return on investment corresponding to the three scenarios.

Table 5: Capital decrease scenarios

Strategy	Capital decrease	New capital	Cash payback
Major expansion	-	427,518	
Reinvest in pre-existing sectors	25%	320,638	106,880
No reinvestment	50%	213,760	213,760

Example: if Zain's board decided to go with reinvesting in existing sectors strategy, its expected dividends will be 0.188 (from Table 4) plus 0.100 capital payback. Assuming a purchase price is KWD 1.000 and the closing price of KWD 1.250 as of the date of general assembly's approval of the cash dividends and capital decrease , the total return on investment will be: (1.250-1.000) + 0.188 / 1.000= 43.8% , in addition to the capital payback of 0.100 which will have no effect on the total return because the market price will be adjusted upward to offset the capital decrease.
It is important to note that the decrease in capital will increase dividends and earnings per share.

Comparison between Bharti-Zain deal with Qtel- Wataniya deal

Qatar Telecom (Qtel) acquired 51% of Kuwaiti based Wataniya Telecom for a deal worth USD 3.7 billion in march 2007. The deal was concluded on a 8.2x EBITDA multiple, compared with 6x for the GCC Telecom EBITDA multiple average. It seemed fairly priced, as the Qtel were getting a majority stake for a profitable company.
Bharti Airtel's offer to acquire 100% of Zain Africa in an offer worth USD 10.7 billion at 2009E EBITDA multiple of 11.3x, compared with GCC telecom average of 5.4x. Although Bharti seems to be buying at a higher multiple , it shows that African mobile market has a huge potential. In terms of revenue multiple, both deal have almost the same multiple.

Table 6: Comparison Between Zain and Wataniya

	Zain-Bharti	Wataniya - Qtel
Transaction Date	April 2010	March 2nd 2007
Stake	100% of Africa Assets[2]	51% of mother company
Transaction Size	USD 10.7 billion	USD 3.7 billion
Revenue	USD 3.85 billion[3]	USD 1.48 billion[4]
Total Assets	USD 8.7 billion[5]	USD 2.47 billion[6]
Multiple of P/EBITDA	11.3 times[7]	8.2 times
Multiple of P/Revenue	2.8 times	2.5 times

Source: respective company's financial statement, press releases and Reuters

Comparables Valuation

Coast IT & Telecom sector is one of the 16 sectors Coast have created using the ICB standards. The objective of this intuitive is to enhance the market's current underlying mechanisms. Coast, being a vital financial institution and a contributor to Kuwait's development and economic prosperity, have taken the initiative in assessing the underlying operational structure in an attempt to participate in the augmentation of financial innovation within our local and regional markets.
The current proposal serves as the guideline and the justification for renovating the current indices displayed in the Kuwait Stock Exchange (KSE) and crafting internationally recognized and calculated indices. Up to year 2005, there has been no single and credible benchmark eligible for standardizing criteria for sector allocation within global financial markets.

On January of 2005, FTSE Group and Dow Jones Indexes have partnered together in creating what is called the Industry Classification Benchmarks (ICB), which reflects a relevant and user-friendly industry classification for local and global trading and investment decisions.

Using market approach, Zain have several fair values derived from 3 different multiples in 2 different comparables regions. The first being Coast IT & Telecom sector which consists of:

- Wataniya Telecom
- Hayat Communication
- Hits Telecom
- Future Communication
- Al Safat Tec Company
- Automated Systems Company

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[2] Excluding Morocco and Sudan
[3] This figure is an estimate for December 2009. Revenue were USD 2.7 billion in Q3 2009
[4] As of December 2006
[5] As of September 2009
[6] As of December 2006
[7] This figure is an estimate for December 2009. EBITDA was USD 710 million in Q3 2009

The second being GCC region telecommunication companies, the constituents are:

- Wataniya Telecom
- Saudi Telecom
- Eithad Etisalat
- Qatar Telecom
- OmanTel
- Bahrain Telecom
- Etisalat

Table 7: multiples comparables (latest figures)

Company	P/E	P/BV	P/Sales	P/EBIT	P/EBITDA
Wataniya	7.46	2.26	1.72	8.66	4.67
Saudi Tel	8.10	2.09	1.76	6.87	4.33
Etihad	10.67	2.63	2.56	10.04	6.9
QTel	8.53	1.72	1.12	7.14	3.16
OMANTEL	7.92	2.36	2.42	6.89	4.69
Batelco	8.02	1.86	2.64	8.53	5.89
Etisalat	9.72	2.36	2.83	10.56	8.19

Based on our projections, Zain's forecasted multiples for December 2009 were as follows

Zain (Per Share - KWD)	
Forecasted EPS	0.080
Forecasted BV	0.591
Forecasted Sales	0.564
Forecasted EBIT	0.155
Forecasted EBITDA	0.236

Table 8: Coast IT & Telecom sector multiples

	IT & Telecom Q3 2008	ZAIN Fair Value Q3 2008	IT & Telecom Q3 2009	ZAIN Fair Value Q3 2009
P/E	11.52	0.968	12.17	0.974
P/BV	2.06	1.428	2.26	1.335
P/Sales			7.43	0.335
P/EBIT	10.40	1.258	14.02	2.173
P/EBITDA				4.191
Average		**1.218**		**1.762**

Table 9: Coast GCC Telecom sector multiples

	GCC Telecom Q3 2008	ZAIN Fair Value Q3 2008	GCC Telecom Q3 2009	ZAIN Fair Value Q3 2009
P/E	10.90	0.916	10.54	0.843
P/BV	3.29	2.279	3.12	1.844
P/Sales			2.15	0.507
P/EBIT	10.50	1.271	10.17	1.576
P/EBITDA	6.0		5.40	3.048
Average		**1.488**		**1.566**

The comparables figures were derived from 5 years weighted average for each year, and on an equal weights for each constituent.

The closing share price of Zain as of February 2010 was KWD 1.280, and when compared with the IT & Telecom sector in Kuwait, the share price has a 37% potential increase to reach an average fair value of KWD 1.762, while when compared with Coast GCC Telecom sector it has a potential increase of 22% to reach KWD 1.566 When averaging both values, Zain will have a fair value of KWD 1.664 [8]

[8] The fair value does not include the effect of Zain Africa transaction.

Conclusion

Zain Africa sale to Bharti Airtel will have a big influence in the Kuwait market and will alternate the direction of the company. Zain is expected to pay off most of its large debts, a big portion of this debt is from Kuwaiti banks. Banks will be more relaxed in its loan terms and will gradually increase the size of loans they use to give during 2009. Although banks will be more cautious, they definitely will give out more loans than last year. With the low interest rate levels today, it's expected that investors find it a good time to finance their projects through debt, this will stimulate the market again and the securities market will react positively.

As for Zain, it looks like it is preparing for a new strategy soon and the direction of the company will be more apparent this year. Their exit from Africa is surely rewarding, but it will be a onetime deal. Are there more exits to follow? Are there more acquisition? A lot of speculation will be floating around Zain's future, but only the board of directors know exactly where they are going, and it will be announced to the public once it is finalized.

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