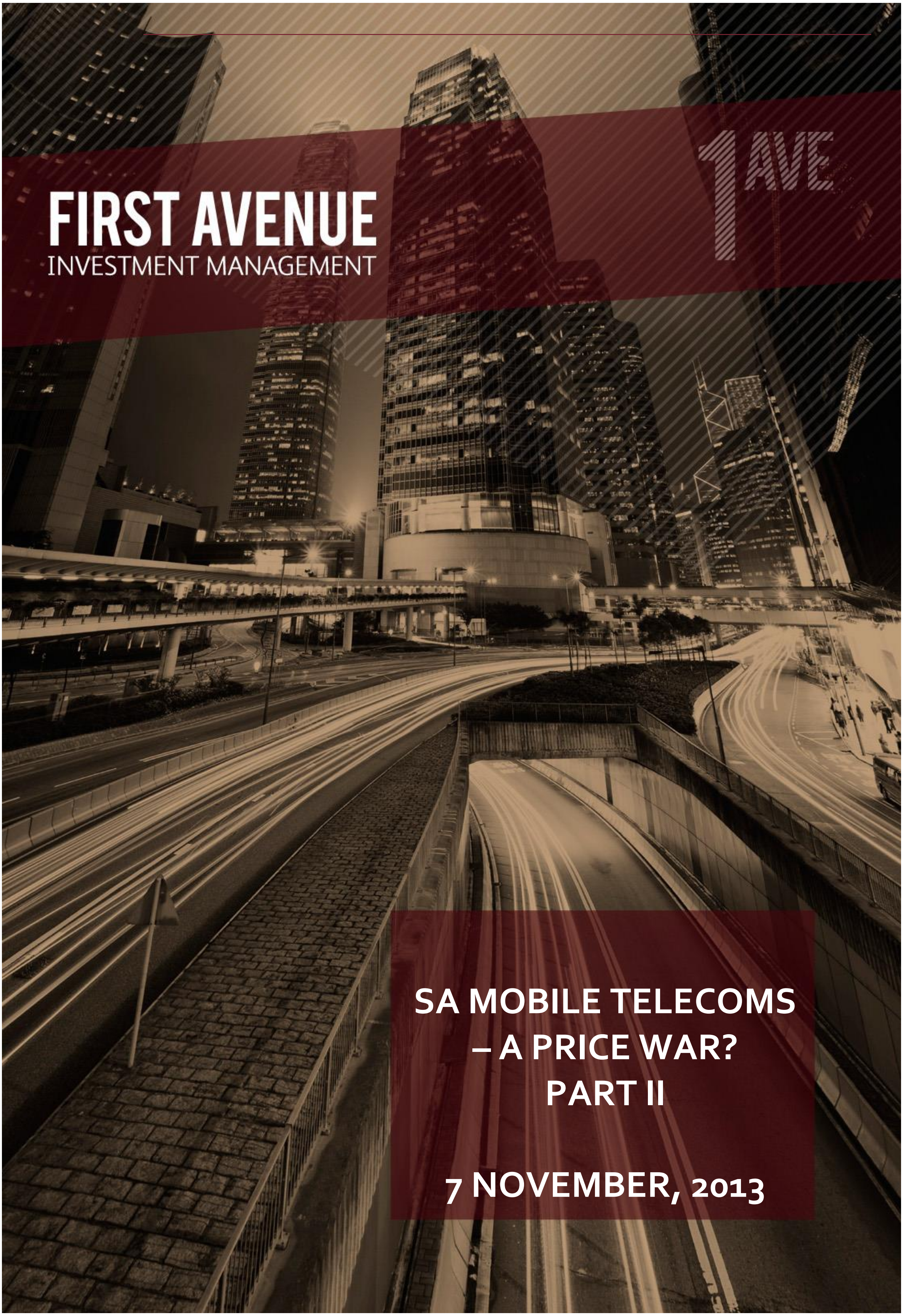


FIRST AVENUE
INVESTMENT MANAGEMENT

SA MOBILE TELECOMS – A PRICE WAR? PART II

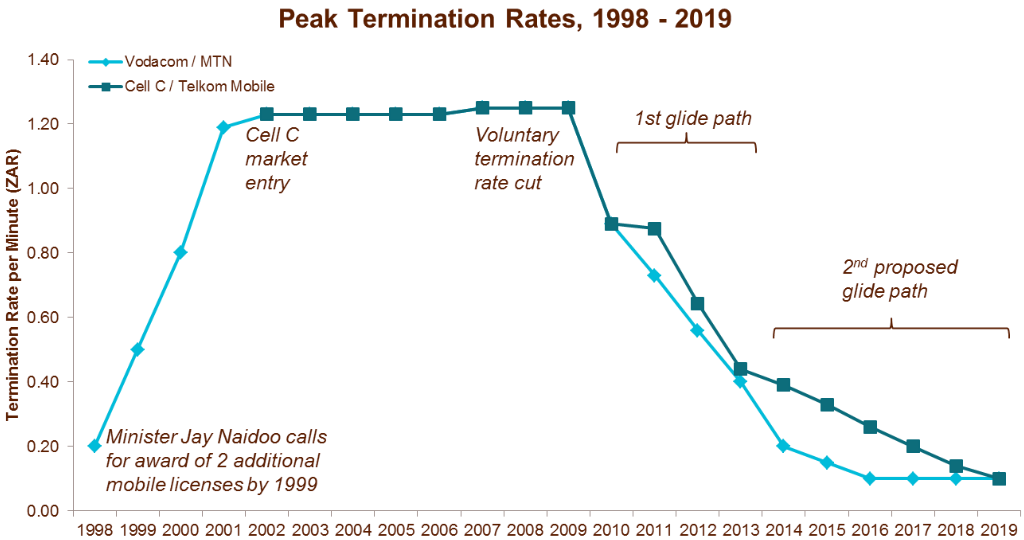
7 NOVEMBER, 2013

ICASA TAKES STRONG STANCE AGAINST HIGH TARIFFS

In our previous note, we explained how the structure of the local mobile telecoms industry has led to inefficient outcomes for consumers. An effective duopoly of MTN and Vodacom has resulted in pricing and tariffs that are amongst the highest in the world. We showed high mobile termination rates (MTRs) to be the key driver of this industry structure as they create an almost insurmountable barrier to entry for both new and small operators who are not able to use price as a competitive tool. The situation is further exacerbated by larger operators offering lower prices for on-net calls compared to off-net calls, resulting in an impenetrable *network effect.* This is the reason why the top 2 operators generate more than 90% of the local mobile industry revenue. The upshot of new and small operators failing to gain critical share of market is an industry that exists without price discovery.

Figure 1 exhibits how MTN SA and Vodacom SA were allowed to increase MTRs as early as 2000, not in response to cost and investment pressures, but rather to the announcement of a third network operator license in 1998. By artificially eliminating price discovery, MTN and Vodacom ensured market failure in mobile telecommunications. ICASA's first attempt to address this situation took place more than a decade later in 2010-2013 when peak MTRs were reduced from R1.25 to 40c per minute (see Figure 1). In addition, smaller operators, Cell C and Telkom Mobile, were provided with preferential, asymmetric tariffs of 20%, 15% and 10% in 2011, 2012 and 2013 respectively further enabling them to compete against larger operators.

Figure 1 – Historical Peak Mobile Termination Rates in South Africa



Source: ICASA, First Avenue Analysis

On 10 April, 2013, ICASA published further draft MTR regulations after they "*determined that ineffective competition existed in the provision of call termination because of, amongst others, inefficient pricing*"[1]. The regulations imposed a steeper reduction in MTRs to 10c by 2016 as well as much higher levels of asymmetry than were previously offered to Cell C and Telkom Mobile (see Table 1 below). This is a strong message that ICASA is serious about addressing the drag that high costs of communication impose on the domestic economy.

The key difference between the first and second round of MTR cuts is the degree of asymmetry that is being offered to smaller operators as shown in Table 1 (95%+ versus current 10%). The regulator envisages an outcome where MTN and Vodacom drastically reduce prices to match both Cell C and Telkom Mobile in the event the latter implement lower tariffs (price discovery). In addition, it also enables them to shift from being a net payer of termination fees to a net receiver of fees (market competitiveness). Asymmetry is often awarded to a third operator at point of entry to a market in order to achieve a sustainable level of scale in their business. Cell C was not awarded this regulatory assistance until after a full 11 years of its operational life. Instead, the company lived with artificially inflated rates right up to the regulator's first attempt to correct market failure in 2011. It is both a testament to the company's instincts of survival and a miracle that it lived to see the day!

[1] Icasa Draft Call Termination Regulations, 10.4.2013 – www.icasa.org.za

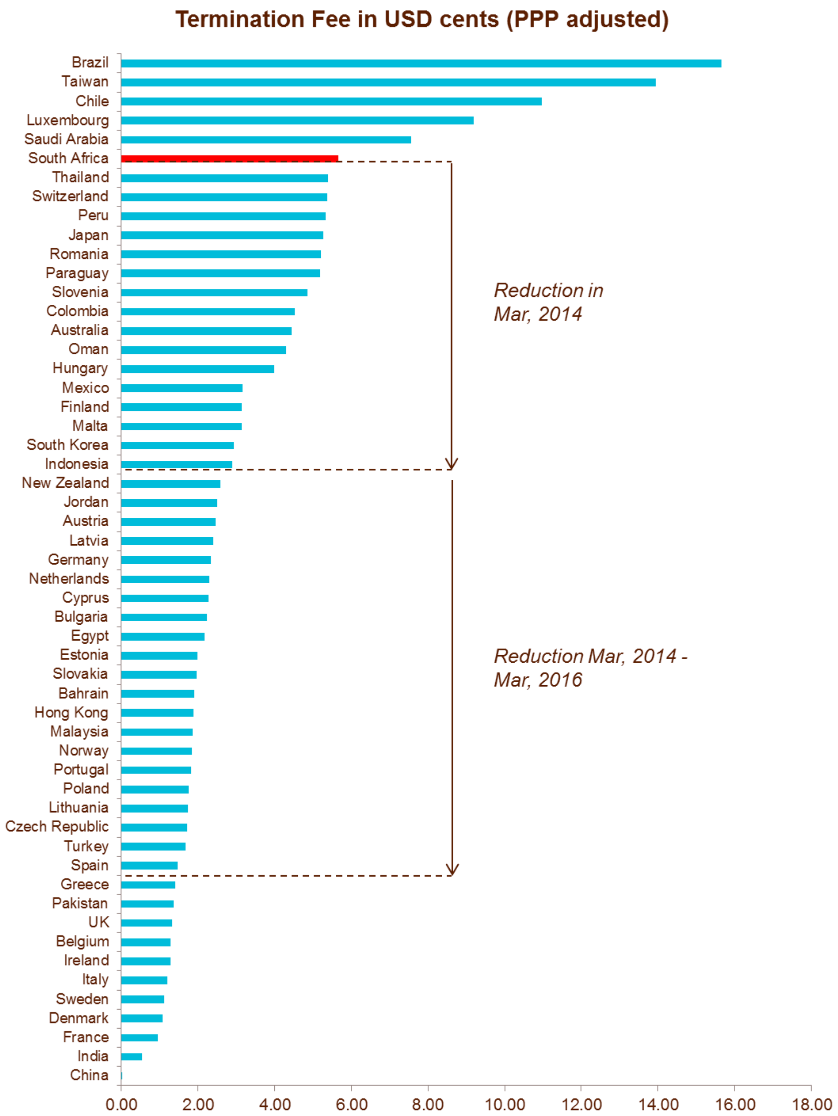
Table 1 – Second termination rate glide path proposed by ICASA

Termination Rate Per Minute	Vodacom / MTN	Cell C / Telkom Mobile	% Reduction	% Asymmetry
March, 2013	40c	44c	29%	10%
March, 2014	20c	39c	50%	95%
March, 2015	15c	33c	25%	120%
March, 2016	10c	26c	33%	160%
March, 2017	10c	20c	-	100%
March, 2018	10c	14c	-	40%
March, 2019	10c	10c	-	-

Source: First Avenue analysis, Icasa

Current termination Fees in SA are not yet globally competitive as shown in Figure 2 below. The proposed reductions will place SA into the lowest quartile of MTRs globally. Countries with low termination fees such as France and India are known for having low tariffs and high levels of competition in market.

Figure 2 –Mobile Termination Rates, SA vs. International Markets, Q2-2013



Source: Ovum, First Avenue Analysis

IMPACT OF THE FIRST ROUND OF TERMINATION RATE CUTS

We first try to understand the impact of the previous round of MTR cuts before forecasting the effect of the next set of cuts. By all measures, it does appear that the price per minute of mobile voice calls did indeed decrease since the introduction of the first round of termination rate cuts. As shown in Table 2 below, effective tariffs for prepaid calls reduced from R1.37 to R1.04 (24%) between June, 2010 and June, 2012. This is less than the 37% reduction in MTRs; therefore, the full termination rate reduction was not passed onto the consumer. Interestingly, both total prepaid revenue and minutes increased – we explore the reason for this in the sections that follow.

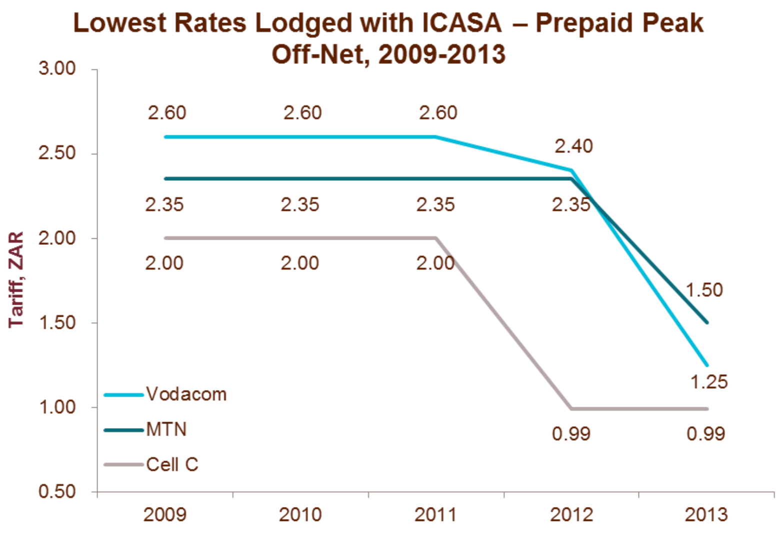
Table 2 – Effective tariff for prepaid voice calls in SA

	Jun-10	Dec-10	Jun-11	Dec-11	Jun-12	% Change
Total Prepaid Revenue (Rand Mil)	12,712	14,399	13,987	15,371	15,047	18%
Total Prepaid Minutes (Mil)	10,572	14,100	14,252	16,935	16,458	56%
Effective Tariff (Rand)	1.20	1.02	0.98	0.91	0.91	-24%
Effective Tariff (Rand incl. VAT)	1.37	1.16	1.12	1.03	1.04	-24%
Peak Termination Charge	0.89	0.89	0.73	0.73	0.56	-37%

Note: Includes effect of free minutes and bonus airtime
Source: ICASA, based on MTN, Cell C and Vodacom data

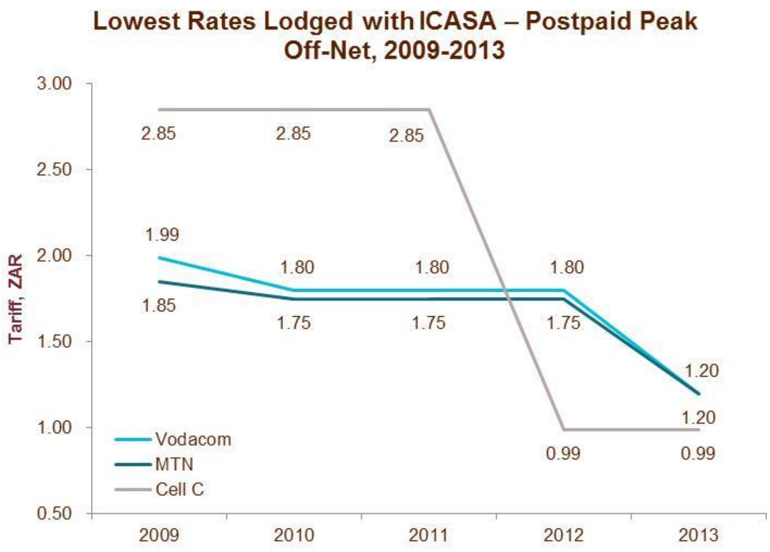
Cell C played an important role, especially in 2012, by introducing a 99c per minute tariff offering a single rate to all networks (see Figure 2 and Figure 3). This helped with reducing the complexity and lack of transparency of existing tariff plans. As shown, tariffs lodged with ICASA by MTN and Vodacom have been reduced substantially in 2013 after Cell C introduced the 99c tariff. Prior to this, lower prices were passed on through promotions and free minutes. However, as shown in Figure 2 and Figure 3, the real price competition has only begun in 2012. Alan Knott-Craig (Cell C CEO) mentioned in a recent conference that it has taken 18 months for the market to respond the 99c tariff – they have grown their base by 33% (1.8 million customers since) over this period.

Figure 2 – Prepaid Peak Off-Net Tariffs (including VAT)



Source: Cell C presentation at 2013 MyBroadBand conference

Figure 3 – Postpaid Peak Off-Net Tariffs (including VAT)



Source: Cell C presentation at 2013 MyBroadBand conference

Even though tariffs have declined between 2009 and 2013, indications are that SA remains amongst the most expensive countries in the world for local mobile phone calls. An indicator of this is the pricing differential between local calls and international calls. Operators are able to offer lower rates for calls to the USA, UK and Nigeria (see Table 3) than calls on their own network (on-net) or calls to other local networks (off-net). Data published in the 2013 ITU Measuring the Information Society report also shows that South Africa is ranked 10th most expensive out of 161 countries using a standard mobile voice usage basket when measured in PPP Adjusted USD terms.

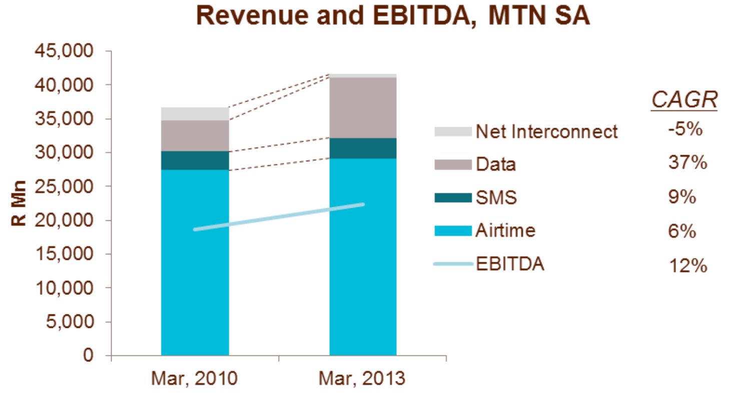
Table 3 – Call Prices to International Destinations

	On-Net Call	Off-Net Call	Call to USA	Call to UK	Call to Nigeria
MTN One4All	R1.20	R1.20	R0.75	R0.75	R0.75
Vodacom	R1.20	R1.20	R0.89	R0.89	R0.89
Cell C 99c for Real	R0.99	R0.99	R0.99	R0.99	R0.99
Telkom Mobile Sim Sonke	R0.29	R0.75	R3.50	R2.50	R2.50

Note: Cheapest prepaid package selected.
Vodacom international rates only applicable with R5 monthly fee
Source: Company websites (as at 23.10.2013)

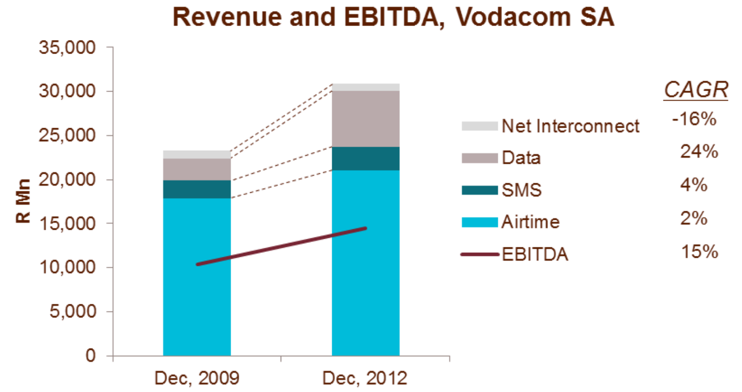
Despite the reduction in tariffs, both MTN SA and Vodacom SA have grown EBITDA by 12% p.a. and 15% p.a. respectively between 2009 and 2012. Figure 4 and Figure 5 show the key drivers of this EBITDA growth. One may therefore conclude that both operators managed to navigate through the first termination rate glide path quite well. Data growth has been a major contributor towards this achievement. Growth in airtime revenue (albeit at a slower rate than in the past) together with greater cost efficiency also contributed towards the higher EBITDA. The impact of lower Net Interconnect revenue was limited if not insignificant. Handset revenue was not considered as it is skewed by subsidisation of handset costs offered on contract.

Figure 4 – Financial Performance of MTN SA during First Termination Rate Glide Path



Note: SMS and Net Interconnect as at Mar, 2012
Source: MTN SA Financial Results

Figure 5 – Financial Performance of Vodacom SA during First Termination Rate Glide Path



Note: Net Interconnect as at Dec, 2011
Source: Vodacom SA Financial Results

However, drilling deeper into Airtime revenue paints a difference picture about the financial performance of MTN and Vodacom during the first termination rate glide path. Airtime is remains a very significant contributor towards revenue and EBITDA accounting for more than 60% of service revenue. In Table 4 and Table 5, we decompose airtime revenue in its 3 constituents (Number of Subscribers, Minutes of Use, and Price per Minute). From this analysis, it is clear that termination rates have successfully reduced the effective tariffs of MTN SA and Vodacom SA. The lower prices did not result in any increase in minutes of use indicating low levels of elasticity. However, it was the high growth in number of subscribers that enabled airtime revenue to grow at single digit rates since 2009. This is unlikely to be repeated as penetration levels in SA are already well above 120% and recent quarterly results have shown a decline in number of subscribers.

Table 4 – Constituents of Airtime Revenue during First Termination Rate Glide Path, MTN SA

	FY Dec, 2009	FY Dec, 2010	FY Dec, 2011	FY Dec, 2012	HY June, 2013	% Change
Monthly Minutes of Use (excl. free mins)	64	71	69	70	64	0%
Effective Price per min (ZAR incl. VAT)	1.60	1.48	1.35	1.22	1.14	-28%
# of Subscribers ('000)	16,067	18,842	22,033	25,421	25,001	56%

Source: Company reports, First Avenue Analysis

Table 5 – Constituents of Airtime Revenue during First Termination Rate Glide Path, Vodacom SA

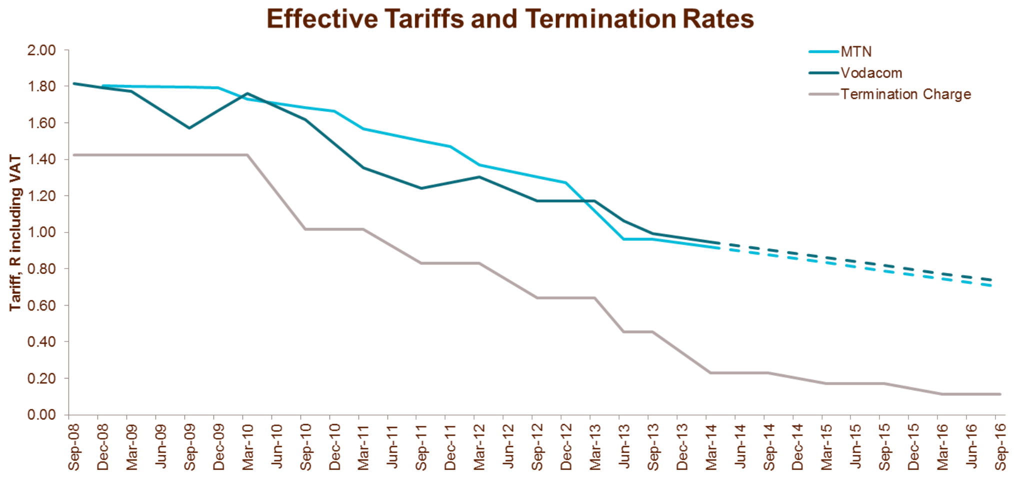
	FY Mar, 2010	FY Mar, 2011	FY Mar, 2012	Q2 June, 2013	% Change
Monthly Minutes of Use (incl. free mins)	114	119	114	112	-2%
Effective Price per min (incl. VAT)	1.46	1.29	1.12	1.06	-27%
# of Subscribers ('000)	19652	22880	28941	30521	55%

Source: Company report, First Avenue Analysis

POSSIBLE IMPACT OF THE SECOND ROUND OF TERMINATION RATE CUTS

In this section, we provide a point of view on the financial impact of the next round of MTR cuts on MTN and Vodacom. First, we try to model the reduction in effective tariffs assuming the same level of termination rate pass-through that occurred during the first round of cuts. Our analysis shows conservatively that tariff should decline from R1.06 – R1.14 per minute to 88c (19% reduction) by 2014 and 75c (29% reduction) by 2016. We feel that this could be an even steeper decline if smaller operators such as Cell C and Telkom Mobile are aggressive with pricing and pass on the full asymmetry and termination rate reductions to consumers. In fact, Telkom Mobile has recently introduced an enhanced Sim Sonke plan that enables calls to any network for 75c per minute even when roaming nationally on the MTN network.

Figure 6 – Effective Tariff Forecast



Source: First Avenue analysis, Operator financial reports

Assuming flat subscriber growth and increase in usage, the net impact of these reductions will be a reduction in airtime revenue of R6bn and R8.5bn for MTN SA and Vodacom SA respectively. This impact could be worse if these operators lose market share or need to lower tariffs further than forecasted. To put these reductions in perspective, data revenue would have to grow between 65% and 70% over the next three years in order to absorb this impact on EBITDA. However, this is unlikely given that SA data revenue growth has already slowed to 16%-20% p.a. as competition has intensified over the past year. Given recent capex and opex growth of approx. 5%-11%, we expect that EBITDA will decline over the next 3 years as a result. Asymmetry will also move Vodacom and MTN SA from being net receivers of interconnect to net payers of interconnect which will further impair margins. The level of EBITDA decline will depend on efficiency gains achieved through cost cutting; we anticipate an EBITDA decline of more than 15%.

Vodacom SA is most exposed with 89% of EBITDA generated in SA. In contrast, MTN has 25% of its EBITDA generated in SA. Furthermore, MTN is spending R 6.4bn p.a. and Vodacom is spending ~R7Bn p.a. on capex. Our view is that this level capital expenditure will not be rewarded with a return above cost of capital given the changing industry dynamics. As a result, the next few years will be challenging for both operators and there will be greater reliance on foreign operations and / or new operations to compensate for the lack of growth in South Africa.

From a strategic point of view, the question may arise as to whether Cell C and Telkom Mobile have sufficient 'firepower' to enter into another price war. As shown in Table 6 below, their profits before fixed cost will increase substantially with the termination rate reduction if current tariffs are maintained. They will also become a net recipient of interconnect / termination fees. Our view is that there is sufficient scope to pass on a large proportion of the termination rate reductions in order to gain critical market share. Asymmetry should allow them to pass on at least the full benefit of termination rate cuts. Cell C also recently received an equity investment of $350Mn from its largest shareholder as well as a R2.2bn long term financing package allowing it to enhance the quality of its network.

Table 6 – Cell C Cost Structure for Off-Net Calls if Tariff Remain Unchanged

	Current	Mar, 2014	Mar, 2015	Mar, 2015
Tariff	99c	99c	99c	99c
VAT	12.2c	12.2c	12.2c	12.2c
Distribution cost per min.	26c	26c	26c	26c
Termination charge per min.	40c	20c	15c	10c
Profit before fixed costs per min.	20.8c	40.8c	45.8c	50.8c

Source: Based on presentation by Alan Knott Craig published on MyBroadband.co.za

FINAL THOUGHTS

We end with a quotation from Charlie Munger who is one of the investors we admire greatly:

*"Charles Darwin paid particular attention to **disconfirming evidence**. Objectivity maintenance routines are totally required in life if you're going to be a great thinker. There, we're talking about Darwin's special attention to disconfirming evidence and also about checklist routines. Checklist routines avoid a lot of errors. You should have all this elementary wisdom and then you should go through a mental checklist in order to use it. There is no other procedure in the world that will work as well."*

As investors who need to be objective at all times, the greatest test of temperament is whether new information represents disconfirming evidence or discomforting evidence. If the recent news flow were purely discomforting, then the investor should ignore it as the attractive industry dynamics would remain favourable to MTN and Vodacom. However, if these signals are severe enough to provide disconfirming evidence, then one must reappraise at the investment case objectively and act accordingly.

Our view is that the moves by ICASA send a very strong signal that the high tariffs in SA will not be tolerated indefinitely. We wait to see whether this will be supported by other oversight bodies such as the Competition Commission. We also observe similar moves by regulators in other geographies such as Nigeria in particular. Our objective assessment is that these signals cannot be ignored and the changes by ICASA will stimulate more competition than has ever been seen in the local mobile industry. The market appears to be ignoring the regulatory action possibly because it sees this as discomforting news more than disconfirming of the investment case – this is largely because of the long, impressive run that MTN and Vodacom have had in the past and inertia in believing that the future might be different.

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Registration Number 2008/027511/07

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