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Sterling Capital Limited

Market Update

Sector: Telecommunications

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Airtel-Telkom Planned Merger

"Is the merger major?"

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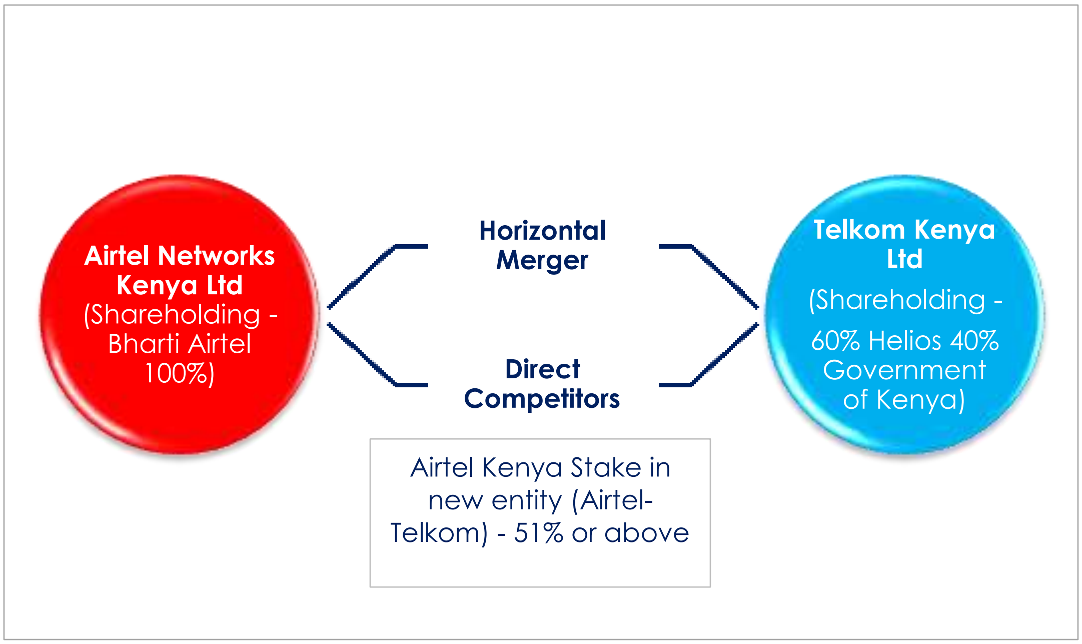
Executive Summary

- Airtel Networks Kenya "Airtel" and Telkom Kenya "Telkom" on 8th February 2019 announced plans to merge their mobile, business and carrier businesses in Kenya subject to regulatory authority.
- We expect the approval of the Communications Authority of Kenya (CAK) even if the merger will create a duopoly in the mobile telecommunications sector.
- The new entity whose combined shareholding remains unknown at this time, will operate under the name Airtel-Telkom.
- In the near term, the two entities will operate as they were "*Additionally, both brands: 'Airtel' and 'Telkom', as well as their respective products and solutions, will continue to co-exist. Similarly, service delivery to the respective companies' customers as well as engagement with all business partners of both companies will continue to operate as usual." says the press statement released on the day.*
- However, we see a more comprehensive integration in both businesses to form a front against the market leader Safaricom Plc "Safaricom" "…both the partners will combine their operations in Kenya and establish an entity with enhanced scale and efficiency, larger distribution network and strategic brand presence, thereby enhancing the range and quality of products and service offerings in the market, and greater choice and convenience to the consumer." The press statement continues.
- This company update is a summary of our views on the impact of the planned merger on the competitive intensity of the telecommunications industry.
- It specifically covers voice calls, SMS and mobile data where we see the potential likelihood for a new wave of price competition.
- Although the new entity could come up with a new mobile money service to challenge Safaricom's M-Pesa, we believe the considerable competitive advantages and market share that it enjoys is almost impossible to erode.
- An ever growing customer base and agent network, well thought out strategic business partnerships and general increase in usage will continue to drive customer loyalty in mobile money services.
- Overall we do not see the merger as presenting a significant threat to Safaricom's dominance in terms of loss of subscribers with minimal impact on business revenues and overall business profitability."

Deal attributes - Merger will create a duopoly in the Kenya mobile telecommunications sector

- The Airtel-Telkom merger is a horizontal merger (business consolidation between firms that operate in the same industry) and will create a duopoly in the mobile telecommunications sector (Fig.1).
- Merger is subject to regulatory approval and customary closing condition and thus its timeline is unclear.
- **Related Parties** - Helios through Telkom owns a stake in West Indian Ocean Cable Company (WIOCC).
- Safaricom, Telkom and the Kenya Government hold 32.5%, 22.5% and 20% stakes in the East Africa Marine System (TEAMS) undersea fibre optic company respectively.
- Safaricom also holds a stake in Seacom a submarine communications cable operator.

Fig.1: Airtel-Telkom merger - Horizontal merger that will create a duopoly



Source: Sterling Capital

Safaricom's enviable position at the top

- We identify the following as key reasons why Safaricom holds its enviable position at the top of the telecommunications sector:

  1) **Capital expenditure and large network coverage** - Safaricom's sound financial position has enabled it to spend an average of KES.33.4Bn in Capital Expenditure (Capex) over the last 5 years. A bulk of this Capex has been used to expand network coverage. With over 4,000 towers Safaricom enjoys the widest network coverage in the country compared to the top two competitors' networks combined (3,129 towers).

     In line with network advantages is Safaricom's "first mover" advantage as was the case with the roll-out of the 3G and 4G network.
  2) **Growth of M-Pesa** - The growth and usage of M-Pesa driven by increased usage, business partnerships and a large agent network.
  3) **Leader in innovation and customer centric products** - Safaricom is a leader in product innovation with most of its services enjoying a fast uptake.
  4) **Strategic Business Partnerships** - We identify partnerships such as M-Shwari, KCB M-Pesa, as well as others in the health, insurance and agriculture sectors as key in promoting customer loyalty.
  5) **Ineffectiveness of competitor's strategies** - Both Airtel and Telkom Kenya have focused primarily on pricing as their main customer acquisition strategy ignoring the impact of product diversity.

     Although this has been somewhat effective in the short term, it has not delivered the desired impact in terms of business revenue growth and profitability.

     In addition Safaricom, has quickly regained market share through counter pricing strategies and its almost non-replicable money transfer service M-Pesa that has been its biggest driver of customer loyalty.

Safaricom's market leadership attributable to capex, M-Pesa, innovation, business partnerships and ineffectiveness of competitor strategies.

Airtel-Telkom to benefit from merger synergies

- The merged entity is likely to benefit from several business advantages emanating from operating as a single entity:

  1) **Economies of scale** - Achieved through larger scale operations and **enhanced knowledge and technology** may also increase the efficiency through diffusion of know-how following a merger.

  2) **Cost rationalization -** The ultimate goal of the merger is to establish a profitable business going forward. It is likely that the new entity will adopt a cost rationalization strategy to reduce operating costs and increase operational efficiency. This could include staff layoffs in the case of duplicated or non-essential roles.

  3) **Capex could decline -** The Airtel-Telkom merger could enable the new entity to increase its network coverage at a lower cost than would have been the case if they went about it as separate entities.

Airtel and Telkom are reported to have 1,581 and 1,548 base stations respectively (aggregate of 3,129). This is significantly lower than Safaricom's over 4,000 base stations. However we note that Telkom is selling 723 towers to American tower corp for cash by 31st December, 2019 this will reduce their combined towers to (2,406).

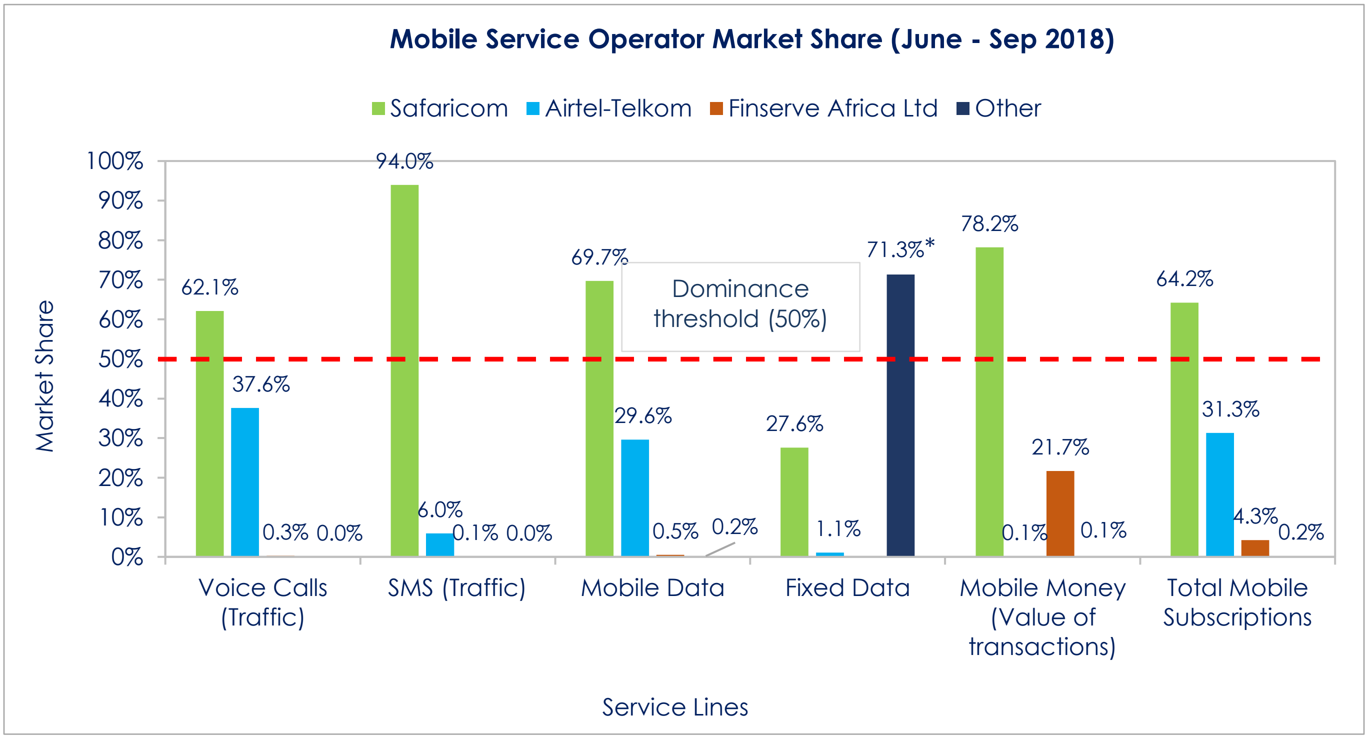
Here we make the assumption that both Airtel and Telkom could be serving the same areas and the merger will allow for decommissioning of some stations to areas where either network is poor or absent altogether.

4) **Playing to their strengths -** The merger makes sense for either party in terms of taking advantage of what either is better at. Airtel has recently made big gains in voice calls and mobile data but could benefit from Telkom's strengths in mobile data.

Safaricom is dominant and will remain as such even after the merger

- According to the Competition Authority Kenya (CAK), "*An entity that controls not less than half (50%) of the services that are rendered in its sector is dominant.*"
- On the basis of this definition, Safaricom is the dominant player in the mobile telecommunications sector (Fig.1) even with the exception of fixed data where it holds 27.6% share of total subscribers.

Fig.2: Safaricom continues to dominate the mobile telecommunications industry



Source: Communications Authority of Kenya

*Wananchi companies (Kenya) Ltd held 39.2% fixed data market share as at Sep 2018. Data includes Wananchi Telecom, Wananchi Group, Simbanet Ltd and ISAT Africa Kenya Limited (Formerly Alldean Satellite Networks Ltd).

So how will market power/concentration be affected?

- On the basis of the Herfindahl-Hirschman Index (HHI) and latest market share data as at the end of September 2018, market concentration will increase from 4,717.61 to 5,119.01 (Table.1).
- This suggests higher market power for the top two operators which itself is a risk to subscribers (Table. 2).
- This also means an increase in the competitive intensity of the sector.
- **This is a possible concern for CAK as it will limit subscribers' options but we see a very lower threat of disapproval.**

Table.1: Merger will increase sector market concentration and competitive intensity

Service Line	Pre - Merger HHI*	Service Line	Post-Merger HHI*
Safaricom	64.2%	Safaricom	64.2%
Airtel Kenya	22.3%	Airtel – Telkom	31.3%
Telkom Kenya	9.0%	Finserve	4.2%
Equitel	4.2%	Other	0.2%
Other	0.2%		
	4,718		**5,119**

Source: Sterling Capital

Table.2: Merger will create a duopoly in the mobile telecommunications sector

Market Structure	Number of Players	Degree of Product Differentiation	Barriers to Entry	Pricing Power of the Firm	Non-Price Competition	HHI Index
Perfect competition	Many	Homogeneous	Very Low	None	None	<1,000
Monopolistic Competition	Many	Differentiated	Low	Some	Advertising and Product Differentiation	1,000-1,800
Oligopoly ↓	**Few**	**Homogeneous / Standardized**	**High**	**Some/ Considerable**	**Advertising and Product Differentiation**	**>1,800**
Duopoly Kenya Telecoms	**Few - 5 operators**	**Homogeneous - 2G, 3G, 4G, fibre, voice, SMS & mobile money**	**High license fees, capital investment & infrastructure costs**	**Pricing power**	**Advertising and multiple products offering**	**5,119**
Monopoly	One	Unique Product	Very High	Considerable	Advertising	10,000

Source: Sterling Capital

Airtel-Telkom merger could trigger a new wave of price competition

Voice and mobile data customers are highly sensitive to price and Airtel-Telkom could adopt a low cost pricing strategy to drive customer growth.

- In October 2018 we released a 6 part series titled **"Is Safaricom Losing its grip**?" where we sought to determine whether each of Safaricom's services enjoyed "pricing power"
- We concluded that Safaricom does not have pricing power in the voice call and mobile data business lines because of price sensitivity of their subscriber who could easily use pricing as a basis to switch their service provider.
- We maintain this position should Airtel-Telkom choose to implement a low pricing strategy as a customer acquisition strategy.
- Recent tariff reductions by Safaricom particularly on mobile data emphasizes the impact that price competition has on subscribers.
- We had previously stated that the possibility of Airtel and Telkom lowering their tariffs further as separate entities to woo new subscribers was low as it would push their faltering businesses further into loss making territory.
- However, this merger changes this position as thinner margins could be offset by larger volumes supported by a larger customer base and this could be a strategy employed by the new entity.

Mobile money - M-Pesa Unshaken

Airtel-Telkom could launch a new mobile service but this is unlikely to gain enough traction to challenge M-Pesa's dominance.

- The same pricing report concluded that Safaricom's market positioning in mobile money is strong as customers are insensitive to pricing because ease of access and convenience override the cost of the service.
- *"M-Pesa holds considerable pricing power in both money transfer and payment services but in the latter we observe a growing competitive threat especially from Equitel that could erode its pricing power in the long-term."*
- The position remains the same for the following reasons:

  1) Strategic business partnerships particularly those that integrate financial services like mobile lending including Safaricom's short term overdraft service "Fuliza" has encouraged customer loyalty.
  2) Latest regulator reports (as at end of September 2018) indicate that Safaricom has 162,800 agents equivalent to 74.5% of the total share of mobile agents. This large network has been instrumental in driving customer convenience and loyalty.

- So do we see the possibility of Airtel-Telkom launching a new mobile money service? The answer is "Yes, highly likely but with minimal success".
- To effectively roll out a strong competitor, the new entity will need to build a huge agent network and develop strategic business partnerships as close alternatives to those entered into by Safaricom such as those related to mobile lending a fast growing revenue earner.
- We are not convinced that they have the ability to develop a good mobile money proposition neither are we about the willingness of the Kenyan subscriber to switch to an alternative even it comes at a lower price.

Fixed Data could get more competitive with the entry of Airtel-Telkom

Airtel-Telkom could enter into the fixed data business to take advantage of the absence of a dominant player in the business.

- Fixed data has emerged as a new growth frontier for Safaricom which continues to increase its market share aggressively.
- With the main player Wananchi Companies controlling a 39.2% (comparatively lower than other mobile services), fast losing market share combined with reports of a possible exit from the market, we are likely to see Airtel-Telkom enter into this business segment.
- The new entity will be in a favourable financial position to commit resources to setting up a fibre network to support fixed data and we cannot rule out low pricing as a possible market entry strategy.

Merger could reduce pressure on the regulator to act on Safaricom's dominance

- The two operators have in the past called on the CAK to reign in on what they consider unfair competition or abuse of Safaricom's market position.
- In our report released in November 2018 titled **"Safaricom dominant. Fact or fiction?"** we identified several potential cases of abuse of dominance including the following:

    1) Consumer/Supplier exploitation through exclusive dealing
    2) Discriminatory Pricing
    3) Imposition of high prices on consumers
    4) Market restrictions or tied selling
    5) Preventing competitive conduct by competition

- We take the view that the planned merger of Safaricom's top two competitors could mean the following:

    1) **Reduced threat of regulation to reduce dominance** - The combined entity would have a total subscriber market share of 31.3% (Airtel 22.3% and Telkom Kenya 9% as at September 2018), and a marked increase in market shares in the different service lines than was the case as individual entities previously.

The threat of regulation will significantly decline with a merger of Safaricom's top two competitors.

- In addition to the above, we draw attention to the dominance report:

    "Recent market trends showing Safaricom loss of market share suggests that competition intensity is increasing courtesy of market forces and there need not be any regulatory intervention to reduce its dominance."

    2) **"Let's go it alone"** - The decision to merge was perhaps driven by lack of operators' optimism on the CAK's willingness to implement proposals by Analysis Mason or take further action to reduce Safaricom's dominance. The merged entity they believe would be a more formidable competitor for the market leader.

- **Although we believe that the merger reduces the threat of regulation, we cannot rule out the possibility of the merged entity pursuing the matter in the future altogether.**
- This could be the case especially if the new business does not meet revenue and business performance expectations.

Overall it could be a case of "all bark with no bite"

Merger unlikely to significantly alter Safaricom's dominance.

- The biggest beneficiary of the merger will be the Kenyan mobile subscriber who has in recent years benefitted from huge drops in mobile service tariffs and product diversity.
- However, the merger is unlikely to significantly alter the competitive structure of the mobile communications sector.
- Safaricom will retain its position as the sector's leader enjoying the benefit of scale and will maintain focus on high growth products such as M-Pesa, mobile and fixed data.
- Airtel-Telkom's success will highly depend on how effectively they can offer close alternatives to the services that have driven Safaricom's customer loyalty.

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