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Topical Note

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Safaricom Plc

"Is Safaricom losing its grip?"

Part 3: SMS - "No one's texting"

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Executive Summary

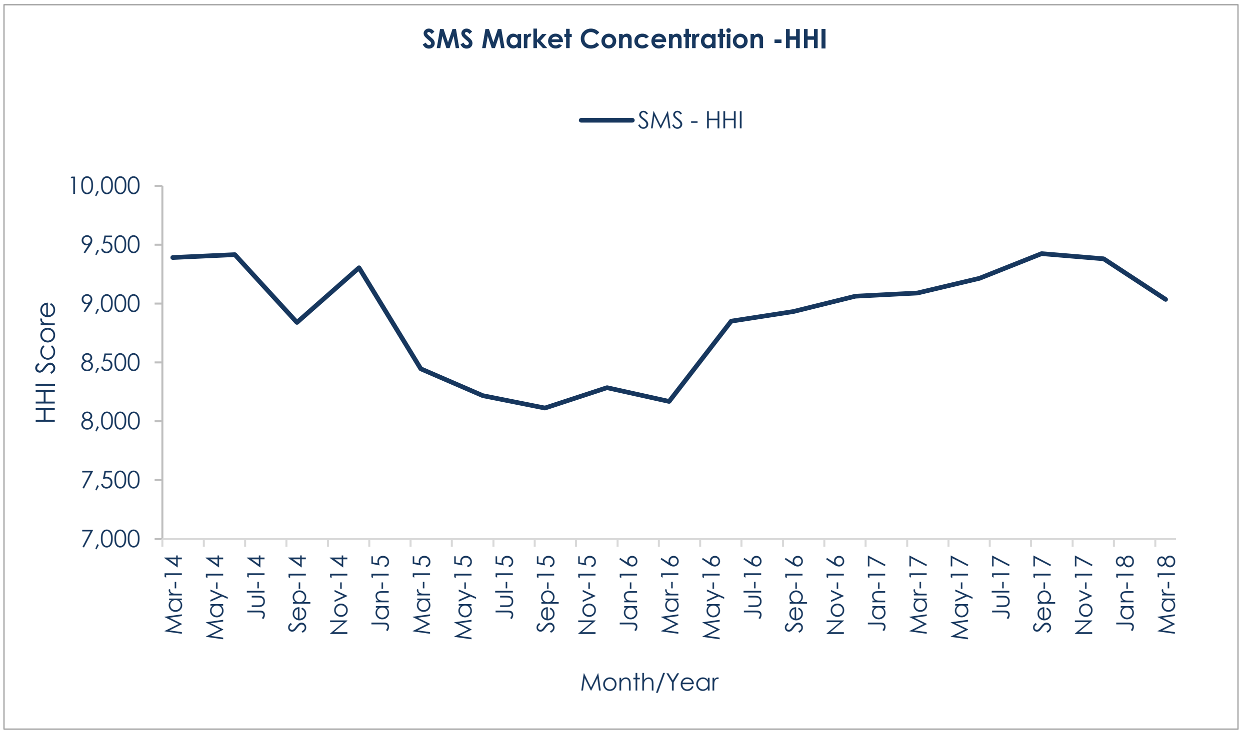
- **Short Message Service (SMS) - "No one's texting"** is the 3rd part of our 6 part series report titled **"Is Safaricom losing its grip?"**
- In the 1st part - **"Pricing Power Explained"** we explained the concept of "pricing power" which we defined as the ability of a company to raise prices over time without reducing demand for its products.
- We used the Herfindahl Hirschman Index (HHI) theoretical framework to determine each business line's concentration levels and identified the levels of Safaricom's pricing power in each business line.
- We covered **Voice calls - "Dialing the Wrong Number**" in the 2nd report and concluded that Safaricom does not hold pricing power as downward tariff adjustments by the competition results in a significant loss of market share as customers are highly price sensitive.
- In this report, **we conclude that the SMS market is highly concentrated and by analyzing SMS traffic market share we identify Safaricom as a dominant player possessing strong pricing power.**
- SMS traffic volumes are on a decline across the telecommunications industry however, as is the case with voice calls because of a growing shift to over the top services (described in the report).
- Person to person (P2P) SMS traffic has been declining while that of business to person (B2C) is increasing.
- Finally, we conclude by mentioning the negative impact of declining traffic volumes on SMS service revenue.

"Is Safaricom losing its grip?"	**Report Title**
Part 1	"Pricing power explained"
Part 2	Voice Calls - "Dialing the wrong Number"
Part 3	**SMS - "No one's texting"**

Short Message Service (SMS) - "No one's texting"

- Safaricom's SMS business is a near monopoly with almost the entire SMS traffic (combined on and off network) flowing through its network (95% as at March 2018).
- The HHI Index for Safaricom SMS stood at 9,035.2 as at March 2018 translating to high concentration with the dominant player possessing strong pricing power.
- The general industry trend in this business line as is the case with voice calls is a growing shift to Over the Top Services (OTT) such as skype, facebook messenger and other data driven mobile device applications.
- We also see a reverse in traffic trends where person to person (P2P) SMS traffic is declining while that of business to person (B2C) is increasing.

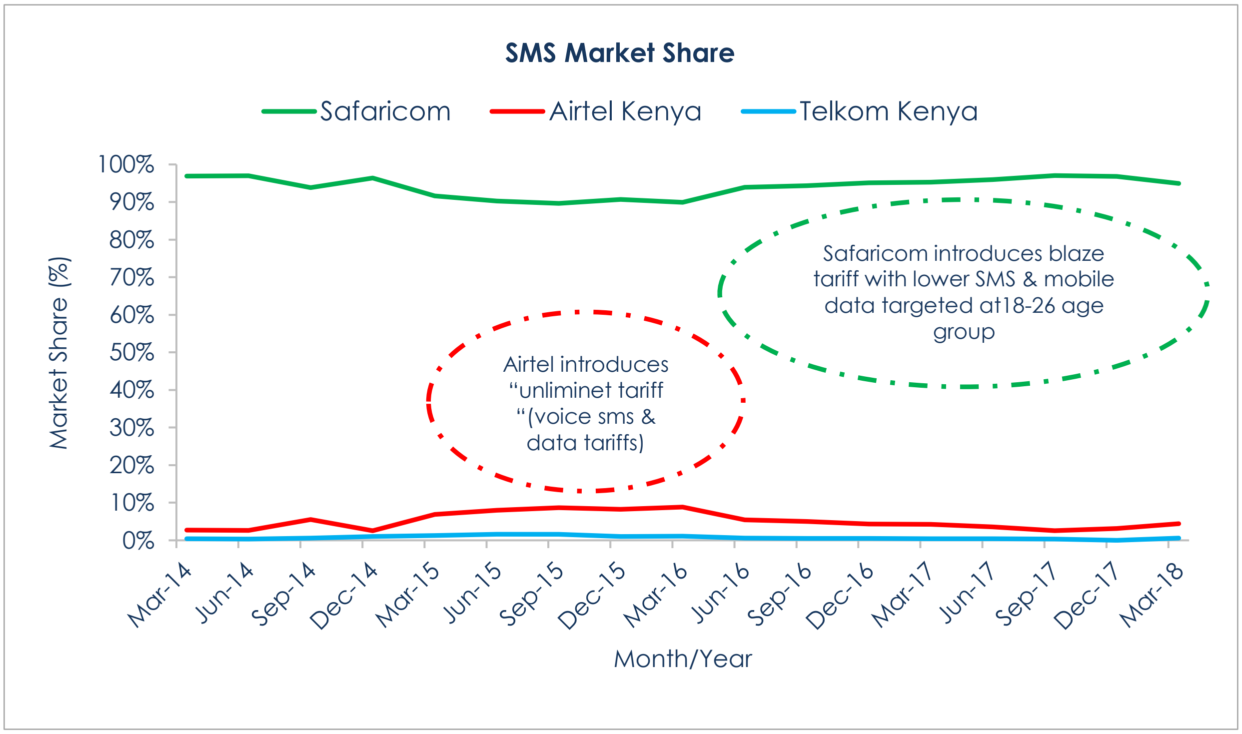
Fig.1: SMS market is a near monopoly with Safaricom the dominant player



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

- We expect Safaricom's to maintain a high market share (90%+) of the total SMS traffic even as Airtel and Telkom make gains in subscriber numbers (mainly attracted by low voice call and mobile data costs).
- Recent price adjustments by all operators in response to an increase in excise duty from 10% to 15% is unlikely to alter demand patterns.

Fig.2: SMS traffic volumes controlled by Safaricom

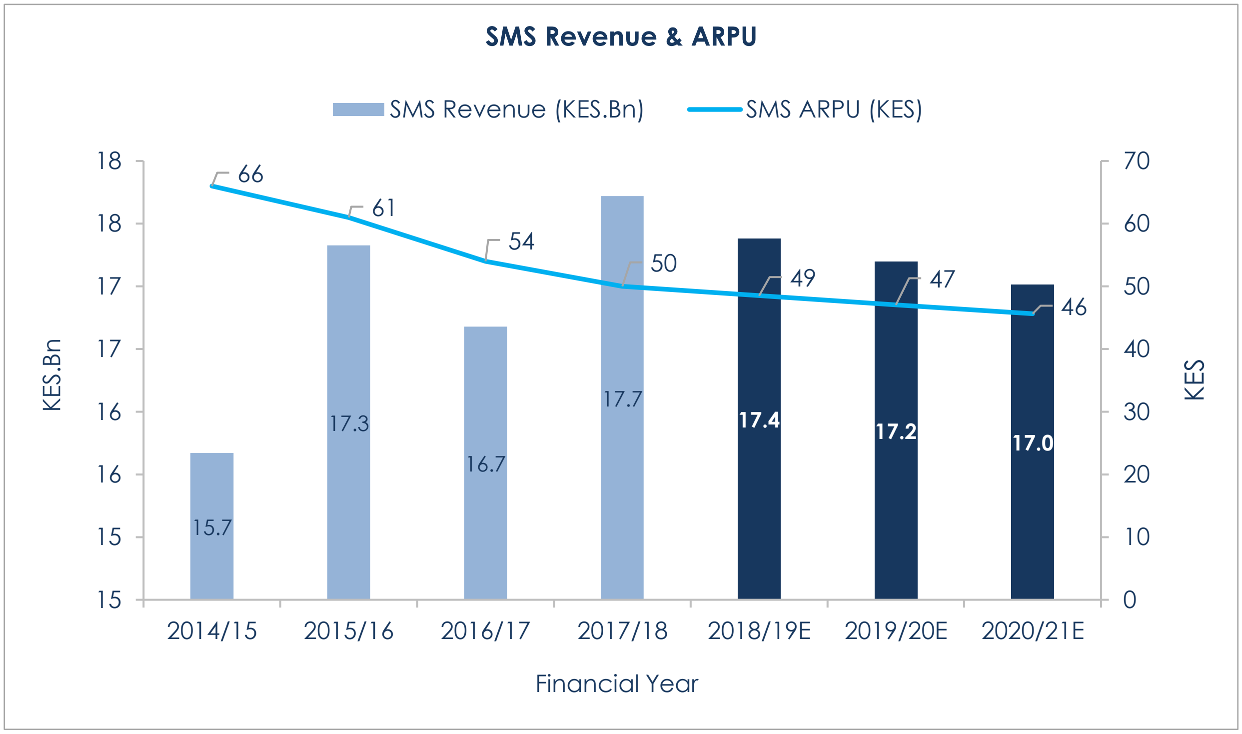


Source: Communications Authority of Kenya (CA)

Lower SMS traffic will hurt SMS revenues

- With a less spending per subscriber and declining traffic volumes, we see a decline in ARPU to KES.47 FY2018/19 from KES.49 the previous financial period.
- This is expected to negatively impact total SMS revenues which we estimate at KES.17.4Bn FY2018/19 a 1.9% decline over the previous year and KES.17.2Bn FY2019/20.
- Contribution to total service revenue over the same period is expected to decline to 7.0% from 7.9% over the previous year.

Fig.3: SMS revenues expected to decline gradually as spending per customer declines



Source: Company filings & Sterling Capital estimates

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