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# Topical Note

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### Safaricom Plc

**“Is Safaricom losing its grip?”**

**Part 1: Pricing Power Explained**

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## Executive Summary

- Our 4<sup>th</sup> Topical Note answers the question “**Is Safaricom losing its grip?**” This is in direct reference to investor concerns regarding Safaricom PLC's “Safaricom” declining market share in some of its business lines which in turn has had a negative impact on service revenue growth.
- The ultimate concern for investors is that Safaricom's dominance is under threat and so is its medium to long term financial performance.
- We identify the Kenya telecommunications sector as an oligopoly with few players, homogenous products and some degree of pricing power.
- The underlying question we wish to answer is whether Safaricom has **pricing power** in specific business lines; Voice calls, SMS, M-PESA as well as both mobile and fixed data.
- This is the **first of a 6 part report series on pricing power** as we build towards the release of the company's Half Year financial results on 3<sup>rd</sup> November 2018.
- Pricing power is broadly defined as the ability of a company to raise prices over time without reducing demand for its products.
- We use the **Herfindahl Hirschman Index (HHI)** theoretical framework to determine each business line's concentration levels.
- On the specific business lines, Safaricom has pricing power in the SMS and M-Pesa (mobile money transfer) businesses. Safaricom is fast gaining market share in fixed data and the likelihood of developing pricing power in the long-term is high.
- What is clearly evident from recent trends is that voice calls and SMS revenues are under threat not only because of competition but also technological advancements and changing customer preferences.
- Declining Voice and SMS traffic over the last one year is an indication of growing preference for Over the Top Services (OTT) because of comparatively lower costs and improved user experience.
- To investors, Safaricom's pricing power or lack of it is of great importance. Not only does it have a direct impact on the company's market share but also its revenues and overall company profitability.
- For the management of the company, the concern will be how to maintain existing or regain lost market share.
- Also of concern is how sustainable is the company's pricing power in the business lines that it holds this advantage. History has shown that pricing power in the Kenya telecommunications industry can be easily eroded.

## Pricing power explained

- **Pricing Power** is broadly defined as the ability of a company to raise prices over time without reducing demand for its products.
- It's related to the economic concept of "price elasticity": that is how sensitive are customers to price variations.
- We briefly explain the structure of the Kenya telecommunications industry (Table.1) and use a theory advanced by Herfindahl-Hirschman Index (HHI) to determine market concentration levels for the entire mobile telecommunications industry and selected products.
- In consideration of concentration levels, we conclude that the Kenya telecommunications industry is an **oligopoly** with a moderately high degree of market concentration.
- A company that offers a **unique product** or has **few competitors** typically has strong pricing power and it could raise prices without diminishing demand for the product. However this is not the case with Safaricom.

**Table.1: Kenya mobile telecommunications sector is an oligopoly with high concentration**

Market Structure	Number of Players	Degree of Product	Barriers to Entry	Pricing Power of the Firm	Non-Price Competition	HHI Index
Perfect competition	Many	Homogeneous/ Standardized	Very Low	None	None	<1,000
Monopolistic Competition	Many	Differentiated	Low	Some	Advertising and Product Differentiation	1,000-1,800
<b>Oligopoly</b>	<b>Few</b>	<b>Homogeneous/ Standardized</b>	<b>High</b>	<b>Some/ Considerable</b>	<b>Advertising and Product Differentiation</b>	<b>&gt;1,800</b>
↓						
<b>Kenya Telecoms</b>	<b>Few - 6 operators</b>	<b>Homogeneous- 2G, 3G, 4G, fibre, voice, SMS &amp; mobile money</b>	<b>High license fees, capital investment &amp; infrastructure costs</b>	<b>Some - Pricing power</b>	<b>Advertising and multiple products offering</b>	<b>4,973</b>
Monopoly	One	Unique Product	Very High	Considerable	Advertising	10,000

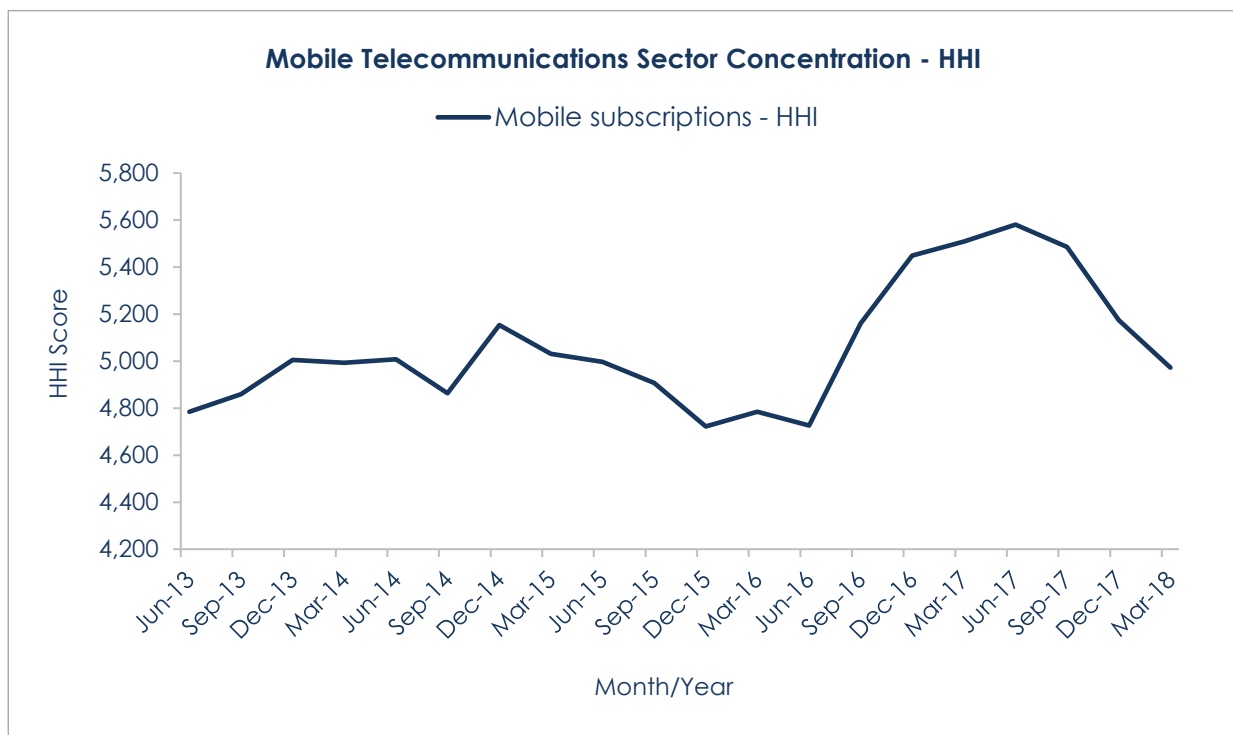
Source: Communications Authority of Kenya (CA), Sterling Research & CFA Institute

**Table.2: Kenya mobile telecommunications sector highly concentrated**

Operator	Market Share (%)
Safaricom Limited	67
Airtel Networks Kenya Limited	19.7
Telkom Kenya Limited (Orange)	8.6
Others	4.7
<b>HHI Index (Concentration)</b>	<b><math>67^2+19.7^2+8.6^2+4.7^2= 4,973</math></b>
Range	Concentration
<1000	Low
1000- 1800	Medium
>1800	High
10,000	Complete (100%)

Source: Communications Authority of Kenya (CA), Sterling Research & CFA Institute

**Fig.1: Kenya mobile telecommunications sector - Concentration declining, competitiveness rising**



Source: Communications Authority of Kenya (CA), Sterling Research & CFA Institute

### Does Safaricom possess pricing power?

- We also use HHI to assist us determine whether Safaricom holds pricing power in each of its different service lines (Table.3).
- Safaricom faces stiff competition in the voice and mobile data business where price competition has resulted in a significant loss of market share.
- Its dominance in M-Pesa (particularly mobile money transfer) and SMS is clearly evident.
- On fixed data, Safaricom is the “market challenger” and is fast capturing market share base because of the competitive advantage it holds in network coverage and service reliability.

**Table.3: Safaricom’s service revenue pricing power analysis summary**

	Service	HHI Score	Market Concentration	Conclusion
1.	<b>Voice Calls</b>	5,260	- Moderately high but declining	<ul style="list-style-type: none"> <li>- Relatively low pricing power.</li> <li>- High customer price sensitivity.</li> <li>- High risk of loss of market share.</li> </ul>
2.	<b>SMS</b>	9,035	- High	<ul style="list-style-type: none"> <li>- High pricing power.</li> <li>- P2P* SMS volumes declining while B2C*volumes growth positive.</li> <li>- Overall industry consumption declining as data supported services gain popularity.</li> </ul>
3.	<b>Mobile Data</b>	5,270	- Moderately high but declining	<ul style="list-style-type: none"> <li>- Low pricing power.</li> <li>- High customer price sensitivity.</li> <li>- High risk of loss of market share.</li> </ul>
4.	<b>Fixed Data</b>	2,397	- Low	<ul style="list-style-type: none"> <li>- No provider holds pricing power.</li> <li>- Price sensitivity low.</li> <li>- Service reliability &amp; network coverage area of competitive advantage.</li> </ul>

Source: Communications Authority of Kenya (CA), Sterling Research & CFA Institute

**\*P2P - Person to person**  
**B2C – Business to customer**

	Service Revenue	HHI Score	Market Concentration	Conclusion
5.	<b>M-Pesa money transfer</b>	6,683	- High	<ul style="list-style-type: none"> <li>- High pricing power.</li> <li>- Low price sensitivity.</li> <li>- Large agent network/discriminatory pricing area of competitive advantage.</li> <li>- Service market positioning appears sustainable in the medium and long-term.</li> </ul>
6.	<b>M-Pesa mobile payments</b>	6,469	- High but declining	<ul style="list-style-type: none"> <li>- Pricing power diminishing.</li> <li>- High risk of loss of market share as Equitel threatens competitive positioning.</li> </ul>

Source: Communications Authority of Kenya (CA), Sterling Research & CFA Institute

### How sustainable is Safaricom's pricing power?

- Safaricom's market positioning in the services where it holds no pricing power or where this power has been declining is under threat in the medium to long-term.
- It is for this reason that we forecast a decline in actual revenues (voice calls and SMS) or a decline in the revenue growth rates (mobile data) by FY2021/22.
- We however expect Safaricom to implement several marketing and pricing strategies to maintain market share.
- In fixed data where Safaricom is not the dominant player, service quality rather than pricing is expected to be the differentiator.

**Next report: "Is Safaricom losing its grip?" - Part 2: Voice Calls - "Dialing the Wrong Number"**



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