STERLING CAPITAL LIMITED

Tuesday, 30 April 2019

Telecommunications Sector

Safaricom Plc

FY2018/19 Earnings Expectations & Valuation Update

"Safaricom On Hold"

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Executive Summary

- We release our Safaricom Plc "Safaricom" full year 2018/19 earnings expectations and valuation update report ahead of the annual financial results release slated for 3rd May 2019.
- We recommend a **HOLD** on Safaricom on the basis of our fair value estimate of KES.30.01 a revision from KES.27.22 following the company's HY2018/19 Financial results release in October.
- Our Profit After Tax (PAT) estimate FY2018/19 is KES.67.6Bn a 22.2% growth over the previous year and with it a KES.1.35 dividend (FY2017/18 - KES.1.10)
- We are optimistic about strong growth in earnings in key service revenue lines such M-Pesa and data (both mobile and fixed).
- Our voice and mobile data revenue forecast is KES.96.1 & KES.41.4Bn respectively.
- However, we are less optimistic about the traditional telecommunication service revenue lines voice and messaging forecasting 0.5% growth in revenues for the period in focus.
- It is probably still too soon to accurately predict the impact of Safaricom's new overdraft service "Fuliza" but believe that it will have a major impact on M-Pesa revenues, customer acquisition as well as retention in the medium term.
- We are of the opinion that "Masoko" Safaricom's E-Commerce business is still at its infancy with minimal contribution if any to the company's bottom line.
- In terms of subscriber market share, Safaricom has remained fairly resilient to aggressive competition especially in the business lines of voice calls and mobile data.
- It has however implemented several strategies that we view as fairly effective in protecting its market share.
- The customer retention impact of Fuliza also means that all other service revenues benefit from this customer loyalty as much as the ownership of multiple sim cards and multiple sim card phones is growing.
- The threat of regulation appears to be declining perhaps influenced by market data that shows a reduction in Safaricom's market share in the last two years or the proposed merger between Safaricom's two main competitors Airtel and Telkom.
- We expect the merger to have a major impact in the competitive intensity and particularly on the services where customers are highly price sensitive such as mobile data and voice calls.
- There is a possibility of the merged entity aggressively tapping into the mobile money industry but this we expect to have limited success.
- Safaricom in our opinion still presents great business value with forecasted growth in earnings, continuous innovation and market growth opportunity.

Safaricom Plc

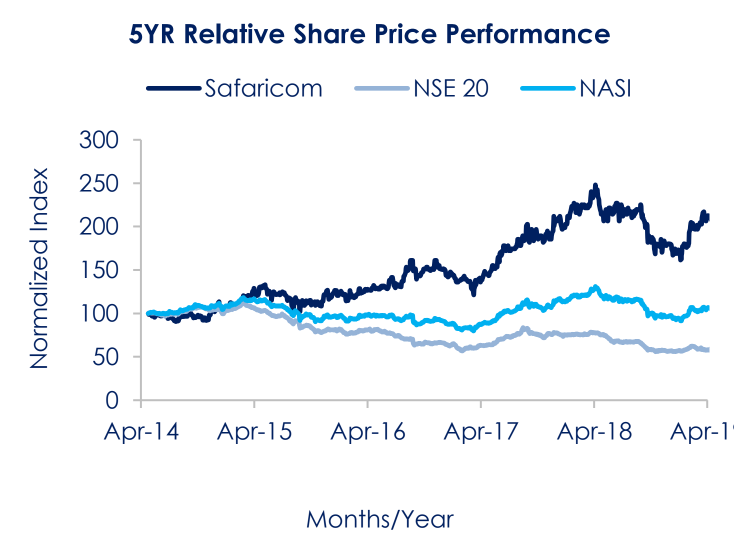
- We recommend a **HOLD** on Safaricom based on a fair value estimate of KES.30.01, a 7.4% upside from the current market price (KES.27.95 26th April 2019).
- We had previously recommended a BUY with a fair value estimate of KES.27.22 following the release of the company's HY2018/19 financial results in October 2018.
- Our revised estimate is largely driven by our expectations of strong earnings especially in the M-Pesa and mobile data and fixed data service lines.
- "Fuliza" the new overdraft facility will be key to insulating Safaricom from loss of market share whilst driving M-Pesa revenues.
- Voice calls and messaging revenues appear to have reached a peak and we are less optimistic about future earnings growth.
- The threat of anti-competitive regulation has somewhat declined, however we acknowledge the potential impact of increased competition following the planned merger of two main rivals Airtel and Telkom Kenya.

Table.1

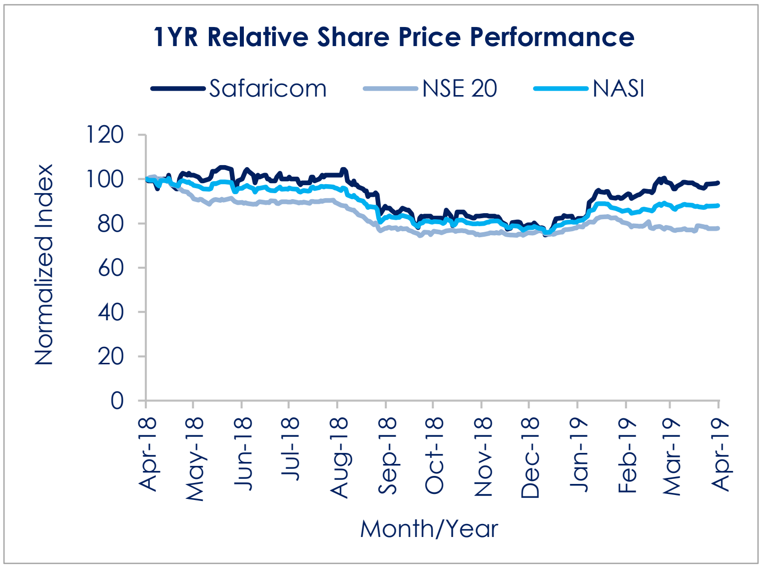
Share Data	
NSE Code	SCOM
Bloomberg Code	SCOM:KN
Current Price (KES)	27.95
Target Price	30.01
Upside/ (Downside) (%)	↑7.4%
Recommendation	**HOLD**
Market Cap (KES. Bn)	1,120
Free Float (%)	25%
Price Change YOY (%)	↓ 1.1
Price Change YTD (%)	↑ 25.6
52 Week High/Low (KES)	32.50 -21.00
P/E (X)	20.3
P/B (X)	10.1

Source: Nairobi Securities Exchange & Sterling Capital Research

Fig.1: Safaricom share performance



Source: Nairobi Securities Exchange



Source: Nairobi Securities Exchange

Table.2

Index	5YR	1YR	6M	1M
Safaricom	112%	-1%	19%	-0.5%
NSE-20	-42%	-22%	3%	-0.5%
NASI	6%	-12%	9%	-0.7%

Source: Nairobi Securities Exchange

For important disclosures refer to the disclosures section located at the end of this report.

Market share analysis - Competitive threats still exist

Safaricom has lost mobile subscriber market share largely because of price competition in voice calls and mobile data.

- Safaricom's market share of total mobile subscriptions is 63.3% (Fig.2) according to the latest available Communications Authority (CA) report (December 2018).
- This is a significant decline from 71.9% over the same period in 2017, a trend we attribute to stiff price competition particularly in the voice calls and mobile data service lines.
- Airtel has been the biggest beneficiary of Safaricom's loss of market share following an aggressive price war and aggressive marketing in these business lines.
- Safaricom's market share of mobile subscribers will remain stable over the near term although competitive threats are expected to emerge in the medium and long-term if the proposed merger between Airtel and Telkom is realized.

Airtel-Telkom merger likely to increase competitive intensity

Planned Airtel Kenya-Telkom merger likely to increase competitive intensity especially in voice calls and mobile data.

- With a combined market share of 33% the new entity would be in a better financial position to deploy effective customer acquisition strategies.
- The most probable strategy would be price competition particularly in service lines where customers are highly price sensitive such as voice calls and mobile data areas where Airtel in has previously implemented successfully.
- We however expect Safaricom's M-Pesa supported by its new mobile money overdraft facility product "Fuliza" to play an important role in protecting its subscriber market share with the overall net effect on market share negligible.
- The following are key recent developments in the telecommunications sector:

1) Safaricom is dominant in most service lines in spite of comparatively higher tariffs.

   However, it is losing its market share in some business lines like voice calls and mobile data due to the growing multiple SIM card ownership.

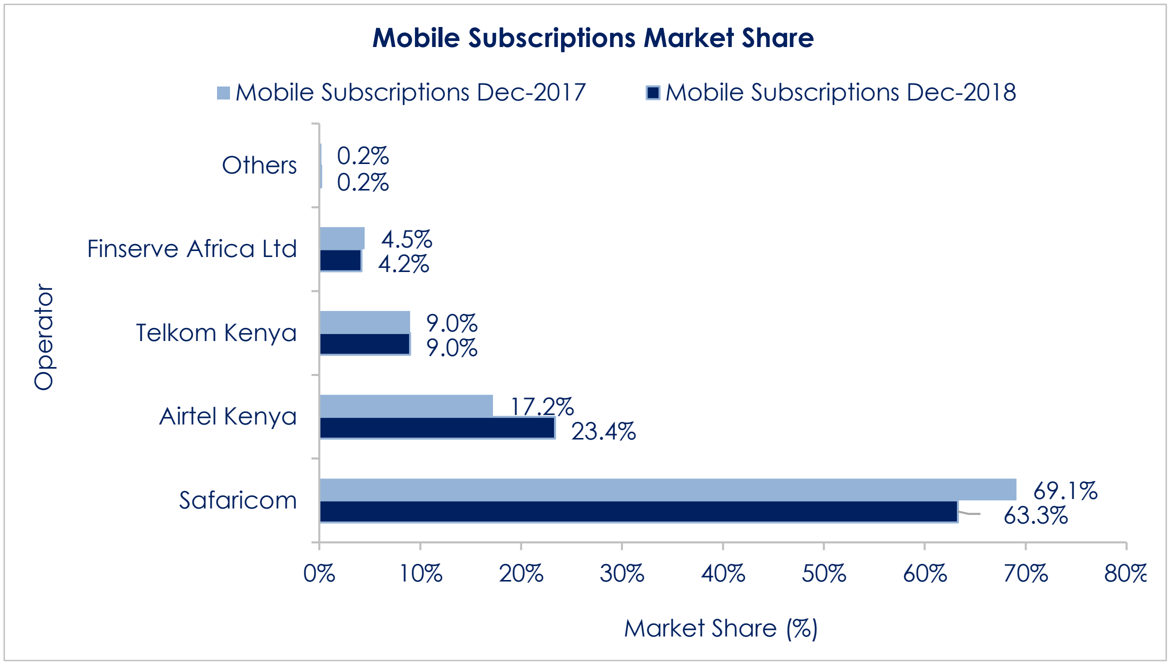
2) Mobile Money - Equitel's growing challenge to M-Pesa's dominance of Mobile payments.

   This is due to Equitel Eazzypay's price differential for merchants and its ability to accept payments from all mobile money wallets, making it convenient to subscribers across all networks.

3) In January 2019 Safaricom introduced Fuliza, a mobile money overdraft facility available to M-Pesa subscribers that allows them to complete both money transfer and payment transactions when they have insufficient funds in their M-Pesa accounts.

   We believe Fuliza will have a positive impact on M-Pesa revenues and also protect Safaricom's market share.

Fig.2: Safaricom has lost subscriber market share to Airtel Kenya



Source: Communications Authority

Threat of regulation on market dominance declining but new ones likely to emerge

The threat of regulation on uncompetitive behavior declining but new threats are emerging such as regulation on mobile lending (credit)

- We draw reference to our February 2019 report ***"Is the merger major?"*** where we explained why we believe that the threat of regulation to reduce Safaricom's market dominance (Refer to the Analysys Mason report 2016) has declined significantly more so since the announcement of the proposed merger:

  1) Airtel-Telkom will have a combined market share of close to 33% of total subscribers, thus showing an increase in competitive intensity without the direct intervention of the regulator.
  2) The decision to merge perhaps influenced by the two operators' pessimism on lack of regulatory intervention.

- We cannot rule out the probability of the two operators or the merged entity attempting to influence regulatory action to reduce Safaricom's dominance in the future.
- **Mobile lending/credit could face regulation** - Due to high lending rates, growing customer credit dependence and data privacy.
- This we expect regulation of mobile/digital lending in the medium to long-term.
- Regulation of mobile lending rates will directly affect "M-Shwari" and KCB M-Pesa, Safaricom's mobile lending products.
- "Fuliza" could technically be exempted from this action as it is technically an overdraft facility attracting an access fee rather than interest. This however is inconclusive at this point as the access fees and other commissions could also be impacted by new regulation.

Product Innovation and business partnerships remain a key competitive advantage

Safaricom is a leader in innovation with most new products based on its financial service offering M-Pesa.

- Innovation is a key competitive advantage for Safaricom which has launched a number of products recently:

  1) Partnerships with global remittances companies like Western Union and PayPal.
  2) Partnering with Alibaba Group by providing mobile payment services on Aliexpress.com
  3) Digital lending platforms partnerships; M-Shwari (with CBA), KCB M-Pesa (with KCB Group) and Fuliza (with CBA and KCB Group).

- Most new innovations would most likely leverage on the M-Pesa service platform.
- We believe that Safaricom is well placed to extend its financial service offering beyond savings and lending and could include:

  1) Insurance and wealth management.
  2) Business/SME lending.
  3) Cyber security/data vending and protection.

- Expansion of mobile money transfer services in other countries will remain a key focus with Ethiopia reportedly being in advanced stages.

Strong service revenue growth expected FY2018/19

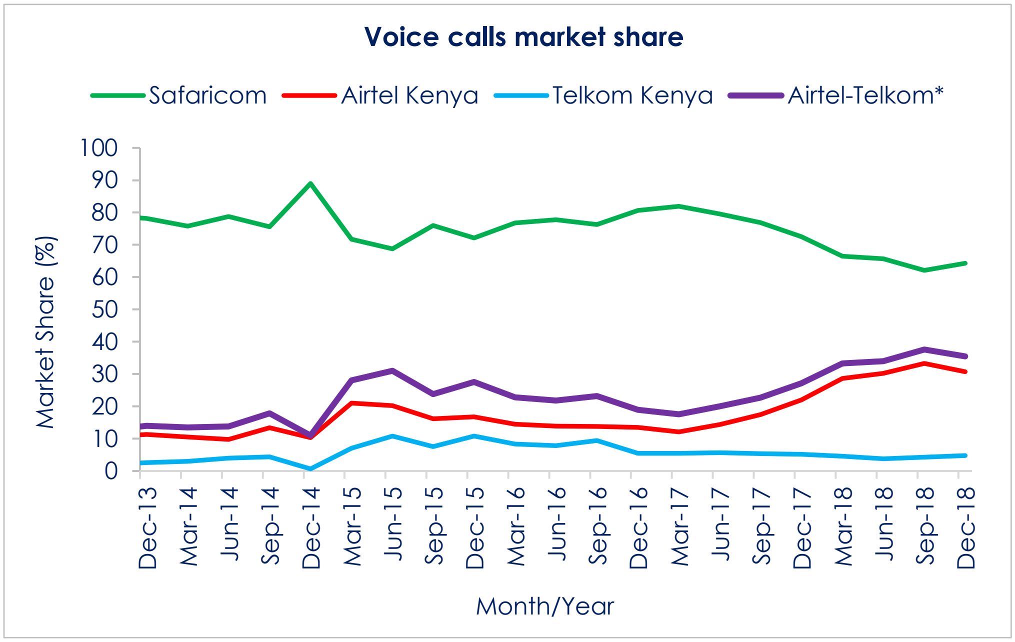
- Overall, we expect a 7.7% growth in total service revenue to KES.241.9Bn with M-Pesa, mobile and fixed data posting strong earnings.
- Voice calls and SMS will record marginal growth as they suffer from the impact of stiff price competition and changing preferences but this is unsustainable and we expect revenues to come under pressure in subsequent years.

A) Voice Calls - Sluggish revenue growth expected FY2018/19

- In the quarter ending December 2018, Safaricom recorded a 11.8% increase in voice traffic over the previous quarter to 9.5Bn minutes resulting in 2.1% growth in voice market share to 64.3% (Fig.3).
- This gain was directly reflected in Airtel's loss of market share during the period in focus by 2.6% to 30.7% and was a reversal of a trend in loss of market share in recent periods.
- The growth in market share attributable to the "Safaricom @ 18" promotion is in our view unsustainable because voice call subscribers are highly price sensitive and are likely to switch to lower cost tariff operators s after the expiry of the promotional period (December 2018).
- Our topical note on Safaricom's pricing power released in November 2018 - ***"Dialing the wrong number"*** concluded that Safaricom does not hold pricing power because past tariff adjustments by other mobile operators have led to a significant loss of market share.

- Airtel and Telkom's low cost pricing strategies have been effective and this we expect to have an adverse impact on Safaricom's voice revenue growth FY2019.
- The proposed merger of its two main competitors could further pose a challenge as they could start another wave of price competition.
- Safaricom is likely to counter this threat through promotions and loyalty discounts.

Fig.3: Voice calls - Price competition remains a threat to market share



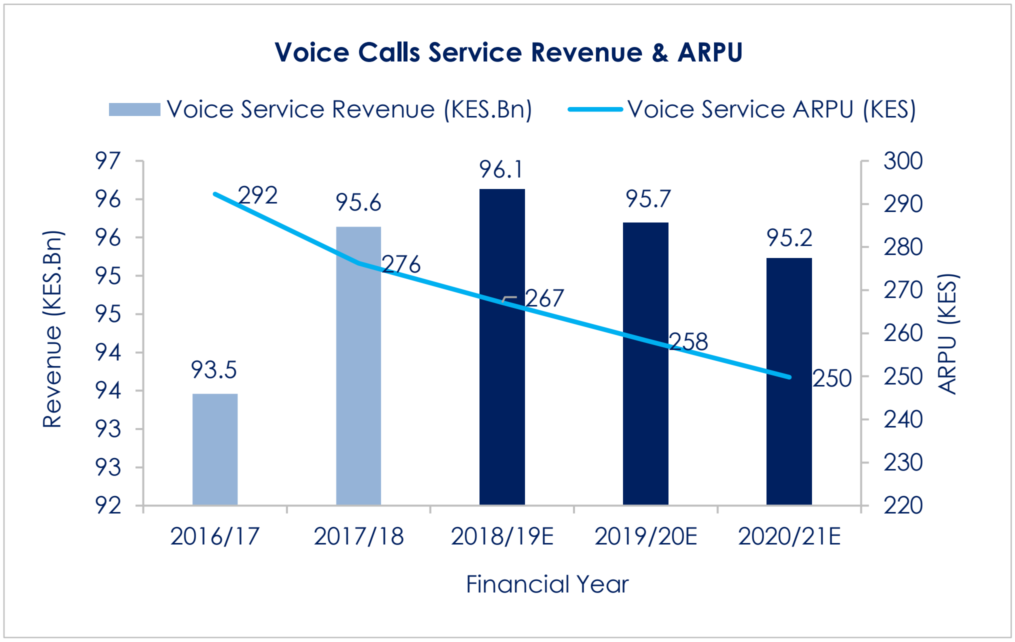
Airtel-Telkom (Assumes combined market share after planned merger)

Source: Communications Authority

Voice ARPU declining mainly due to loss of market share and competition that has pushed voice tariffs lower.

- We forecast a 0.5% growth in total voice calls revenues to KES.96.1Bn in FY2018/19, driven by 1.5% growth in number of subscribers and voice call traffic in the second half of FY2018/19 (Fig.4).
- We however see a 0.5% decline in voice calls revenue FY2019/20 due to a combination of stiff competition and overall industry decline in voice call traffic.
- Voice call ARPU fell 5.5% FY2017/18 to KES.276 and we expect to see a further decline to KES.267 FY2018/19 and KES.258 FY2020/21.
- Voice contribution to total service revenue FY2018/19 forecasted at 39.7% and 36.9% FY2019/20 a decline from 45.8% and 42.6% FY2016/17 and FY2017/18 respectively.
- This is a direct impact of stiff price competition and strong growth in M-Pesa and data service revenues.
- Safaricom's voice revenues are likely to come under pressure if the Airtel-Telkom merger is approved as the new entity is likely to reduce tariffs to increase voice traffic and revenues.

Fig.4: Voice calls ARPU and revenue to decline FY2019/20 & FY2020/21



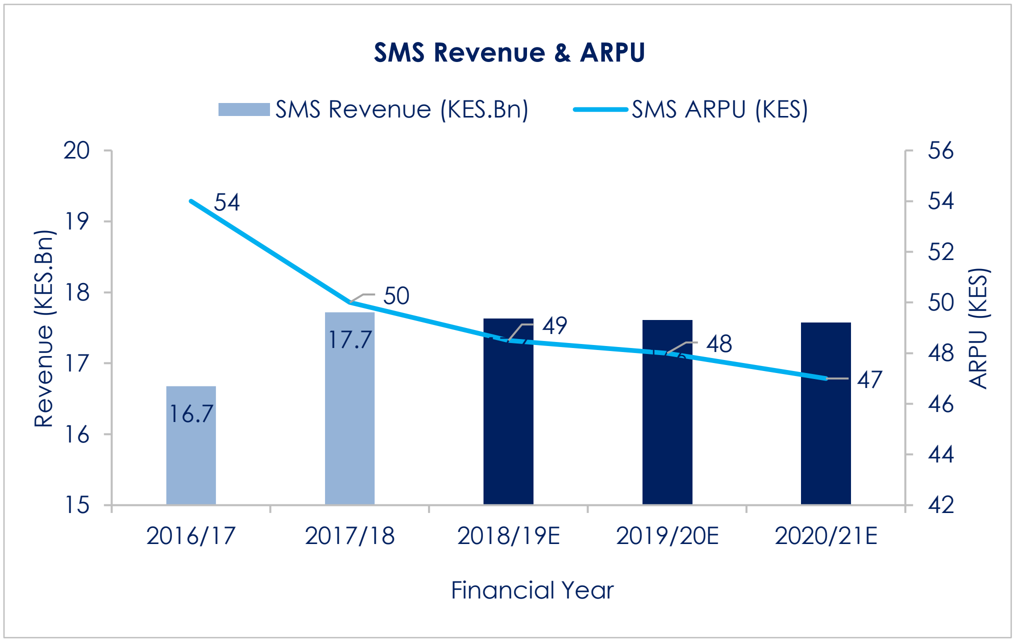
Source: Company Filings & Sterling Capital Research

B) Messaging - Changes in trends and preferences to depress revenues

Messaging revenues have reached a peak and we estimate revenues at KES.17.6Bn FY2018/19-2020/21

- Mobile telecommunications companies around the world continue to record declining messaging (SMS) revenues as a result of intense competition from Over the Top (OTT) data supported services such as WhatsApp, Facebook messenger etc.
- Safaricom's market share in SMS remains virtually unchanged at 94.1% (December 2018), a benefit of increased subscriber numbers for data, voice and M-Pesa services.
- Safaricom reported a decline of 1.2% in SMS revenues to KES.8.8Bn HY2018/19 compared to KES.8.92Bn HY2017/18 and we expect this trend to continue FY2018/19 (Fig.5).
- The shift to data usage as an alternative to SMS will result in a decline in P2P message volumes and by extension a decline in SMS revenues to KES.17.6Bn FY2019/20 and FY2020/21.
- Advances in data technology and speeds such as introduction of 5G data network is also expected to have cannibalization effects on SMS revenues.
- SMS revenues contributed 8.1% of total service revenues FY2017/18 and we expect this to decline further to 6.8% and 6.7% FY2018/19 and FY2019/20 respectively.

Fig.5: Messaging revenues set decline losing revenue to mobile data



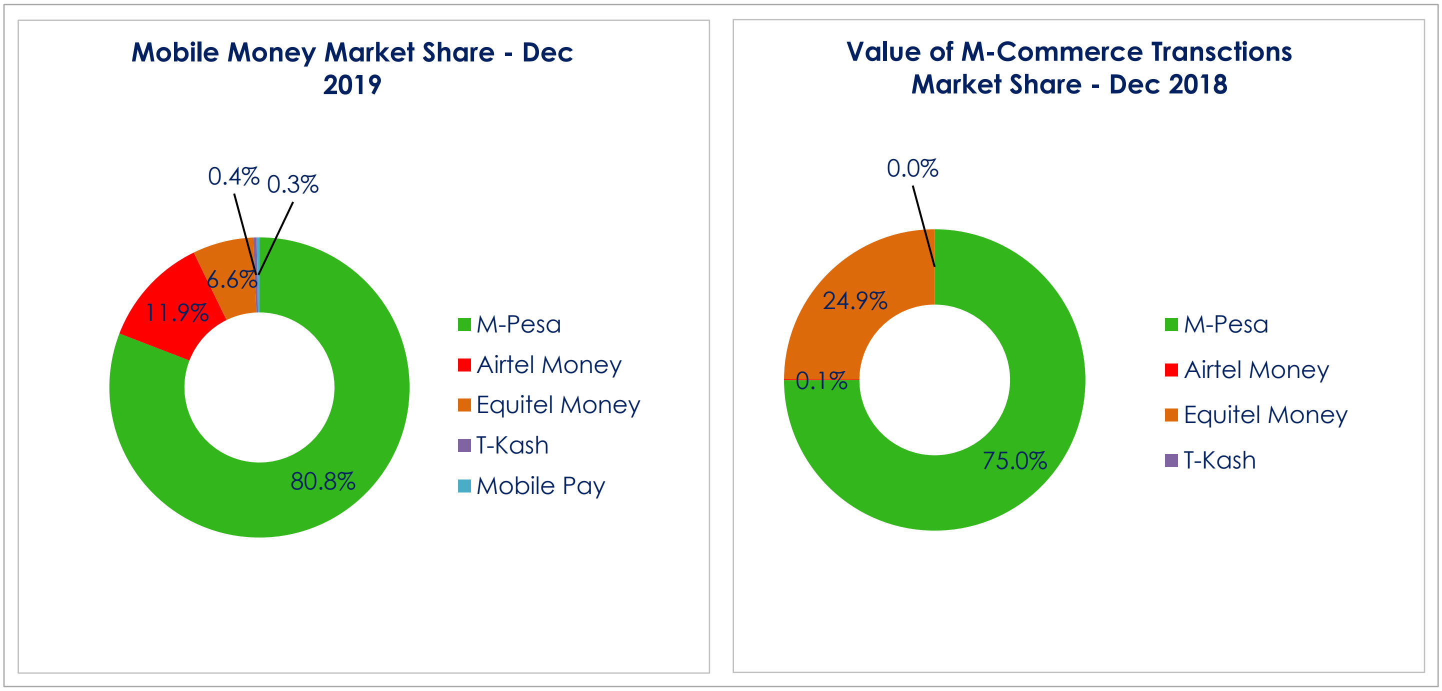
Source: Company Filings & Sterling Capital Research

C) M-Pesa - Mobile cash remains king

M-Pesa accounts for 80.8% of total active mobile money subscribers, 77.8% of total value of transactions and 75% of total M-commerce (payment) transactions.

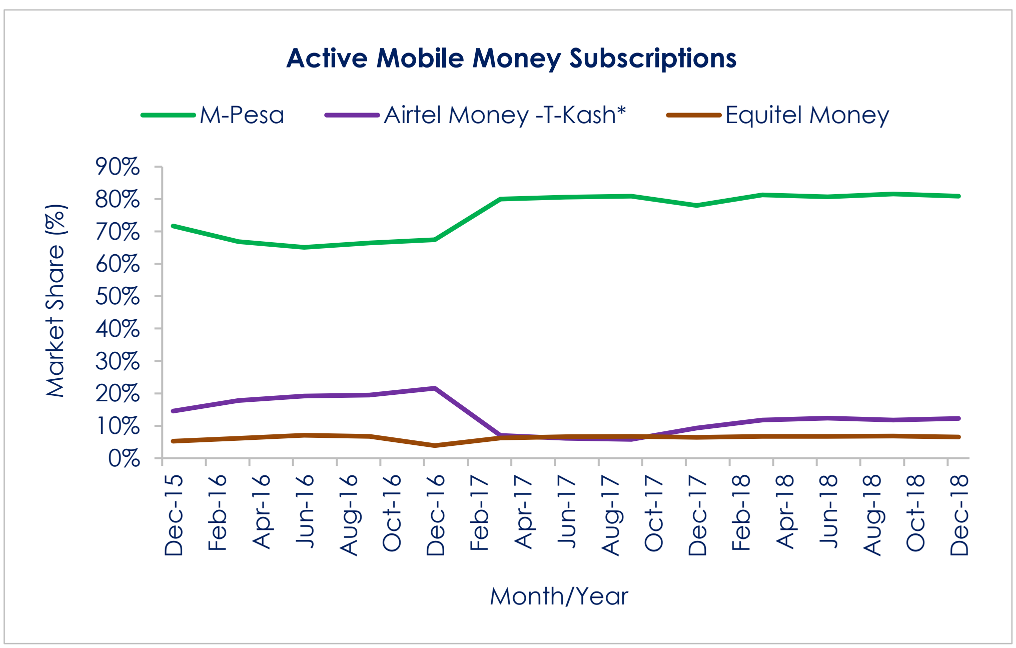
- M-Pesa is the dominant operator in the mobile money transfer and payment business accounting for 80.8% of total mobile money subscribers, 77.8% of total value of transactions and 75.0% of total mobile commerce transactions (Communications Authority December 2018) (Fig.6).
- Our analysis of M-Pesa's market share between March 2017 and December 2018 (Fig.7) shows minimal distortions in market share of active mobile money subscribers in spite of aggressive competitive activity by both Airtel and Telkom Kenya.
- The loss of market share of mobile subscribers during the same period has not adversely impacted M-Pesa market share, a trend we attribute to multiple sim card ownership with M-Pesa the preferred mobile money transfer and payment service.
- We however draw attention to the threat of Equitel in the mobile payment transaction business (Fig.6) where it has 24.9% market share as at December 2018.

Fig.6: M-Pesa holds a strong market share in mobile money transfer but faces growing competition in payments



Source: Communications Authority

Fig.7: M-Pesa is dominant in the mobile money business



Airtel-Telkom (Assumes combined market share after proposed merger).

Source: Communications Authority

M-Pesa growth supported by continuous marketing activity, product Innovation, agent and merchant network growth, partnerships, low regulatory threat and low competition.

- We are not overly concerned about the short to medium term growth prospects of M-Pesa for the following reasons:

1) **Effective subscriber acquisition and retention strategies** such as marketing activity and loyalty programs resulting in sustainable growth in subscriber numbers and usage of the service.

2) **Growth in the number of M-Pesa agents (168,620 - December 2018) and merchants** ensures that M-Pesa remains by far the preferred mobile money transfer and payment service.

3) **Strategic business partnerships** especially with financial institutions on the mobile lending and savings, payment channels etc.

4) **Product Innovation** - Most new service innovations are based on the M-Pesa service such as Fuliza launched in January 2019.

5) **Regulatory threats on the decline -** The Analysis Mason's report whose main focus appeared to be on M-Pesa's dominance appears to be fading away due to perceived increase in competitive intensity.

6) **Low competitive intensity** - Especially in the mobile money transfer business, where we mentioned a high possibility of the merged entity revamping their mobile money offering in our February 2019 report - Airtel-Telkom planned merger report titled "Is the merger major?"

   "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...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.

The M-Pesa - Fuliza connection

"Fuliza" will have a positive impact on customer acquisition and retention as well as an increase in the number of M-Pesa money transfer and payment transactions.

- In our March 2019 report on "Fuliza" titled "Fuliza in numbers" we described the service as "a well thought-out product from a revenue generation, customer acquisition and retention perspective" and continue to hold this view for the following reasons:

1) **Fees and commission income** - "Fuliza" will drive M-Pesa revenues through overdraft service charges and standard M-Pesa money transfer and payment transaction fees.

2) **Market share protection** - The growing need for short-term mobile credit/advances will translate to growth in Safaricom and M-Pesa registered subscribers.

   Here the increase refers to both M-Pesa subscribers and 30 day active subscribers as continuous M-Pesa usage builds a credit record.

3) **Growth in the number of money transfer and payment transactions** due to Fuliza that enables these transactions to progress even in the absence of funds in subscribers' mobile wallets.

- We illustrate our Fuliza revenue estimates (Table. 3) with the service having a considerable impact on subscriber numbers and money transfer and payment transaction volumes:

M-Pesa and Fuliza - The revenue growth opportunity

- As mentioned, Fuliza has a significant impact on customer acquisition and retention as well as both mobile money transfer and payment transactions.
- This translates to a positive impact on M-Pesa revenues (Table.3) and we expect a steep growth rate in the short term before gradually declining to a more sustainable rate in 2020/21.

Table.3: Impact of Fuliza on M-Pesa revenues cannot be underestimated

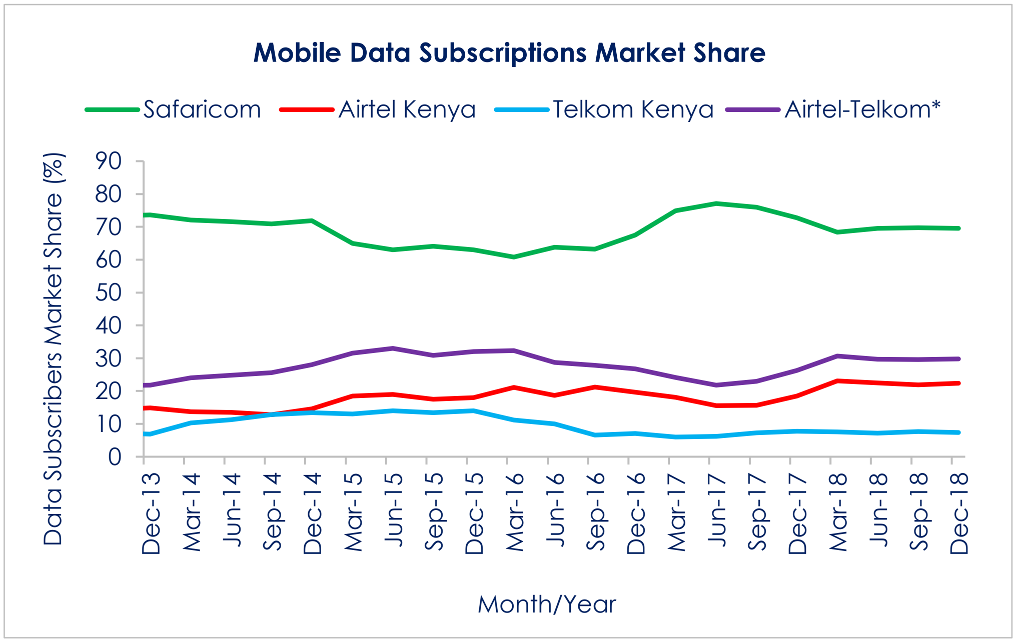
M-Pesa Revenue Estimates (2018/19-2020/21)			
Period	**2018/19**	**2019/20**	**2020/21**
Total Safaricom subscribers (Mn)	30.4	31.3	32.2
Total M-Pesa subscribers (Mn)	26.7	29.8	31.5
30-Day active M-Pesa subscribers (Mn)	23.2	26.2	27.6
Total Fuliza customers (Mn)	4.9	10.8	17.6
Total Amount advanced (KES. Bn)	7.3	18.4	33.3
Fuliza Access fees (1.08%) KES. Bn	0.2	1.7	3.1
Maintenance fees 0.5% per day - 80% pays within 2days (KES. Bn)	0.2	1.2	2.3
Maintenance fees 0.5% per day - 10% pays within 5days (KES. Bn)	0.1	0.4	0.7
Maintenance fees 0.5% per day - 10% pays within 10days (KES. Bn)	0.1	0.8	1.4
Safaricom revenue share - 40% (KES. Bn)	0.2	1.6	3.0
CBA revenue share - 40% (KES. Bn)	0.2	1.6	3.0
KCB revenue share - 20% (KES. Bn)	0.1	0.8	1.5
Total estimated revenue generated from Fuliza (KES. Bn)	**0.5**	**4.0**	**7.5**
M-Pesa Revenue (Excluding Fuliza) (KES. Bn)	**72.8**	**80.9**	**89.3**
Total M-Pesa Revenue (Including Fuliza) (KES. Bn)	**73.0**	**82.6**	**92.3**
M-Pesa ARPU (KES)	**293**	**308**	**323**
M-Pesa contribution to total revenue (%)	**30.1**	**31.2**	**34.4**

Source: Safaricom Plc & Sterling Capital Research

D) Mobile Data - Price competition has forced price cuts but growth positive

- Safaricom has lost a considerable market share of mobile data subscribers in the last two years due to price competition from both Airtel and Telkom further illustrating the price sensitivity of the mobile data subscribers.
- Safaricom's loss of market share is also partially attributable to calls by an opposition political part to boycott Safaricom products.
- In the last five years, the demand for data has been on an uptrend, total mobile data subscriptions increasing from 13.2Mn in Dec 2013 to 45.3Mn in Dec 2018.

Fig.8: Safaricom facing stiff competition in mobile data



Airtel-Telkom (Assumes combined market share after proposed merger).

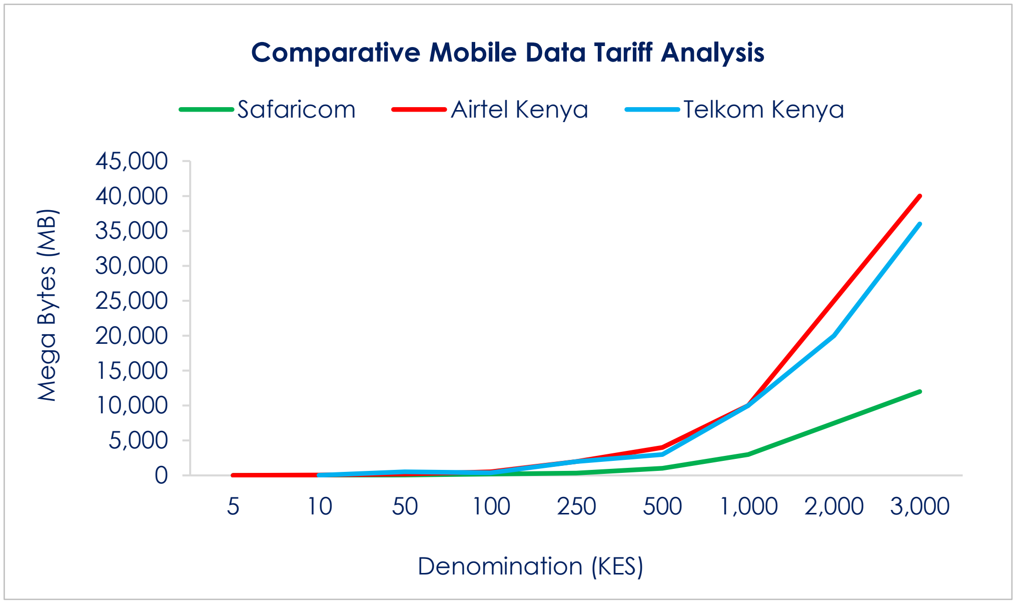
Source: Communications Authority

Safaricom reduced effective rate per MB by 36% YoY as of September 2018 to counter the threat of competition.

Mobile Data - Pricing is key as subscribers are highly price sensitive

- To counter the competitive threats in the last three quarters, Safaricom has reduced their effective rate per MB by 36% YoY as of HY2018/19.
- It however still remains comparatively more expensive in mobile data tariffs (Fig.9).

Fig.9: Airtel & Telkom Kenya mobile data tariffs are significantly lower



Source: Company tariff guides

- We expect price competition to intensify once the merged entity (Airtel-Telkom) start operations with mobile data a key focus.
- This is likely to negatively impact Safaricom's mobile data subscriber market share but have a lesser impact on mobile data revenues which will continue to grow albeit at a slower pace as was the case.
- This was the case in FY2016/17 and FY2017/18 where data revenue growth rates stood at 38.6% and 24.0% respectively compared to FY2015/16 where it grew by 42.7%.
- Safaricom will however retain its market leadership position enjoying the benefit of scale and will focus on investment in its network.
- Safaricom will continue to drive data usage through promotions and sales of smartphones to counter the threat of declining market share in subscribers.

Mobile data revenue growth rates might have declined but demand continues to grow

Mobile data growth opportunities exist due to supportive economic and demographic structures. Airtel-Telkom merger could present stiffer competitive threats.

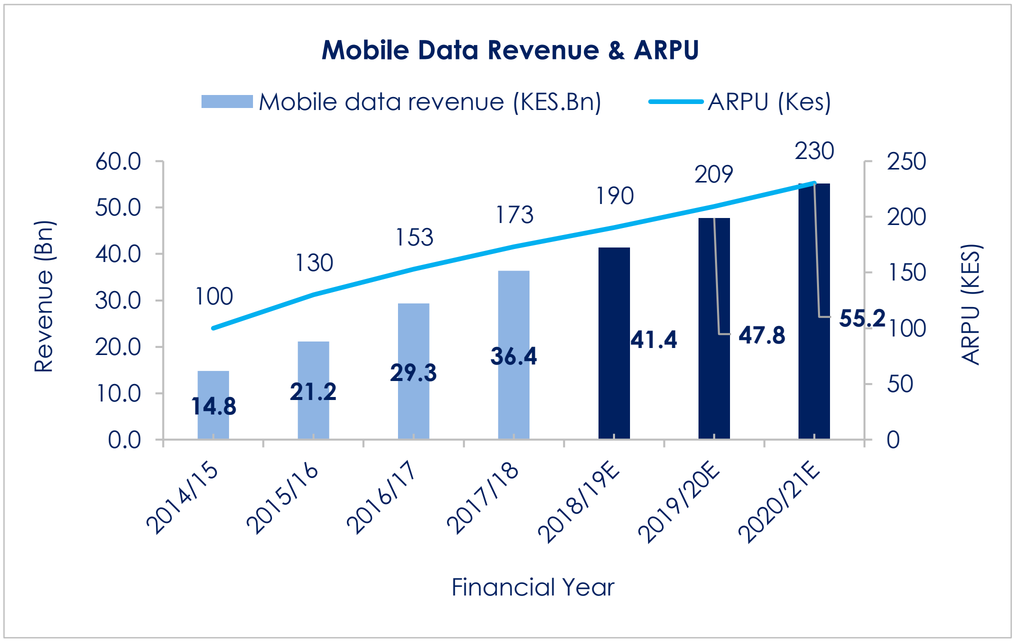
- We forecast FY2018/19-FY20/21 ARPU at KES.190, KES 209 and KES 230 respectively a marked increase from FY2017/18 (KES.173) (Fig.10).
- Our FY2018/19 to FY2020/21 mobile data revenue forecasts are KES.41.4Bn, KES.47.8Bn and KES.55.2Bn.
- FY2018/19, FY2019/20 and FY2020/21 projections for data revenue as a proportion of total service revenue are 17%, 18% and 21% respectively an increase from 16% FY2017/18.
- Our mobile data revenue forecasts are supported by the following:

1) **Increased GDP Growth -** Projected GDP growth for 2019, 2020 and 2021 is 5.8%, 6.0% and 6.2% **(Source: World Bank)** respectively. This we expect to result in an increase in subscribers' disposable income for customers. According to Safaricom, 70% of the data enabled phones have usage below 100MBs and current usage stands at 639.8MBs/user - HY2019.

2) **Youthful population** - Younger generation are more tech Savvy and have high technology adoption and internet usage rates. Almost three-quarters of the population is under the age of 30 with the current median age at 19.7.

3) **Increased smartphone penetration** - According to the Jumia mobile report 2019, Kenya is Africa's Silicon Savannah. Internet connectivity in Kenya is at a penetration rate of 84% with 43.3M of the total population having access to the Internet in Kenya. Google only identifies 13M active internet users in the country. We expect this continued penetration to drive internet usage and mobile data revenues for Safaricom.

Fig.10: Mobile data revenue to record positive growth FY2019/20 & FY2020/21



Source: Company Filings & Sterling Capital Research

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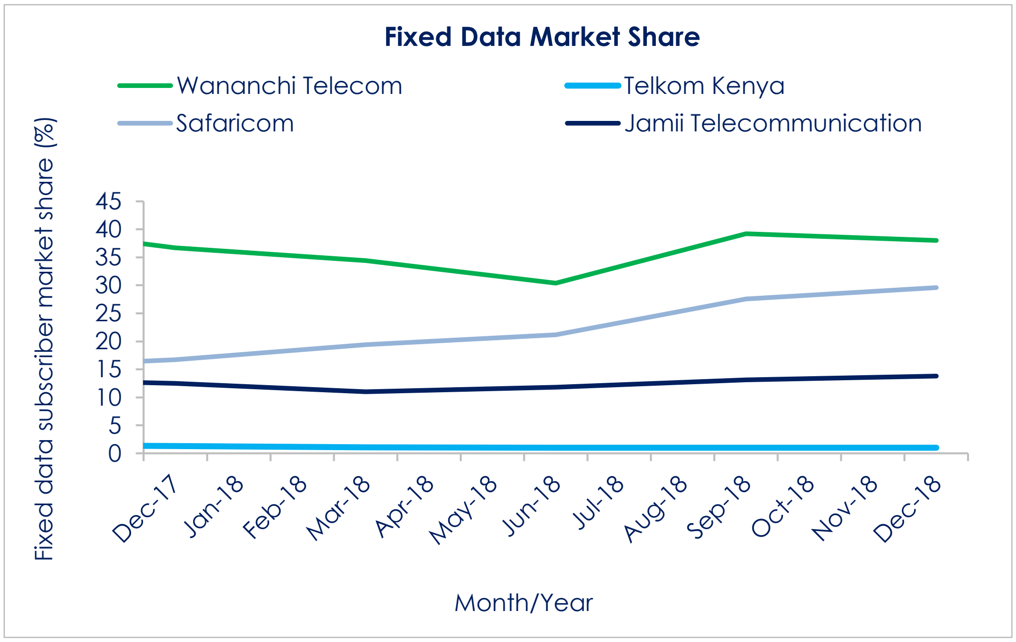
E) Fixed Data - Safaricom closing in on the dominant player

Fixed data service revenue growing rapidly as Safaricom increases market share.
Safaricom to become the dominant market player in 3-5 Years.

- Fixed data is a fast growing business for Safaricom which holds 29.6% of total subscriptions (December 2018) compared to 38% and 13.8% held by Wananchi Group Limited and Jamii Telecommunication respectively.
- Wananchi market share has been on a downward trend from a high of 48% in December 2014 to 38% December 2018.
- Rapid market share growth attributable to network expansion, reliability and service unreliability of the largest player
- According to management, the company will initially limit fixed data network expansion to the larger towns/cities due to a cost benefit analysis.
- Safaricom will be the biggest beneficiary of Wananchi's rumored market exit where we forecast a market share of +50% in the next five years.
- The Airtel-Telkom merger could change the competitive landscape in the future considering an improved financial position to commit resources to setting up a fibre network to support fixed data.
- We however do not see an immediate threat on Safaricom's market share because of the huge Capex investment required.

Fig.11: Safaricom likely to be the market leader in fixed data service in the next 3-5 years

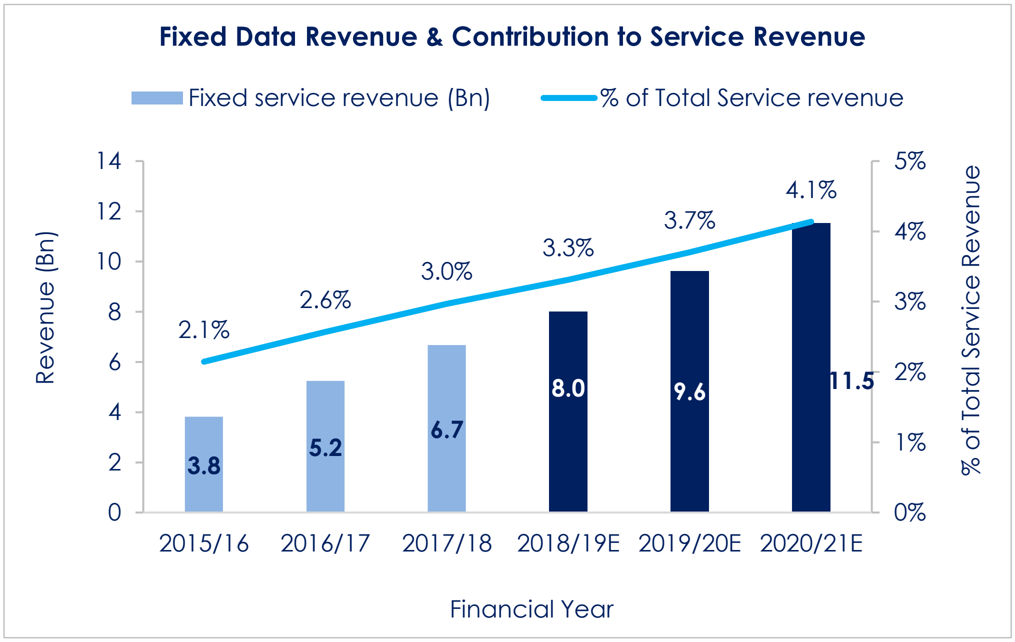


Source: Communications Authority

Fixed data represents a huge revenue growth opportunity

- We forecast an increase in the fixed service revenues to KES.8.0Bn, KES.9.6Bn and KES.11.5Bn FY2019, FY2020 and FY2021 respectively.
- We expect revenue growth to be driven by network reliability, aggressive advertising & customer centricity and high barriers to entry.

Fig.12: Fixed data showing rapid revenue growth potential with increased market share forecasts



Source: Communications Authority

F) "Masoko" - E-Commerce yet to gain traction

Kenya ranked 3rd in Africa with 2.2Mn online shoppers, with 24% shoppers being internet users.

- We have minimal data on the business performance of one of Safaricom's new business, its E-Commerce platform "Masoko" launched in November 2017.
- E-Commerce is growing relatively fast (Table.4) but has generally struggled to gain traction in the country where traditional in-store shopping remains the preferred shopping method.
- Some of the factors negatively impacting the adoption of E-Commerce growth in the country according to CA include limited internet access, a poor national address system, limited access to financial service, inefficient physical logistics, prohibitive customs and duties and concerns over internet fraud.
- Kenya is ranked 3rd in Africa with approximately 2.2Mn online shoppers with an equivalent of 24% of shoppers being internet users.
- "Masoko" has a positive impact on M-Pesa revenues through mobile payments and to a lesser extent brand loyalty.

- We continue to see long-term growth potential for the business as the Kenyan population becomes more receptive to online shopping and E-Commerce with Safaricom having the benefit of a wide agent network which will support distribution.
- At this point we are unable to accurately forecast the impact of the E-Commerce business on Safaricom's total service revenues.

Table.4: E-Commerce adoption in Kenya growing but still comparatively lower than traditional in-store shopping

Rank	Country	Online purchase (% age 15+) 2017	Online shoppers (000s)	Online shoppers (000s) rank in Africa	B2C Index rank in Africa	Internet use	Shoppers (% of Internet users)
1.	Libya	14.6	629	10	13	20	67%
2.	Mauritius	14.4	129	26	1	55	26%
3.	Namibia	12.1	184	21	11	31	24%
4.	Kenya	9.3	2,164	3	7	39	24%
5.	South Africa	7.9	2,929	2	3	59	13%
6.	Gabon	6.1	74	29	12	62	10%
7.	Tanzania	5.3	1,593	4	16	25	21%
8.	Zambia	5.1	459	11	26	24	21%
9.	Tunisia	4.7	366	14	4	56	8%
10.	Mozambique	4.3	665	9	32	23	19%

Source: United Nations Conference on Trade & Development (UNCTAD) E-Commerce Index

Financial Summary

Income Statement (KES. Mn)							
Financial Year	**2014/15**	**2015/16**	**2016/17**	**2017/18**	**2018/19E**	**2019/20E**	**2020/21E**
Total Service Revenue	**156,247**	**177,784**	**204,109**	**224,535**	**241,901**	**259,615**	**278,758**
Growth	12.9%	13.8%	14.8%	10.0%	7.7%	7.3%	7.4%
Voice Revenues	87,368	90,802	93,459	95,639	96,134	95,694	95,230
Contribution Margin	55.9%	51.1 %	45.8%	42.6%	39.7%	36.9%	36.7%
SMS Revenues	15,671	17,328	16,679	17,721	17,633	17,607	17,576
Contribution Margin	10.0%	9.7%	8.2%	7.9%	7.3%	6.8%	6.7%
Mobile data Revenues	14,823	21,154	29,328	36,357	41,360	47,771	55,175
Contribution Margin	9.5%	11.9%	14.4%	16.2%	17.1%	18.4%	21.3%
Fixed service Revenue	3,128	3,815	5,242	6,673	8,008	9,609	11,531
Contribution Margin	2.0%	2.1%	2.6%	3.0%	3.3%	3.7%	4.4%
M-Pesa Revenue	32,626	41,500	55,084	62,907	73,004	82,597	92,274
Contribution Margin	20.9%	23.3%	27.0%	28.0%	30.1%	31.2%	34.4%
Other service Revenue	2,631	3,185	4,317	5,238	5,762	6,338	6,972
Non-service Revenue	7,118	17,902	8,776	9,182	9,306	9,622	9,956
Total Revenue	**163,403**	**195,686**	**212,885**	**233,717**	**251,207**	**269,237**	**288,714**
Other Income	576	231	2,511	-	-	-	-
Direct Costs	56,911	63,015	66,782	70,555	68,130	69,623	72,318
Growth	9.2%	10.7%	6.0%	5.6%	-3.4%	2.2%	3.9%
Gross Profit	**106,492**	**123,622**	**148,536**	**163,470**	**183,415**	**199,983**	**216,801**
Operating Expenses	35,837	40,573	44,928	50,636	54,769	59,287	64,325
EBITDA	**71,231**	**83,049**	**103,608**	**112,834**	**128,646**	**140,696**	**152,476**
EBITDA Margin	43.6%	42.4%	48.7%	48.3%	51.2%	52.3%	52.8%
Depreciation& Amortization	25,571	27,943	33,234	33,568	33,180	36,053	39,185
EBIT	**45,660**	**55,106**	**70,374**	**79,266**	95,466	104,634	113,274
EBIT Margin	27.9%	28.2%	33.1%	33.9%	38.0%	38.9%	39.2%
PBT	46,189	55,744	70,632	79,909	94,522	105,785	114,512
PAT	**31,911**	**38,086**	**48,444**	**55,289**	**67,565**	**74,050**	**80,158**
EPS	**0.8**	**0.95**	**1.21**	**1.38**	**1.69**	**1.85**	**2.00**
DPS	**0.64**	**0.76**	**0.97**	**1.10**	**1.35**	**1.48**	**1.60**

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Balance sheet (KES Mn)						
Financial Year	**2015/16**	**2016/17**	**2017/18**	**2018/19E**	**2019/20E**	**2020/21E**
Equity						
Share capital & Premium	4,203	4,203	4203	4203	4203	4203
Retained Earnings	82,052	64,422	75,640	89,153	103,963	119,995
Proposed dividends	30,483	38,863	44,071	54,052	59,240	64,127
Total Equity	**116,738**	**107,488**	**123,914**	**147,408**	**167,406**	**188,324**
Current Assets						
Inventories	816	1,371	1,605	3,733	3,815	3,963
Receivables and prepayments	22,904	19,965	15,857	20,647	22,129	23,730
Total Current Assets	**27,659**	**25,160**	**27,462**	**60,994**	**87,757**	**114,309**
Total Assets	**159,181**	**161,686**	**167,439**	**200,283**	**224,733**	**248,879**
Current Liabilities						
Payables & Accrued expenses	40,069	36,567	39,341	42,931	43,872	45,570
Borrowings	-	16,544	4,040	4,646	5,342	6,144
Total Current Liabilities	**42,443**	**54,197**	**43,525**	**48,665**	**50,303**	**52,804**
Total Non-Current Liabilities	**-**	**-**	**-**	**-**	**-**	**-**
Total Liabilities	**42,443**	**54,197**	**43,525**	**48,665**	**50,303**	**52,804**

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Valuation:

- We used 3 valuation methods in calculating our fair value estimate: **1) Discounted Cash Flow Method (FCFF) 2) Relative Valuation approach (EBITDA Multiple - Enterprise Value) 3) Relative Valuation approach (P/E Multiple)** and made the following assumptions:

  1) Discount rate (cost of equity) of 14.99%.
  2) Terminal growth rate 9% (average internal growth rate over the 3 year forecast period)
  3) A beta of 0.67.
  4) A risk-free rate of 10.38% (2-year bond).
  5) Market risk premium of 6.89%.

- We gave equal weighting to each of the three valuation methods (33.3%) to arrive at our fair value estimate.

Free Cash Flow to the Firm						
Financial Year	**2015/16**	**2016/17**	**2017/18**	**2018/19E**	**2019/20E**	**2020/21E**
EBIT	55,124	70,375	79,266	95,466	104,634	113,274
Taxes	(17,658)	(22,188)	(24,620)	(28,957)	(31,736)	(34,354)
Net EBIT	37,466	48,187	54,646	66,510	72,898	78,921
Add: Depreciation & Amortization	27,943	33,234	33,568	33,180	36,053	39,185
Less: Capex	33,337	35,334	36,422	36,348	35,979	39,212
FCFF	32,072	46,087	51,792	63,342	72,973	78,895
Time Period					0.92	1.92
Discount factor					0.88	0.76
Terminal Value						1,438,243
Terminal Value Y3 summation						1,517,138
Discounted Values					64,167	1,160,113
Sum of discounted values					1,224,280	
Number of outstanding shares					40,065	
Fair Value Estimate					**30.56**	
Enterprise Value (KES)	83,067	103,609	112,834	128,646	140,687	152,460
Average Market capitalization						1,119,828.
Add: Debt						4040
Add: Preferred stock						0
Add: Minority Interest						0
Less: Cash						9,497
EV/EBITDA (x)						1,114,372
Implied Market Cap						9.88
Enterprise Value:						1,270,533
Number of outstanding shares						40,065
Fair Value Estimate						**31.71**
P/E Multiple (x)						16.46
Industry P/E (X)						1.69
Fair Value Estimate (KES)						**27.76**
Fair Value Estimate						
Valuation Method	**Weighting**	**Avg. Fair Value**				
FCFF	33.3%	10.19				
EV/EBITDA	33.3%	10.57				
P/E	33.3%	9.25				
Weighted Fair Value Price (KES)	**100%**	**30.01**				

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For important disclosures refer to the disclosures section located at the end of this report.

Risks to our valuation and recommendation

- Our valuation model is based on the current and medium term forecasted business operational, economic and competitive environment.
- We however cannot ignore some risks that could significantly alter our financial forecasts and fair value estimates for the company:

1) **Competition Intensity** - The merger of Airtel-Telkom creating resulting in stiffer than initially expected competition resulting in a loss of market share and with it business profitability.
2) **Regulation** - Imposition of new regulation directly impacting Safaricom itself such as competitive regulations or all industry players such as new taxation could adversely impact revenues, operational costs and ultimate profitability.
3) **Macro-Economic/Political risks** - Slow-down in economic activity, inflationary pressure, currency volatility, and political instability could have a big impact on business performance, operational costs and overall financial performance.

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Strong Buy: FV more than 30% above CSP
Buy: FV between 20% and 30% above CSP
Accumulate/Long-Term Buy: FV between 10% and 20% above CSP
Hold: FV between -10% and 10% around CSP
Underweight: FV between 10% and 20% below CSP
Sell: FV more than 20% below CSP

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