November 2018

Safaricom Plc
"Remaining Gem?"

Bloomberg Ticker	SAFCOM KN
Reuters Ticker	SCOM.NR

Share Statistics	
Fair Value (KES)	**33.15**
Current price (KES)	25.00
Upside (%)	32.6
Market Cap (KES B)	1,001
Market Cap (USD B)	9,9
Year end	March
Float (%)	25.1
Foreign ownership (%)	11.5
3-month Avg Trading Val (USD M)	2.0

Safaricom announced its 1H19 results this morning posting an impressive **20.2% y/y growth in its net earnings to KES 31.5B; 2.7% lower than our estimates of KES 32.4B.** The impressive performance was attributed largely to **cost containment** which saw the firm **raise its EBITDA margin 320bps y/y to 50.5%** as well as a relatively **strong 7.7% y/y growth in service revenue to KES 118.2B.**

Sitting on a monumental **cash balance (+ 30.7% y/y to KES 36.7B)** the market was looking forward to an interim/special dividend from the telco; though this was not forthcoming. With the telco anticipated to **raise its free cash flow**, pegged on growing bottom-line and easing capex intensity, the **market may be anticipating a special dividend** in FY19.

Service revenue; cannibalization commences

Subdued growth in voice revenue as SMS revenue dips marginally: With both voice and SMS products arguably mature products, their revenues were anticipated to plateau and possibly dip. Voice revenue edged up 1.4% y/y to KES 48.0B with voice ARPU dipping 0.4% y/y amidst rising active voice customers (+4.2% y/y to 23.17M). SMS revenue ebbed 1.2% y/y to KES 8.8B; falling slower than our estimated 4.5% y/y decline. With the active SMS customers rising 2.0% y/y, its ARPU declined 2.0% y/y as the platform is continuously cannibalized by OTTP platforms.

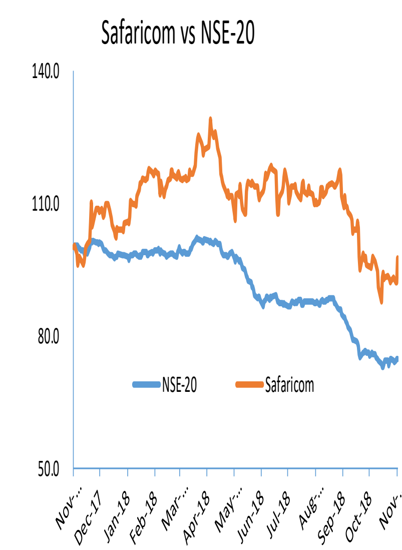
M-Pesa continues impressive growth: Despite the telco losing overall market share to its competitors, it maintains a strong grip on mobile money market; a fete largely cemented by its number of M-Pesa agents that grew 9.9% y/y. Leveraging on the large number of agents as well as M-Pesa availability, the telco managed to grow its active M-Pesa customers by 8.8% y/y to 21.0M customers. The telco intends to entice more usage of M-Pesa services and is content with slowly rising revenue from withdrawals (+10.2% y/y) which is seen as more customers retaining larger M-Pesa balances that translates to increased transactions per customer (+14.8% y/y to 12 transactions per month in 1H18).

With increased usage of M-Pesa services, P2P continues to register impressive revenue growth (+26.2% y/y) though lipa na M-Pesa (LNM) steals the show with a revenue surge of 49.9% y/y. LNM, though rallying historically, has lower yields per transaction translating to relatively slower growth in M-Pesa ARPU (+10.2% y/y) compared to 5-year historical CAGR of 15.4%.

The rising ARPU, transactions per user per month and number of users translated to a growth of 18.2% y/y to KES 35.5B in M-Pesa revenue; contributing 30.0% of service revenue.

Mobile data; increased usage at the expense of rallying top-line, for now: Leveraging on its expansive mobile data coverage (96% coverage, 3G coverage of 91% and 4G coverage of 53%) the telco managed to marginally grow its active mobile data customers by 3.8% y/y to 17.6M. The richer data offers by the firm resulted in a surge the MB usage per user by 67.4% y/y to c.640MB in 1H19. Management asserts that the new data offers are as a response to customer needs in the market. However, with the telco lowering data offerings at

Price Trend



Source: (Bloomberg)

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the same time as its competitors, we may assume that the newer offerings are a move by Safaricom to protect its market share in the vast growing space of mobile data as its competitors turn up the heat via price competition. Despite the richer offers to its consumers, the telco managed to raise its mobile data ARPU by 7.9% y/y. Mobile data revenue grew 10.8% y/y to KES 19.5B; largely underperforming our estimates of KES 22.2B. The telco maintains that, to encourage mobile data usage, it'll have to consider enhancing the offerings to its consumers and contend with slower short-term growth in mobile data revenue to achieve faster growth in the long-term.

Fixed data, fastest growing revenue steam: Still in the growth phase, fixed data revenue leapt 21.1% y/y to KES 3.9B on the back of increased connectivity (>79k homes and >2k commercial buildings connected). The rally in customer numbers came from the 17.0% y/y increase in fibre laid down to 5,500Kms, extending the coverage to 38% (+400bps y/y). Safaricom has managed to raise its market share in this space to 21.2% (behind Wanachi Group's 30.4%) despite being a relatively new entrant into the space. The telco is increasingly looking to entice more consumers with bundled FTTH packages that now encompass mobile data, voice and SMS (on the option of the consumer), content partnering with Kwese and Showmax as well as the enabling of smart homes which incorporate surveillance.

Cost containment rallies bottom-line: With the telco looking at new products in different market spaces, its ability to keep costs contained is quite commendable. The firm's direct operating costs came off 1.5% y/y to KES 35.1B (lower than our estimates of KES 38.0B) whilst its operating costs edged up 3.9% y/y to KES 25.8B. With the top-line (+7.2% y/y) outpacing the rising costs, the firm's EBITDA margin rallied 320bps y/y to 50.5%; ahead of our 49.2% estimate.

Capex intensity continues to cool off: Capex dipped marginally to KES 17.0B (-2.3% y/y) resulting in a 140bps y/y decline in capex intensity to 13.8%. A bulk of the capex (51.2%) was spent on enhancing radio access leading to a 61.8% y/y gallop in the firm's 4G coverage sites to 2,353. The firm intends to maintain its status as the fastest and most accessible data provider to raise data consumption.

Is the burgeoning bottom-line sustainable?

New products; exciting, not yet rewarding; Management is still eyeing lucrative returns from the relatively underserved agribusiness segment. Through its *Digifarm* platform, the telco has managed to sign up c.1M farmers with the potential to raise this to c.20M. It plans to marry the agribusiness platform with *Masoko* (the e-commerce platform) to enhance utility of the two platforms.

With logistics standing as the most challenging hurdle for *Masoko*, the firm intends to use its wide array of agents and dealers as possible distribution and collection points. Despite the re-assuring statements from management, the new products' contribution to the firm's top-line remains to be seen; which may surpass current expectations, or fail altogether; as is the nature of market disruptions.

Fixed data: The recent enactment of higher excise taxes on data in the country may curtail the growing revenue line item. The economy is continuously grappling with lower disposable incomes as a result of the newly enacted taxes on various commodities as well as inflation which may curtail the uptake of fixed data. However, management has maintained its guidance for the full year numbers, suggesting little impact of the new taxes on the uptake of fixed data in the immediate short-term. As a reprieve, we don't see the current tax regime being a sustainable measure for the Government in raising its revenues. As such, we project an amendment of the same leading to largely unchanged uptake for fixed data in the long-term. Consequently, we expect the line item to continue on the robust growth in the medium-term, before normalizing in the long-run.

M-Pesa: The avenues for growth in M-Pesa lie in LNM with the platform's full utility in the country barely scratching the surface. The telco intends to enhance the user experience with improved M-Pesa API, QR Scancode and progress on the social media platform dubbed *Bonga*. Safaricom intends to launch M-Pesa overdraft facility in the coming week following final approval by the CBK. In addition, the firm intends to announce a partnership with Western Union (after recently partnering with PayPal) to enhance global and regional payments.

With the telco maintaining its market leadership position on mobile money facilitated by its vast number of M-Pesa agents, as well as the lack of agency inter-operability, Safaricom is likely to keep on milking the cash-cow.

Mobile data: Safaricom intends to make data more affordable to a bigger number of its consumers to enhance data consumption. Despite the current data consumption recording leaps, there remains headroom to grow this number given the huge number of customers that consume less than 100MBs per month (c.70%). Safaricom remains a market leader in mobile data with some of the data offerings being a first in the market (e.g. 1GB free data on a customer's birthday, one week extended roll over period for data products and ability of the customer to dictate the desired speed based on cost). The new offerings are anticipated to record slowed growth in mobile data revenue in the short-term, though increased usage of mobile data by its growing subscriber base is anticipated to rally mobile data revenue in the long-run.

Cash rich and asset light investments; Special Dividend, Acquisition, or both?: The telco is currently sitting on a rather healthy sum of cash balances (KES 36.7B in 1H18) and is projected to rise going forward on account of sustained profitability growth and easing capex intensity. The market was looking forward to a special/interim dividend but our optimistic view is that it may be announced in FY19 results. The telco may be looking to surge the revenue growth of fixed data and could consider taking up Wananchi Group's Zuku; with the owners looking to exit the firm.

Though alluring (the combined market share of 51.7% upon full acquisition of Zuku), Safaricom may be looking at growing its market share organically, which may be cheaper than acquisition and allows it (Safaricom) to control the quality service. If/when the special dividend fails to materialize, investors should take solace in that the firm is looking at more attractive ventures that will eventually enhance value. The aforementioned are mainly "what if" scenarios which may or may not occur; but the only certain thing about the future is its uncertainty.

Is Safaricom still a Gem?: With a very high ROE (53.6%) and impressive net earnings margin (25.6%), the firm ticks most boxes for fundamental investors. There exists some headwinds in the current nature of taxes imposed in the country as well as possible adverse regulation. The telco has shown in the past its ability to navigate through uncertain waters. The new revenue avenues that the telco is increasingly looking at need to be customer-centric, facilitated by big data analytics that the firm is currently employing.

We maintain our **Strong Buy recommendation** on the counter despite the potential headwinds that the firm may be facing. The strong numbers announced pushed the counter's price to KES 24.75 (+5.3% d/d), though deeply discounted based on our **fair value of KES 33.15.**

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1H19 Financials

Income Statement	1H18	ApexAfrica Estimates	1H19	Deviation from estimates	y/y change
	KES B	KES B	KES B	%	%
Voice revenue	47.4	49.3	48.0	-2.5	1.4
SMS revenue	8.9	8.5	8.8	3.5	-1.2
Mobile data revenue	**17.6**	**22.2**	**19.5**	**-12.5**	**10.8**
Fixed service revenue	**3.2**	**4.0**	**3.9**	**-1.0**	**21.1**
M-PESA revenue	**30.1**	**37.5**	**35.5**	**-5.2**	**18.2**
Other service revenue	2.6	3.3	2.5	-24.6	-5.3
Service revenue	**109.7**	**124.7**	**118.2**	**-5.2**	**7.7**
Other income	5.0	4.9	4.8	-1.6	-4.2
Total revenue	**114.7**	**129.6**	**123.0**	**-5.1**	**7.2**
Direct cost	(35.6)	(38.0)	(35.1)	-7.7	-1.5
Operating costs	(24.8)	(28.1)	(25.8)	-8.1	3.9
EBITDA	**54.3**	**63.5**	**62.1**	**-2.1**	**14.5**
Depreciation and amortization	(16.7)	(17.7)	(17.6)	-0.6	4.9
EBIT	**37.5**	**45.8**	**44.6**	**-2.7**	**18.7**
Net finance income/(cost) & associate profit	0.3	0.03	1.4	-	-
Pretax profit	**37.8**	**45.8**	**46.0**	**0.3**	**21.5**
Tax	(11.6)	(13.5)	(14.5)	7.4	24.5
Net Income	**26.2**	**32.4**	**31.5**	**-2.7**	**20.2**
EPS (KES)	**0.65**	**0.78**	**0.79**	**0.7**	**20.2**

Statement of Financial Position	1H18	2H18	1H19	h/h change	y/y change
Shareholder funds	**94.8**	**123.9**	**111.3**	**-10.1**	**17.4**
Non-current assets	138.6	140.0	139.6	-0.3	0.8
Current assets	47.6	27.5	59.4	116.2	24.8
Current liabilities	91.3	43.5	87.7	101.4	-4.0
Net assets	**94.8**	**123.9**	**111.3**	**-10.1**	**17.4**

Statement of Cash Flows	1H18	2H18	1H19	h/h change	y/y change
Cash flows from operating activities	**49.5**	**42.5**	**55.1**	**29.8**	**11.3**
Cash flows used in investing activities	(17.4)	(19.0)	(16.9)	-11.4	-3.1
Cash flows from financing activities	(10.0)	(42.0)	(11.1)	-73.7	10.4
Net change in cash and cash equivalents	**22.1**	**(18.6)**	**27.2**	**-246.4**	**22.9**
Opening cash and cash equivalents	6.0	28.1	9.5	-66.2	59.4
Closing cash and cash equivalents	**28.1**	**9.5**	**36.7**	**286.1**	**30.7**

Ratios and Margins	1H18	2H18	1H19	h/h change	y/y change
EBITDA margin (%)	47.3	49.2	50.5	1.3	3.2
EBIT margin (%)	32.7	35.1	36.2	1.1	3.5
Net income margin (%)	22.8	24.4	25.6	1.2	2.8
ROaA (%)	30.1	32.9	34.4	1.5	4.2
ROaE (%)	51.8	53.2	53.6	0.4	1.7
Current ratio (x)	0.5	0.6	0.7	0.0	0.2
P/E (x)			20.2		
P/B (X)			9.0		

Source: Company Filings, ApexAfrica Research

Appendix

Investment ratings

✦ **Strong Buy:** Issued on counters with strong fundamentals with a fair value above 20.0%. The counter is anticipated to register strong growth with and is currently undervalued.

✦ **Buy:** Issued on counters with strong fundamentals whose upside lies between 10.0% and 20.0%. The same may be issued for counters with challenged fundamentals whose upside is over 20.0%. Such a scenario is targeted for risk neutral investors.

✦ **Accumulate:** Issued on counters with an upside of between 5.0% - 10.0%. The counter may be facing contracting avenues for growth with a tepidly growing bottom-line.

✦ **Hold:** Issued on counters with an upside of between 0% and 5.0% with limited avenues for growth. Contracting bottom-line with an attractive dividend yield of about 5.0%.

✦ **Lighten:** The company is anticipated to record a moderate downside on its fair value, though it may have strong fundamentals.

✦ **Sell:** The counter currently has weak fundamentals coupled with significant potential downside.

Disclaimer

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