MENA Telecoms

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Omantel snaps up 10% of Zain Group; a puzzling move from Omantel, but a good opportunity for Zain

Industry Update

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Winners and losers

Omantel offered to acquire 425.7mn shares in Zain Group for KWD0.600/share in cash only, implying a deal value of USD846.1mn (OMR325.6mn, or KWD255.4mn) and giving it a stake of 9.84%. We see the deal as very positive for Zain, as it monetises a sizeable portion of its balance sheet that has been idle for years. We also believe this is at an attractive valuation for Zain shareholders (23.0% premium to our TP of KWD0.488 and 23.5% to market price). The picture looks less appealing for Omantel shareholders, in our view, as the multiples look rather rich – although management say they are within the peer range – and we are not completely convinced with Omantel's rationale, especially given that the value of synergies is unknown.

Deal multiples on the high side

Omantel said the deal values Zain at a 2017e EV/EBITDA of 6.6x vs. 6.8x for peers (Etisalat Group, STC, Ooredoo Group, and Mobily). On EV to simple FCF (EBITDA less capex), the deal puts Zain at 10.0x vs. 10.6x for the aforesaid peers (ex. Mobily). Based on our estimates, the deal values Zain at a 2017e EV/EBITDA of 7.0x on total EBITDA or 7.7x on proportionate EBITDA. On all counts, we see the valuation as rather expensive. Our MENA telecoms coverage trades at an average 2017e EV/EBITDA of c5.4x, and STC's acquisition of a stake in Viva Kuwait in January 2016 went at a forward FY16e EV/EBITDA of 3.7x (trailing FY15a EV/EBITDA of 4.0x).

Low probability of Omantel being outbid on 24 August

Boursa Kuwait's rules stipulate that any offer for more than 5% of a listed company's shares must be opened for a public auction after 10 working days (24 August), during which any interested investor is allowed to put a higher offer price for the same stake. This means that Omantel's offer may or may not be the highest offer on the table for Zain's shares, but we doubt that there will be higher bids given the rich valuation.

Zain's bid for Oman's third licence on the back burner

Whether or not Zain is allowed to bid for Oman's third licence depends partly on the outcome of the abovementioned auction. So far, there is no sign that Omantel's acquisition offer could compromise Zain's bid for the licence, as Omantel would be a minority investor in Zain with no control nor board representation. Yet, Oman's telecom regulator could decide to disqualify Zain if Omantel becomes one of its shareholders on/after 24 August. This would avail more proceeds to Zain for either debt repayment or special dividends, both of which are better options than investing in Oman's third licence, in our view.

Deal multiples for Zain Group's stake

	EV/EBITDA	EV/FCF**
Zain Group	6.6x	10.0x
Peers*	6.8x	10.6x

* EV/EBITDA peers include STC, Etisalat Group, Ooredoo Group, and Mobily, while EV/FCF are the same but excluding Mobily.
** Using simple FCF (EBITDA less capex).
Source: Omantel

The deal in a nutshell

What we know so far

1- **Omantel signed a definitive share purchase agreement (SPA) to acquire 425.7mn shares in Zain Group** at a price of KWD0.60/share in cash only, subject to regulatory approval, and implying a total deal value of USD846.1mn (OMR325.6mn, or KWD255.4mn). This will give Omantel an effective stake of 9.838% in Zain Group.

2- The **deal values Zain at a 2017e EV/EBITDA of 6.6x** vs. 6.8x for peers (Etisalat Group, STC, Ooredoo Group, and Mobily). On EV to simple FCF (EBITDA less capex), the deal puts Zain at 10.0x vs. 10.6x for the aforesaid peers (excluding Mobily).

3- As per Omantel's statement, **the deal allows potential future cooperation between both companies** in several key areas such as the wholesale telecom business, operations and networks, commercial activities, and knowledge and experience. Moreover, there could be potential opex and capex synergies, but the company did not quantify those.

4- Omantel will **fund the deal entirely through a bridge loan,** which it will later replace with a capital-market instrument. If the company was to take a loan of cOMR300mn, this would put its 2017e net debt to EBITDA at a comfortable c1.0x, in our estimates.

5- The deal **will not affect Omantel's dividend distributions,** according to management. We note that the 1H17 interim dividend was already cut 50% Y-o-Y, but the company said that this was decided prior to the decision to make an offer for Zain's shares, meaning that the dividend cut was more likely linked to the entrance of a third player, the tax hike, and the royalty hike.

6- The deal, if successful, will have **no impact on Zain Group's income statement** as the adjustment will be made directly to the company's equity through the retained earnings account. This would be reflected as of 3Q17 financial statements.

7- **The treasury shares are carried at cost on Zain Group's balance sheet;** in the latest financial statements (1Q17) treasury shares amounted to KWD567.8mn, vs. the transaction value of KWD255.4mn. Hence, there is an implied loss of KWD310.4mn (net of treasury shares reserve of KWD2mn) to be incurred. The loss will be deducted directly from retained earnings, while total equity will increase by a net cKWD255mn and cash will increase by the same amount.

8- **Zain Group will use most of the proceeds for debt reduction,** while part will be used for investments (possibly Oman's third licence) and for a possible special dividend.

What we are missing

1- **The value of synergies is not known,** at least for now. Omantel spoke of potential opex and capex synergies and cooperation, but did not quantify the value of these. It is very difficult to guesstimate the value of such synergies.

2- **Uncertainty on Zain's bid for Oman's third licence:** at this stage it is not clear whether or not Oman's Telecommunications Regulatory Authority (TRA) will disqualify Zain Group's bid for Oman's third licence on the basis that the incumbent, Omantel, could become the owner of two competing licences (directly and indirectly). We believe this is likely to be determined after the auction date for Zain Group's treasury shares, which will be on 24 August.

Omantel conference call highlights

Omantel held a conference call to discuss the deal, with the participation of Martial Caratti (CFO), Menon Gopinath (GM Strategic Finance), and Ali Ahmed Khan (Senior Expert, M&A). Below are the main highlights of the call:

Deal rationale: industry pressure, domestic market saturation, and complementary businesses. Omantel is suffering from various challenges mainly related to the traditional side of the telecoms business, in addition to being exposed to the Omani market only. The global industry is moving towards a digital transformation, and Zain Group is a regional leader on that front. This pushed Omantel's strategy to evolve towards growth through diversification. Moreover, Zain and Omantel complement each other, as Zain is strong in the mobile and digital businesses, as well as being geographically diversified, while Omantel is strong in the fixed and wholesale businesses. The cooperation between both companies will create synergies, according to management.

Value of synergies not public, but will improve profitability: the company cannot disclose the value of the potential opex and capex synergies for now, but it already identified several areas on which Omantel and Zain can cooperate to create value for shareholders. Management mentioned that the potential synergies will improve the profitability for both Omantel and Zain.

Deal multiples below peer average, management said. On an EV to simple FCF basis (simple FCF = EBITDA less capex), Omantel will pay 10.0x vs. the pre-deal market price of 7.9x and vs. an average of 10.6x for primary peers (Etisalat Group, STC, and Ooredoo Group; excluding Mobily). This is a good price when taking into account that Zain's FCF generation is improving and one of its largest FCF generators, Iraq, is already in turnaround mode, management said. Moreover, on an EV/EBITDA basis, Omantel will pay 6.6x vs. 6.8x for primary peers (Etisalat Group, STC, Ooredoo Group, and Mobily). Management believe that if Omantel had opted to buy the 10% stake from the market, it would have ended up paying more than the announced deal value as Zain's share price would have rallied significantly.

Acquisition to be financed entirely through a bridge loan that will be replaced later with a capital-market instrument, depending on market conditions at that point. Management stressed that it will not be done through a capital increase. The terms of the bridge loan and the long-term investment return targets cannot be disclosed at the moment.

No impact on dividends in the short term. Management added that this acquisition creates long-term value for shareholders and will not have a short-term impact on dividends; last week's announced dividend cut was decided prior to the announced transaction. Moreover, the deal should have a positive impact on dividend distribution in the long run.

Deal closing by end-August after regulatory approval. The company has already initiated the process to seek regulatory approval from Boursa Kuwait, and the deal should close sometime between 27 and 29 August.

Omantel will not be entitled to a seat on Zain's board. The company is much more interested in the commercial partnership that will arise from the deal with Zain Group.

Impact on Zain's bid for Oman's third licence: management refrained from commenting on this issue, saying the question must be addressed to Zain Group.

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Company (Reuters/Bloomberg)	Rating (14 Aug 2017)	Price (14 Aug 2017)
Emirates Integrated Telecom (du) (DU.DU/DU UH)	Neutral	AED5.63
Mobily (7020.SE/EEC AB)	Neutral	SAR17.95
Etisalat Group (ETEL.AD/ETISALAT UH)	Neutral	AED17.85
Global Telecom Holding (GTHE.CA/GTHE EY)	Buy	EGP6.50
Omantel (OTEL.OM/OTEL OM)	Neutral	OMR1.09
Ooredoo Group (ORDS.QA/ORDS QD)	Neutral	QAR91.70
Ooredoo Kuwait (OORE.KW/OOREDOO KK)	Buy	KWD1.16
OTMT (OTMT.CA/OTMT EY)	Sell	EGP0.68
Saudi Telecom (7010.SE/STC AB)	Neutral	SAR73.59
Telecom Egypt (ETEL.CA/ETEL EY)	Neutral	EGP11.35
Zain Group (ZAIN.KW/ZAIN KK)	Buy	KWD0.49
Zain KSA (7030.SE/ZAINKSA AB)	Neutral	SAR8.68