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Telecommunications Sector

Safaricom Plc

FY20 Earnings Expectations & Valuation Update

"Dropped calls but M-Pesa holds steady"

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Executive Summary

- We release our FY20 earnings expectations and valuation update report titled **"Dropped calls but M-Pesa holds steady"** ahead of the company's annual financial results announcement on 29th April 2020 with fairly positive bottom-line growth expectations boosted by M-Pesa and fixed data revenues.
- We give a **HOLD** recommendation with a fair value estimate of **KES.31.05** a **9% upside** from the market price of KES.28.50 on 20th April 2020.
- We further predict a KES.1.44 ordinary dividend payment based on the company's traditional 80% dividend payout ratio policy.
- Our Profit After Tax (PAT) estimate FY20 is **KES.72.1Bn, 15.4%** growth over the previous year boosted by 17.4% and 17% growth in M-Pesa and fixed data revenues respectively.
- Voice and messaging revenues are once again expected to come under pressure while mobile data is expected to report sluggish growth due to price competition.
- Also covered in our report are the main factors we expect to impact the performance of the business in the near and medium term including the COVID -19 pandemic, competition, regional expansion as well as the change of management.
- The report covers the expected performance of each service revenue also discussing market share trends singling out voice calls and mobile data revenue as business lines we expect SCOM to face the stiff competition.
- SCOM holds a significant competitive advantage with M-Pesa but revenue growth appears to be slowing down while on Fixed Data competition has intensified.
- With regards to subscriber market share SCOM has been resilient but the expected merger of Airtel and Telkom Kenya is expected to present stiffer competition.
- Overall, we rate the financial performance of SCOM as fairly good in the face of competitive and regulatory threats and predict another year of strong performance.

Safaricom Plc

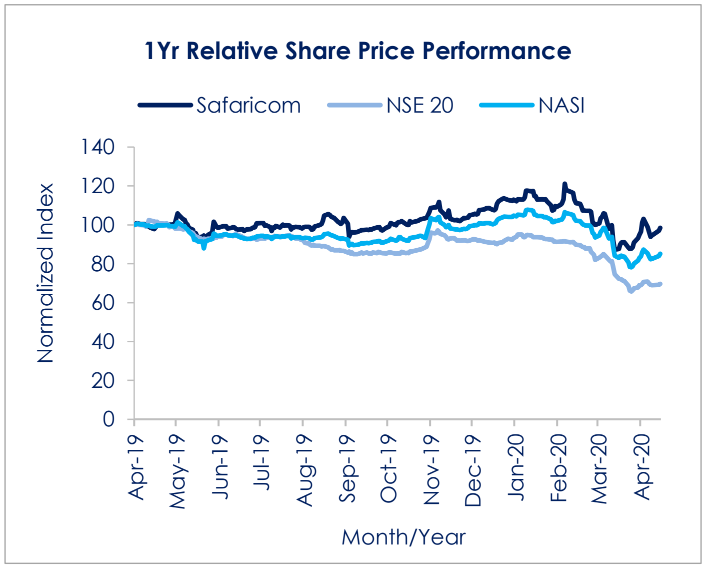
- We maintain our **HOLD** recommendation on Safaricom Plc (SCOM) with a fair value estimate of KES.31.05, 9% upside from the market price KES.28.50 (20th April 2020).
- This is a 3.5% upward revision from KES.30.01 in April 2019 and 2.5% above KES.30.30 in our HY20 earnings preview report.
- Our valuation estimate is supported by 11.7% increase in EBIT to KES.99.4Bn above management guidance (KES.93-97Bn) and 15.4% increase in EPS growth to KES.1.80.
- Stiff competition following the expected Airtel-Telkom merger, the impact of COVID-19 and the long-term business potential of regional expansion are some of considerations guiding our forward earnings estimates.
- We revised our FY20 total service revenue estimates downwards to KES.251.1Bn from our April 2019 forecasts - KES.259.6Bn this however, translating to 4.7% growth over FY19 (KES.239.8Bn).
- Our service revenue forecasts are backed by strong performance by M-Pesa and Fixed Data up 17.4% and 17% respectively.
- This will offset poor performance by Voice (-2.5%) to and Messaging (-11.8%) with both revenue lines falling below our initial expectations due to stiff competition and new technological influences.
- Mobile data forecasted to grow 18.4% to KES.47.8Bn in April 2019 to post a modest 3.9% growth to KES.36.7Bn attributable to stiff price competition and high subscriber price sensitivity.
- Subdued top line growth will see greater focus on cost management efforts that we expect to pay off with operating expenses set to decline 1.5% to KES.52.8Bn (FY19 - KES.53.6Bn).
- Our Capital Expenditure (Capex) estimate FY20 is KES.38.8Bn falling within management guidance - KES.36 - 39Bn.
- We predict an ordinary dividend payment of KES.1.44 per share based on the historical dividend payment policy ratio of 80%.

Table.1 Share Data

NSE Code	SCOM
Bloomberg Code	SCOM:KN
Price 20th April 2020 (KES)	28.50
Fair Value Estimate (KES)	**31.05**
Upside/ (Downside) (%)	↑9
Recommendation	**HOLD**
Market Cap (KES. Bn)	1,141.9
Free Float (%)	25
52 Week High/Low (KES)	32.90 - 24.50
P/E (x)	18.0
P/B (x)	7.9

Source: Nairobi Securities Exchange & Sterling Capital Research

Figure.1 Share Price Performance



Source: Nairobi Securities Exchange

Table.2 Share price performance

Index	1YR	6M	1M	YTD
Safaricom (%)	2.3	0.8%	12.2	-8.9
NSE-20 (%)	-30.8	-19.3	-2.0	-25.7
NASI (%)	-12.9	-7.1	3.7	-17.0

Source: Nairobi Securities Exchange

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Financial Summary

Table.3 Financial Performance and forecasts - Income Statement

Income Statement (KES. Mn)							
Financial Year	**FY17**	**FY18**	**FY19**	**FY20E**	**FY21F**	**FY22F**	**FY23F**
Total Service Revenue	**204,109**	**224,535**	**239,767**	**251,120**	**263,431**	**276,212**	**290,387**
Growth	14.8%	10.0%	6.8%	4.7%	4.9%	4.9%	5.1%
Voice Revenues	93,459	95,639	95,798	93,433	90,218	87,652	86,069
Voice Contribution	45.8%	42.6%	40.0%	37.2%	34.2%	31.7%	29.6%
SMS Revenues	16,679	17,721	19,612	17,292	17,937	17,765	17,491
SMS Contribution	8.2%	7.9%	8.2%	6.9%	6.8%	6.4%	6.0%
Mobile Data Revenues	29,328	36,357	36,265	37,662	38,813	39,906	40,943
Mobile Data Contribution	14.4%	16.2%	15.1%	15.0%	14.7%	14.4%	14.1%
Fixed service Revenue	5,242	6,673	8,101	9,478	11,184	13,086	15,179
Fixed-Service Contribution	2.6%	3.0%	3.4%	3.8%	4.2%	4.7%	5.2%
M-Pesa Revenue	55,084	62,907	74,990	88,053	99,870	112,178	124,854
M-Pesa Contribution	27.0%	28.0%	31.3%	35.1%	37.9%	40.6%	43.0%
Other Service Revenue	4,317	5,238	5,001	5,201	5,409	5,625	5,850
Non-Service Revenue	8,776	9,182	10,051	10,833	10,391	10,692	11,006
Total Revenue	**212,885**	**233,717**	**249,818**	**261,953**	**273,822**	**286,904**	**301,393**
Other Income	2,509	510	465	435	407	382	360
Direct Costs	(66,782)	(70,555)	(71,786)	(74,411)	(76,833)	(79.928)	(84,626)
Direct Costs Growth	6.0%	5.6%	1.7%	3.7%	3.3%	4.0%	5.9%
Gross Profit	**148,536**	**163,470**	**177,894**	**187,313**	**196,666**	**206,556**	**216,767**
Operating Expenses	(44,928)	(50,636)	(53,590)	(52,780)	(53,665)	(54,608)	(55,622)
EBITDA	**103,608**	**112,834**	**124,304**	**134,533**	**143,001**	**151,947**	**160,623**
EBITDA Margin	48.7%	48.3%	49.8%	51.4%	52.2%	53.0%	53.3%
Depreciation & Amortization	33,234	33,568	35,331	35,113	37,186	40,763	44,701
EBIT	**70,374**	**79,266**	**88,973**	**99,420**	**105,815**	**111,184**	**115,922**
EBIT Margin	33.1%	33.9%	35.6%	38.0%	38.6%	38.8%	38.5%
Profit Before Tax	70,632	79,909	91,218	102,993	109,331	114,637	119.306
Profit After Tax	**48,444**	**55,289**	**62,491**	**72,095**	**76,532**	**80,246**	**82,321**
Earnings Per Share (KES)	**1.21**	**1.38**	**1.56**	**1.80**	**1.91**	**2.00**	**2.05**
Dividend Per Share	**0.97**	**1.10**	**1.25**	**1.44**	**1.53**	**1.60**	**1.64**
Special Dividend Per Share (KES)			0.62			0.40	

Company Filings & Sterling Capital research

Table.4 Financial Performance and forecasts - Financial position

Balance sheet (KES Mn)							
Financial Year	**FY17**	**FY18**	**FY19**	**FY20E**	**FY21F**	**FY22F**	**FY23F**
Equity							
Share capital	2,203	2,203	2,203	2,203	2,203	2,203	2,203
Share Premium	2,000	2,000	2,000	2,000	2,000	2,000	2,000
Retained Earnings	64,422	75,640	65,221	83,362	98,668	98,668	115,133
Proposed dividends	38,863	44,071	74,923	57,676	61,225	80,246	65,857
Total Equity	**107,488**	**123,914**	**144,347**	**145,241**	**164,097**	**183,117**	**185,192**
Current Assets							
Inventories	1,371	1,605	1,775	2,243	2,316	2,409	2,550
Receivables and prepayments	19,966	18,320	20,868	22,478	23,372	24,358	25,450
Cash and cash equivalents	5,956	9,497	20,030	23,430	40,776	58,368	61,500
Total Current Assets	25,162	27,462	49,959	64,659	82,941	102,612	105,978
Total Non-Current Assets	136,527	139,977	142,517	141,889	142,564	143,375	144,331
Total Assets	**161,686**	**167,439**	**192.476**	**206,548**	**225,506**	**244,987**	**250,310**
Current Liabilities							
Payables & Accrued expenses	36,571	39,341	41,878	50,967	52,626	54,745	57,963
Borrowings	16,544	4,040	4,032	7,660	6,104	4,444	4,474
Other Liabilities	1,086	144	349	810	810	810	810
Total Current Liabilities	54,201	43,525	46,259	59,437	59,539	60,000	63,247
Total Non-Current Liabilities	-	-	1,870	1,870	1,870	1,870	1,870
Total Liabilities	**54,201**	**43,525**	**48,129**	**61,307**	**61,409**	**61,870**	**65,117**

Company Filings & Sterling Capital research

COVID -19 disruption will have significant business and revenue implications

COVID-19 is expected to have significant revenue implications.

- COVID -19 (Coronavirus) will have a negative impact on SCOM's operations and revenues as well as on the Kenyan economy especially if it is prolonged.
- Areas we see being affected most include the following:

1) Decline in disposable income due to job losses, inflationary pressure or just spending cuts due to economic uncertainty.

   This will affect business and household expenditure on communication services as well as volume and value of mobile money transfer and payments.

   There might be some exceptions with regards to consumer spending on mobile and fixed data as well as messaging.

2) Government intervention actions meant to mitigate the impact of the pandemic on the economy could result in the introduction of new taxes to compensate for loss of income and import taxes.

   The tax amendment Bill 2020 does not explicitly indicate any new taxes to mobile telecommunications services taxes but the reduction in Value Added Tax (VAT) to 14% from 16% would have an impact on final cost of services provided including fixed data and handset costs.

Government interventions could include tax measures with revenue and cost implications.

3) The waiver of fees on some transactions including M-Pesa payments and money transfers of KES. 1,000 or lower and bank to M-Pesa and vice versa will also have revenue implications.

4) Subdued economic activity will result in a decline in expenditure on communication, mobile payments and transfers thus negatively impacting voice and M-Pesa revenues.

5) On the flip side however, the Government stay/work at home directive is likely to result in increased demand for messaging services, mobile and fixed data.

6) Supply chain disruption - Mobile phone and equipment imports likely to be affected due to supply disruptions in source countries and cargo transportation.

Competition - Airtel-Telkom still on course but hurdles could delay merger

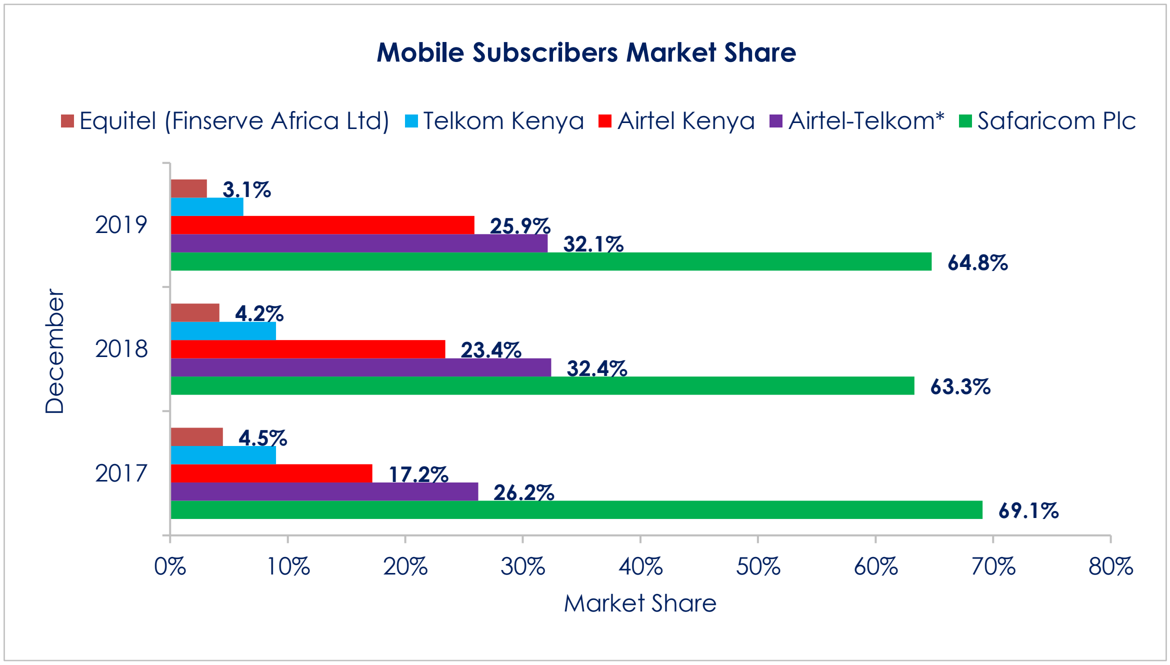
Airtel Kenya-Telkom merger has received conditional approval but set-backs could delay process.

- Progressive developments with regards to the Airtel-Telkom merger have been recorded since our last annual results expectations report but nothing conclusive in terms of timelines of the merger.
- Since then, two regulators the Competition Authority of Kenya (CAK) and the Communications Authority (CA) have approved the merger subject to some conditions being fulfilled (some of which are currently being appealed by the soon to merge entities).
- A few legal hurdles have also emerged the main one being a suit challenging the merger by former Airtel employees seeking compensation for retrenchment.
- SCOM has denied opposing the merger severally indicating reservations over a KES.1.3Bn debt owed by the two entities for services rendered, unequal distribution of spectrum and licensing and operational requirements which the company feels gives the merged entity undue advantage.
- Internal sources indicate that the biggest issue for them is spectrum where Airtel-Telkom will hold 77.5Mhz of spectrum for 17.5Mn subscribers compared to SCOM's 57.5Mhz for 33.5Mn subscribers.
- We however believe that the merger is on course in spite of the challenges presented and give a tentative timeline of June 2021 for the completion of the merger.

SCOM resilient to competitive threats but risks remain in selected business lines like voice calls and mobile data.

- Latest available market share statistics (December 2019) shows SCOM has regained some of its lost market share with Airtel recording the biggest gain amongst the operators (Figure.2).
- This differs slightly with our expectations at this time last year where we forecasted stable market share that could come under further attack in the event of the Airtel-Telkom merger.
- Airtel-Telkom have lost market share to SCOM if we assume combined market share of 32.1% compared to 32.4% over the same period in 2018.
- We however, cannot discount the threat of competition based on the statistics above and maintain the view that the merger would present a more formidable competitor.
- The most likely threats would come from voice calls and mobile data business lines due to the high price sensitivity of subscribers and where we feel exists further headroom for tariff cuts which has been a successful customer acquisition strategy in the past.
- On the basis of the above considerations, we do not expect major deviations in subscriber market share FY20.

Figure.2: Safaricom halts loss of market share with Airtel making modest gains



Source: Communications Authority

Regional expansion - Ethiopia looks compelling as a long-term business growth strategy but roadblocks exist

Regional expansion to create new revenue streams in the long-term.

- SCOM confirmed in a conference call late March 2020 that its intention to expand its M-Pesa service to Ethiopia was still on course and would happen by December 2020 or early 2021.
- The company had communicated that entry would likely be through partnership with a local company (Ethio Telekom is the only operator) as sole entry by foreign companies is restricted.
- The Ethiopia opportunity appears attractive with long-term revenue growth potential on the basis of the country's demographic and economic characteristics.
- We see the possibility of this happening within the time line given as moderate on account of the following:

1) The Ethiopia telecommunications sector just like its financial one is closed to entry by foreign companies in spite of earlier indications that it would be opened up for investment by foreign companies.

2) Operator license costs appear to be extremely high up to US$1Bn (KES.105Bn) thus negatively impacting return on investment and payback periods.

3) We believe that SCOM would prefer a joint venture with its associate company Vodacom as its market entry partner rather than the local operator in the country.

It however has not ruled being part of a consortium for entry of its M-Pesa service.

Ethiopia telecom is also expected to sell as stake and this could be a market entry point.

4) Other countries in the region might have less stringent market entry regulations and this could shift SCOM's interest from Ethiopia.

Safaricom/Vodacom Joint Venture presents new savings and opportunities

JV acquisition of M-Pesa rights will have significant cost savings and strategic implications.

- The acquisition of the M-Pesa brand, product development and support services from Vodafone through a SCOM and Vodacom Joint Venture (JV) in 2020 will have significant revenue and strategic business implications.
- M-Pesa previously owned by Vodafone Sales and Services Limited (VSSL) and managed by SCOM with a 2% quarterly license fee (based on M-Pesa transaction revenue) payable to VSSL effective April 2017.
- Based on our FY20 and FY21 M-Pesa revenue estimates we see the JV saving KES.1.8 to KES. 2.2Bn in what would have been annual license fees between FY20 and FY21.
- With regards to strategic business benefits, it is expected that the JV makes the roll-out of M-Pesa across key markets within East and Central Africa look more feasible than it was in the past.
- This roll-out however appears to be a medium to long-term business growth strategy an advantage once M-Pesa revenues locally approach maturity.

Government digitization strategy to present new revenue streams

- The 2020/21 national Government fiscal budget shows new business growth opportunities with potential positive revenue implications in the near to medium term especially with regards to digital communication services and M-Pesa.
- Some of these initiatives include:

JV acquisition of M-Pesa rights will have significant cost and business strategy

1) **Development of the "digital money grid"** - Involves the development of infrastructure to support digital financial solutions across the country.

2) **National Policy on Digital Finance** - This will allow full integration of mobile money and the banking system, digital payments for Government services and the use a national biometric system for digital transactions.

- It is our opinion that SCOM is well positioned to benefit from these initiatives due to its national network coverage and M-Pesa
- The growing possibility of regulation on digital lending/credit could present new challenges for SCOM as well as other digital lenders.

Ndegwa at the helm, the tasks at hand

- Peter Ndegwa took over as CEO on 1st April 2020 becoming the first Kenyan to head the company.
- Overall, we are confident in Ndegwa's managerial ability and experience to steer the company with the following expected to be his main focus areas:

1) **Limiting the financial and operational impact of the COVID -19 pandemic** - A reduction in disposable income due to a fall income, loss of employment or cut in consumer spending due to uncertainty over future earnings or economic conditions will have a direct impact on SCOM revenues.

   Some of the temporary measures aimed at limiting health risks and promoting business continuity such as the waiver of fees on transfer and payments will have financial implications.

   In addition, we expect the slowdown in economic activity to result in a fall in the number and value of payments and transfers.

   Deteriorating macro-economic fundamentals including depreciation of the Kenya Shilling and inflationary pressure will have financial implications to the company in terms of import costs, finance costs and capital expenditure.

Change of top management does not present an immediate risk to the business.

2) **Declining and plateauing service revenue lines -** Declining voice and SMS as well as slow growth rates in mobile data revenues in the face of changes in technology and stiff price competition.

3) **Regulation** - Ndegwa's experience at East African Breweries Limited (EABL) could come handy with regards to tackling taxation and anti-competitive legislation.

   The issue of market dominance and threat of regulation to reduce SCOM's dominance seems to have declined but remains existent as stated in our April 2019 report.

   However, this threat cannot be discounted in totality and Ndegwa like his predecessors will be expected to counter this threat.

4) **Competition** - The Airtel-Telkom merger will present a formidable competitive force and a threat to SCOM's market positioning with price competition the most likely strategy to be adopted by the entity.

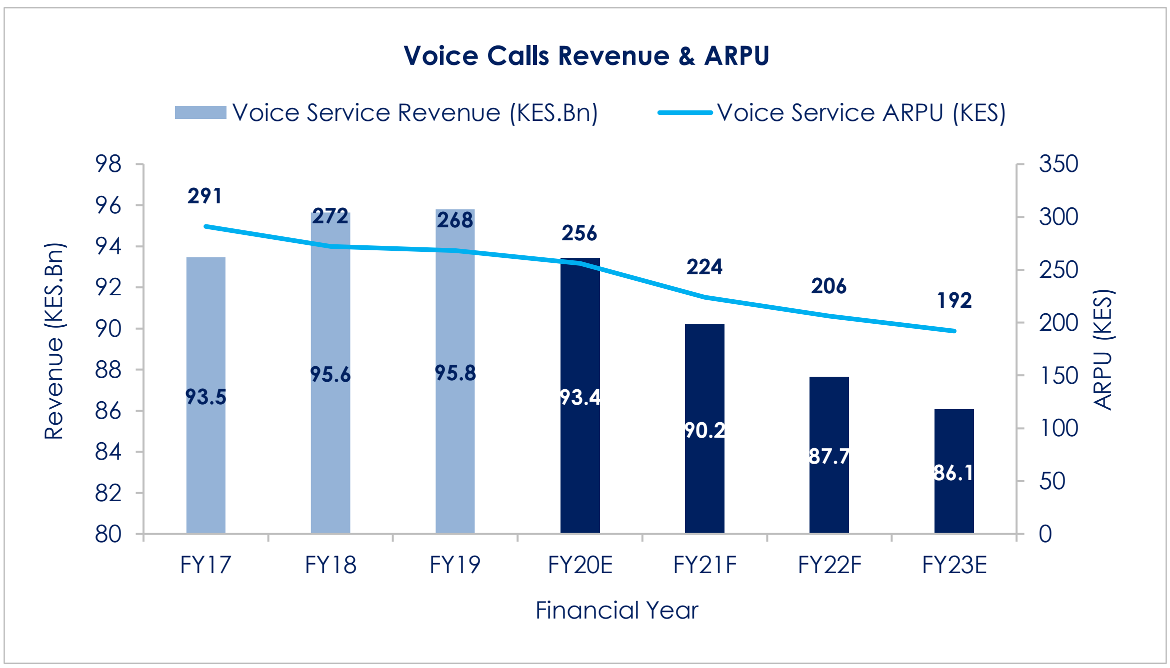
5) **Regional expansion and emerging business opportunities -** The success with which he pursues emerging regional business growth opportunities Such as expansion of M-Pesa services into Ethiopia as well as undeveloped mobile money markets across East and Central Africa.

A) Voice Calls - Competitive intensity to hit ARPU and total revenues FY20

2.5% decline in total voice calls revenue to KES.93.4Bn due to 4.5% drop in ARPU.

- We project a 2.5% decline in total voice call revenues FY20 to KES.93.4Bn from KES.95.8Bn FY19, driven by 4.5% drop in Average Revenue Per user (ARPU) from KES.268 to KES.256 (Figure.3).
- Continuous price competition (especially after the Airtel-Telkom merger) due to high subscriber price sensitivity as well as flat growth or gradual reduction in industry voice call traffic will see ARPU dip further FY21, FY22 and FY23 to KES.224, KES.206 and KES.192 respectively.
- Our revenue forecasts on the basis of the above considerations are KES.90.2Bn, KES.87.7Bn and KES.86.1Bn FY21, FY22 and FY23 respectively.
- We expect voice contribution to total service revenue to decline to 37.2% FY20 from 40% the preceding year and forecast 34.2%, 31.7% and 29.6% in FY21, FY22 and FY23 respectively.
- Voice calls will lose its position to M-Pesa as SCOM's main revenue earner FY21.

Figure.3: Voice calls ARPU and revenues to decline FY20 going forward



Source: Company Filings and Sterling Capital Research

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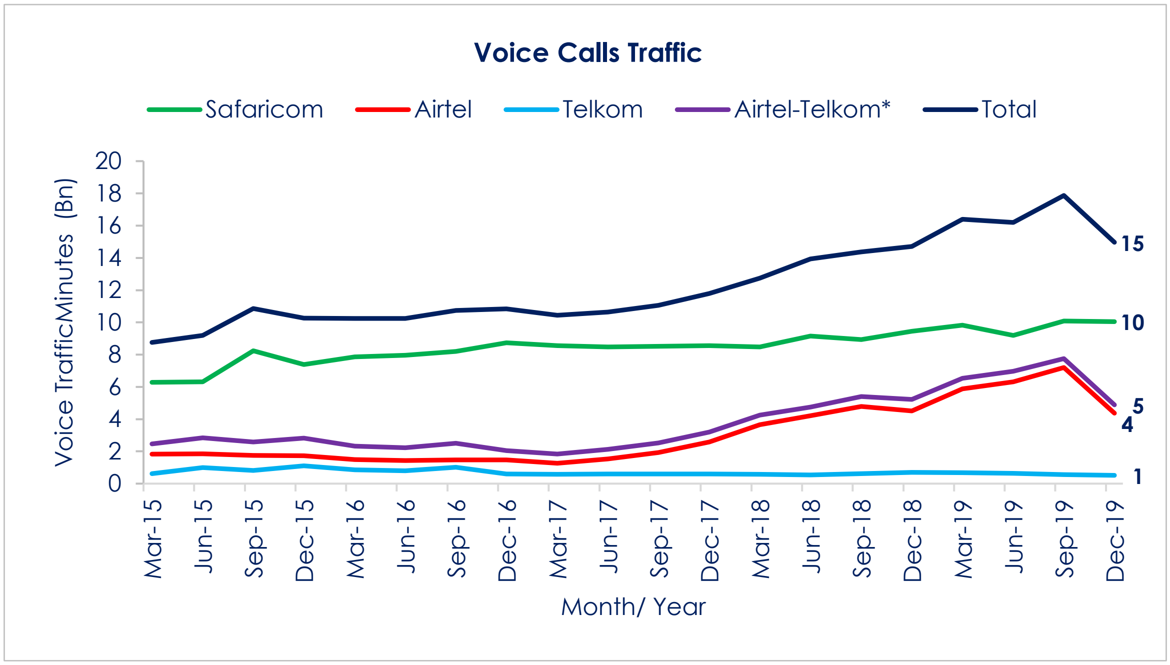
Voice traffic declines in last quarter, we expect slow growth going forward

- We observe a 16.2% decline in total voice traffic in the period between September and December 2019 and believe traffic could decline gradually or remain almost flat going forward as OTT services grow in popularity (Figure.4).

Figure.4: Voice call traffic to hold steady as subscribers call less over voice network

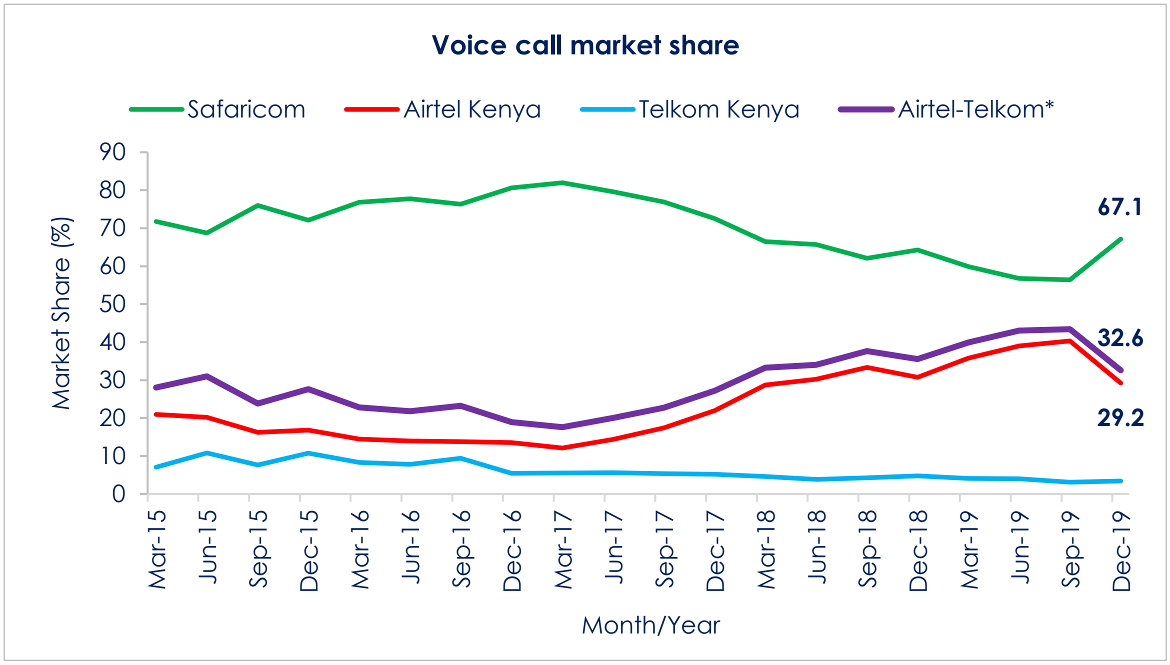


Source: Communications Authority

Reclassification of voice traffic data resulted in an increase in SCOM's market share as at December 2019.

- With regards to total voice call traffic market share, SCOM held 67.1% in December 2019 compared to 64.3% in December 2018 (Figure.5).
- The increase in market share was largely a result of a revision in voice calls traffic volume by Airtel Kenya in the quarter between October and December 2019 which resulted in a reduction of on-net voice traffic by almost half.
- Airtel's justification was that it had been summing up incoming and outgoing on-net traffic in previous quarters instead of providing outgoing traffic considering that only the latter is billed.
- The revision saw Airtel Kenya voice calls traffic drop 39.3% to 4.3Bn minutes with market share falling to 29.2% from 40.3% (30.7% in December 2018).
- Telkom Kenya held a 3.4% market share compared to 4.8% in December 2018 meaning as a combined entity, Airtel-Telkom held 32.6% compared to 35.5% over the same period in 2018.
- This reduction however, does not change our view on the threat posed by the merged entity as their low pricing strategy has been effective in the past.

Figure.5: Safaricom regains market share on Airtel data revision - December 2019



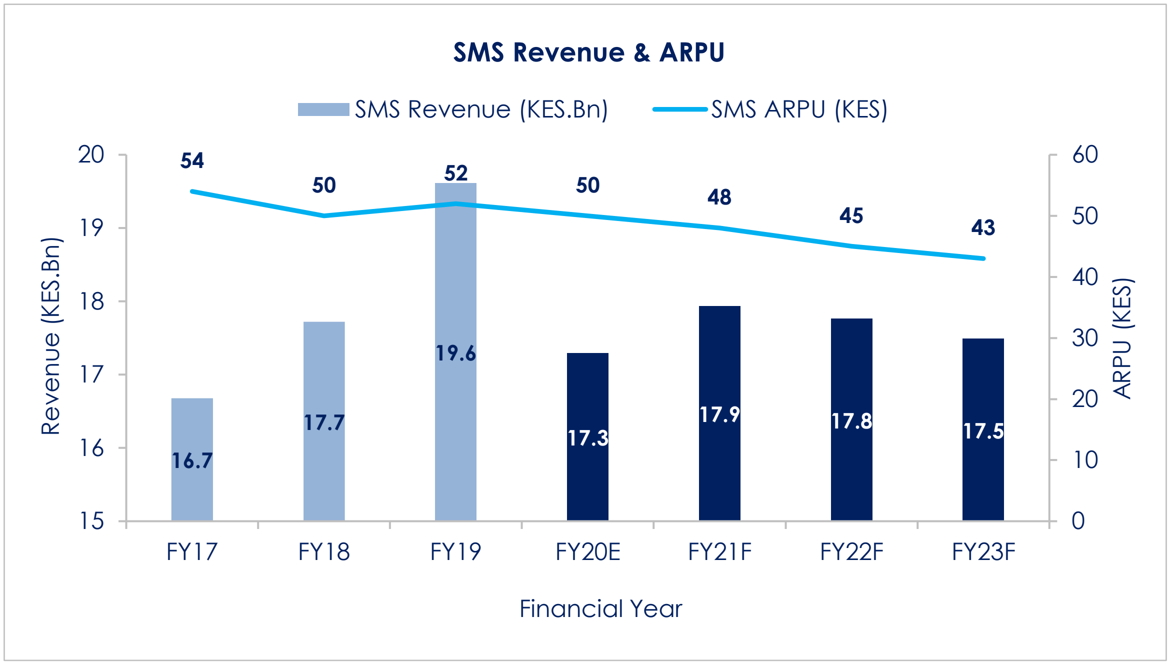
Source: Communications Authority

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

Estimate 11.8% drop in messaging revenues FY20 to KES.17.3Bn.

- SCOM reported a 11% reduction in SMS revenues HY20 to KES.8.6Bn compared to KES.9.7Bn HY19 and we expect the downward trend to continue FY20 to KES.17.3Bn a 11.8% decline over FY19 (Figure.6).
- This is a downward revision from our April 2019 report where we forecasted revenues to drop to KES.17.6Bn both FY20 and FY21.
- Rising OTT popularity and declining gaming activity explain our negative view on messaging volumes and revenues FY20 going forward.
- In addition, the negative impact of the COVID -19 pandemic on disposable income particularly in 2020 is likely to result in a reduction in P2P messaging.
- The decline will however be mitigated to some degree by an increase in B2C messaging as Government, institutions and businesses reach out to subscribers.
- SMS revenues contributed 8.2% of total service revenues FY19 and we expect this to decline to 6.9% FY20 then gradually to 6.8%, 6.4% and 6.0% in FY21, FY22 and FY23 respectively.

Figure.6: SMS revenues FY20 to drop but rising B2C traffic to support revenues FY21

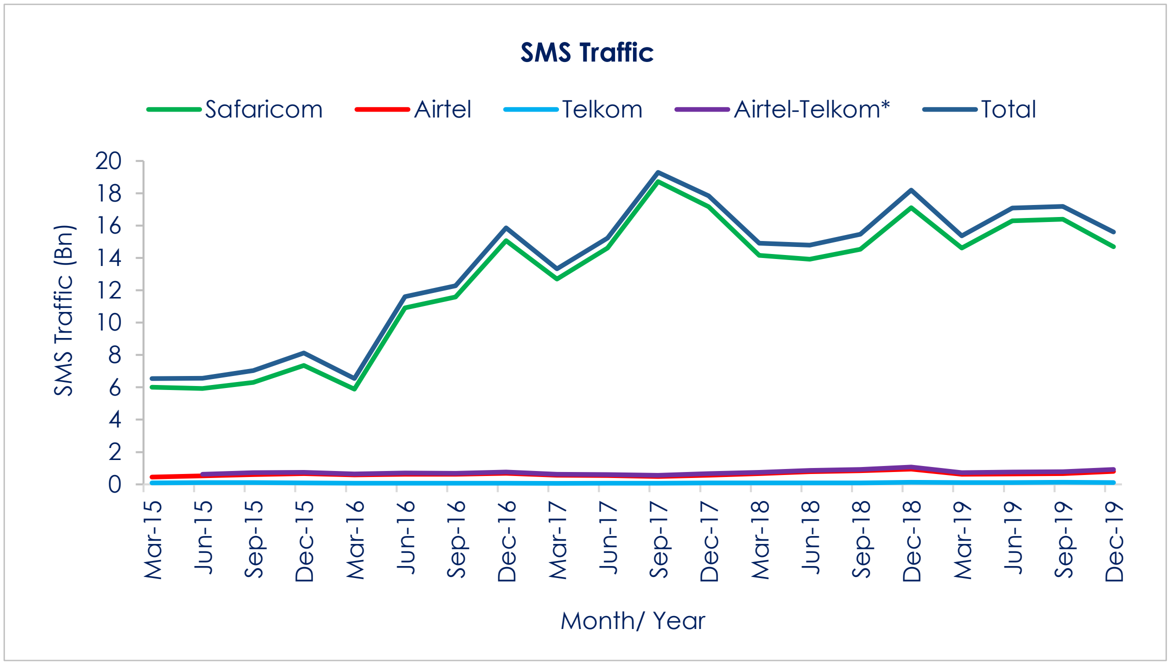


Source: Company Filings & Sterling Capital Research

P2P messaging losing out to internet enabled OTT services

- In our previous, report we reported a decline in messaging as OTT services gain popularity.
- However, we see volatility in message traffic trends during the year and this we expect to be the trend as P2P messaging becomes less popular and B2C gains further traction (Figure.7).
- A decline in gaming and increased B2C messaging partially as a result of COVID -19 means flat growth in the near future with a gradual decline in the medium and long-term expected.

Figure.7: Total SMS traffic to remain almost flat as P2P volumes fall and B2C messaging rises



Source: Communications Authority

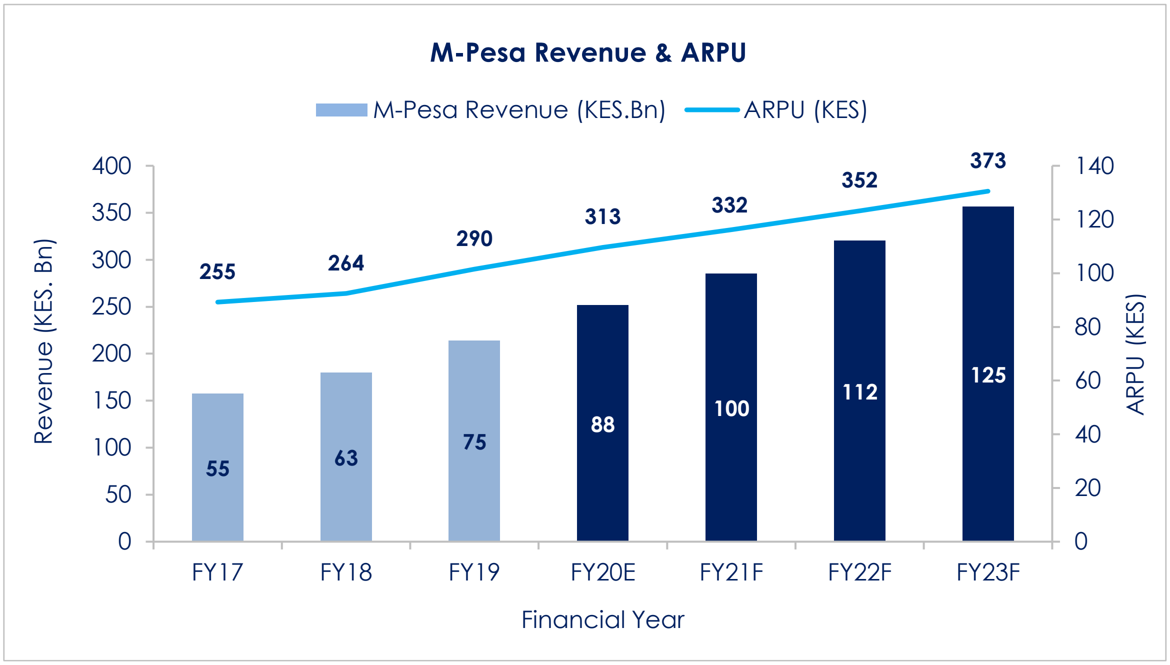
C) M-Pesa - To become Safaricom's biggest driver FY21

Forecast 17.4% growth in M-Pesa revenues to KES.88.1Bn FY20 with ARPU at KES.313.

FY20 - Fuliza contribution to M-Pesa revenue 2.5% (KES.2.2Bn).

- SCOM's dominance in the mobile money business continues through to December 2019 with minimal change from the previous year.
- With regards to business revenues, we project 17.4% growth FY20 to KES.88.1Bn (FY19 - KES.75Bn) attributable to increased transactional volumes supported by a 12% increase in subscribers to 28.6Mn (Figure.8).
- FY21-23 revenue forecasts are KES.KES.99.9Bn, KES.112.2Bn and KES.14.9Bn respectively with growth rate declining 13.4%, 12.3% and 11.3% in the respective financial periods.
- M-Pesa ARPU to grow 8% FY20 to KES.313 and estimated 6% average growth rate FY21-23 to KES.332, KES.351 and KES.373 respectively.
- We further predict that M-Pesa will become SCOM's biggest service revenue earner FY21 accounting for 37.9% compared the 34.2% voice calls to total service revenues in spite of the declining growth rate.
- Fuliza SCOM's overdraft facility has emerged as a key revenue line also helping in its customer acquisition and retention efforts.
- We estimate that Fuliza will contribute KES.2.2Bn to total M-Pesa revenues FY20 equivalent to a 2.5%, also an increase from KES.0.3Bn FY19.
- This is based on our 40:40:20 revenue share distribution assumption between the company and its associate partners KCB Group and NCBA respectively.
- We also see new emerging business opportunities that will continue to support its market position including a move towards digital payments for Government services, expansion to Ethiopia and other regional countries.

Figure.8: Growth in M-Pesa revenue attributed to rising ARPU



Source: Company Filings & Sterling Capital Research

COVID -19 - Waiver of fees to have M-Pesa revenue implications

COVID-19 to have negative short-term revenue implications.

- The COVID -19 pandemic presents short-term risks to revenue growth but presents long-term growth potential.
- SCOM has for ninety days beginning 16th March waived fees on transfer and payment transactions of below KES. 1,000, fees on bank to M-Pesa and vice versa and increased transactions limits from KES. 70,000 to KES. 150,000 with the M-Pesa wallet limit increased to KES. 300,000 from KES. 140,000.
- We believe that this will have a negative impact on revenues in the short-term but is likely to result in increased usage while the higher limits will translate to higher commissions both with long-term positive revenue implications.
- According to management, transactions of less than KES. 1,000 account for about 70% of total P2P volumes and up to 70% of P2P revenue could be impacted.
- Also disclosed was that 34% of total M-Pesa revenue comes from P2P transfers.
- The impact of the temporary measures is difficult to quantify at this point although we see a moderate to high possibility of an extension of the waiver beyond the initial 3 months if the pandemic persists.
- A huge risk to revenue growth however will be if a full country wide lock-down is implemented resulting in a significant reduction in M-Pesa transactions.

Sharp fall in Gaming revenues to have a significant impact on M-Pesa Revenue - KES.3-3.5Bn.

Concern over head-room for growth and the slow death of gaming

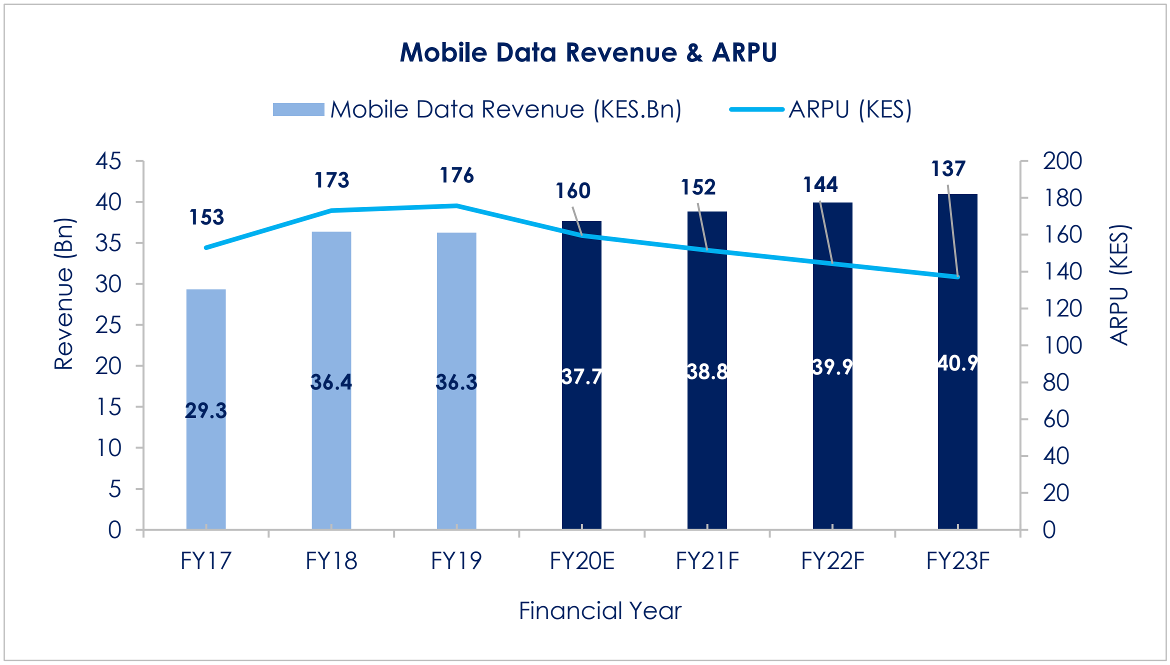
- We are concerned about the declining revenue growth rate as M-Pesa heads towards maturity predicting that 82% of total SCOM subscribers registered for M-Pesa and a further 86% of those subscribers being 30-day active users.
- This also explains why SCOM is looking at regional expansion as a new growth frontier for business.
- The declining contribution of gaming (gambling) to total M-Pesa revenues is another cause for worry considering that the reported 15.5% decline in gaming revenues HY20 translated to a KES.2.2Bn (7.6% increase in HY19 translated to a KES.2.6Bn increase in M-Pesa revenue).
- We therefore predict loss of gaming revenues FY20 at between KES.3-3.5Bn also taking into account that overall gaming revenues have been on a steep decline.
- This a direct result of multiple factors including the exit of the two largest players by market share Sportpesa and Betin and others (as a result of regulatory requirements and tax disputes), suspension of sporting activities due the COVID -19 pandemic and declining disposable incomes.

D) Mobile Data: Fast losing its byte as competition takes its toll on pricing

Price competition to slow down mobile data growth FY20 through to FY23.

- We have made major revisions to both our mobile data ARPU and revenue forecasts on account of stiffer than initially forecasted price competition from both Airtel Kenya and Telkom Kenya and the merged entity.
- Our ARPU is forecasted to decline to KES.160 from KES.176 FY2019 and lower to KES.152, KES.144 and KES.137 FY21, FY22 and FY23 respectively (Figure.9).
- This falls well below our forecasts last year KES.190, KES.209 and KES.230 based on rising subscriber numbers and more stable rather than declining prices.
- Our revenue estimate FY20 is KES.37.7Bn increasing to KES.38.8Bn, KES.39.9Bn and KES.40.9Bn FY21, FY22 and FY23 respectively, a declining growth rate of 3.9%, 3.1%, 2.8% and 2.6% respectively.
- As a result of this sluggish growth, contribution to total service revenue will decline from 15.1% FY19 to 15%, 14.7%. 14.4% and 14.1% in the next four financial years to FY23 respectively.

Figure.9: Subscriber price sensitivity to result in lower ARPU and revenues



Source: Company Filings & Sterling Capital Research

- Mobile data revenue growth is likely to be driven by the following factors:

OTT, social media, smart phone penetration, government's digitization strategy and COVID – 19 to drive mobile data penetration.

1) **OTT, social media and entertainment platforms -** Increased usage of Over the Top (OTT) services such as Facebook messenger and WhatsApp, social media networking sites and entertainment platforms, such as YouTube and Netflix due to increased smartphone penetration will result in increased data consumption and thus mobile data revenue growth.

2) **Data Bundles without expiry** - Introduced by SCOM in November 2019, will not have a direct impact on mobile data revenues but is likely to inspire customer loyalty, protecting SCOM's mobile data market share. Airtel has since introduced bundles without expiry.

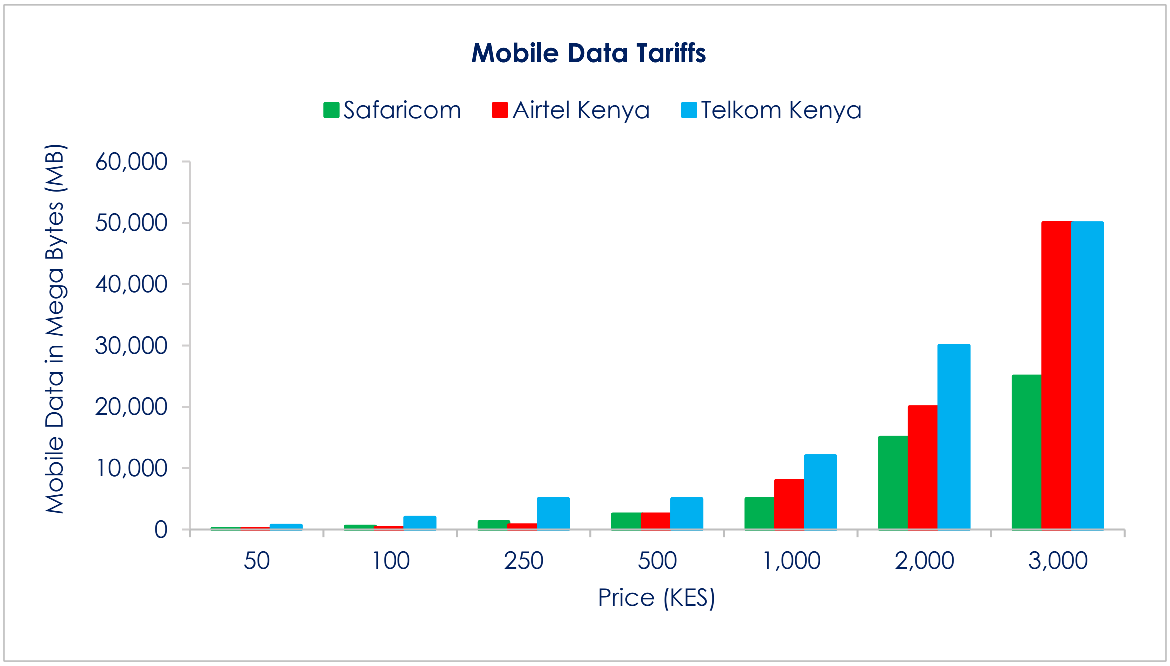
3) **Increased smartphone usage** - The number of smartphones connected on the SCOM mobile data network stood at 12.2Mn, a 11.9% increase over FY2018. We forecast double digit growth FY20 and expect this growth to contribute significantly to mobile data revenues.

4) **Government's digitization strategy** - The Kenya Government intends to introduce digital services that will increase data consumption.

5) **COVID -19 pandemic** - The stay at home directive resulted to a 40% surge in data traffic within the first month of the pandemic in Kenya as usage of social media and movie streaming platforms such as Netflix increased. Online/digital learning to be rolled out soon by the Ministry of Education will result to increased data usage.

- The biggest risk to the mobile data business line is price competition which will intensify with the Airtel-Telkom merger (Figure.10).
- SCOM is considerably more expensive than the competition and we expect this to continue unless it reviews its mobile data costs downwards.

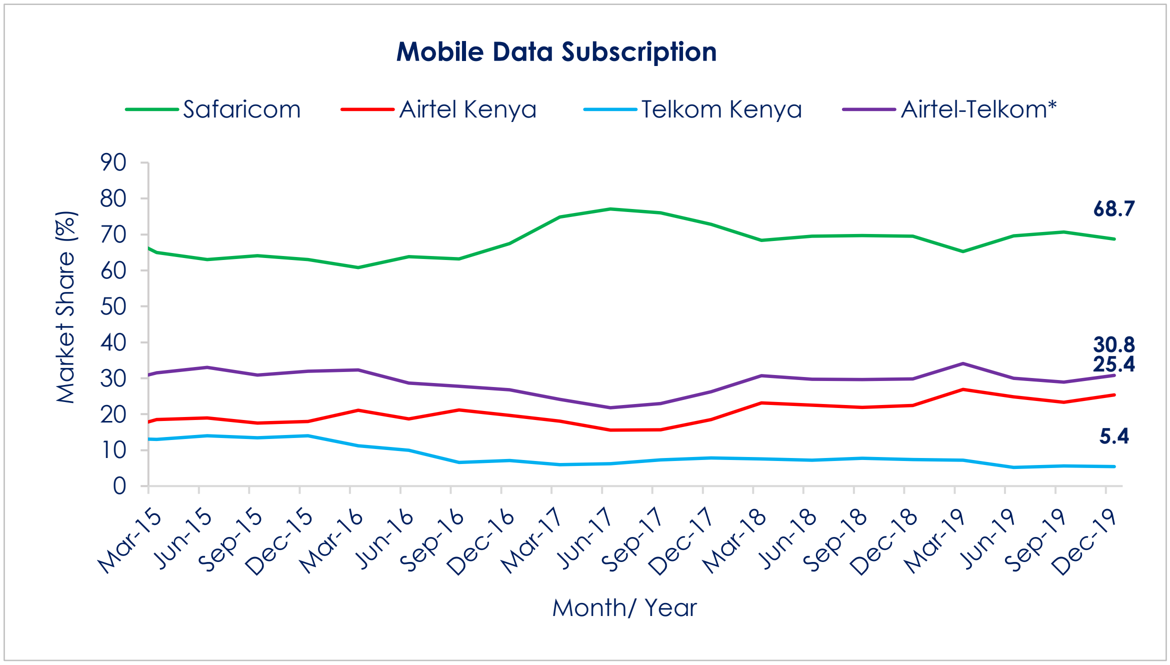
Figure.10: Airtel and Telkom fight for the price sensitive subscriber intensifies



Source: Data Tariff Guides

- CA revised its data collection template in the quarter to December 2019 which saw some mobile data operators revise historical data.
- Total mobile data subscription was reported as 39.2Mn representing 99.8% of total internet subscriptions and a 13.5% decline from 45.3Mn subscribers reported in December 2018.
- SCOM's mobile data market share stood at 65.3%, a reduction from 69.5% over the same period in 2018 (Figure.11).
- The main reason for SCOM's loss of market share is competitive pricing with mobile data subscribers highly price sensitive.
- Globally, telecommunications companies are rolling out the 5G networks with Global System for Mobile Communications Association (GSMA) estimating the network will cover a third of the world population by the year 2025.
- SCOM 4G network coverage in Kenya stood at 63% and we expect it to focus on expanding this coverage in the short-term rather than acquiring the 5G license and infrastructure.
- It is however better positioned than the competition to roll-out 5G and it is likely to exploit this ability to maintain its market position in the medium term.

Figure.11: Airtel and Telkom's fight for the price sensitive subscriber intensifies



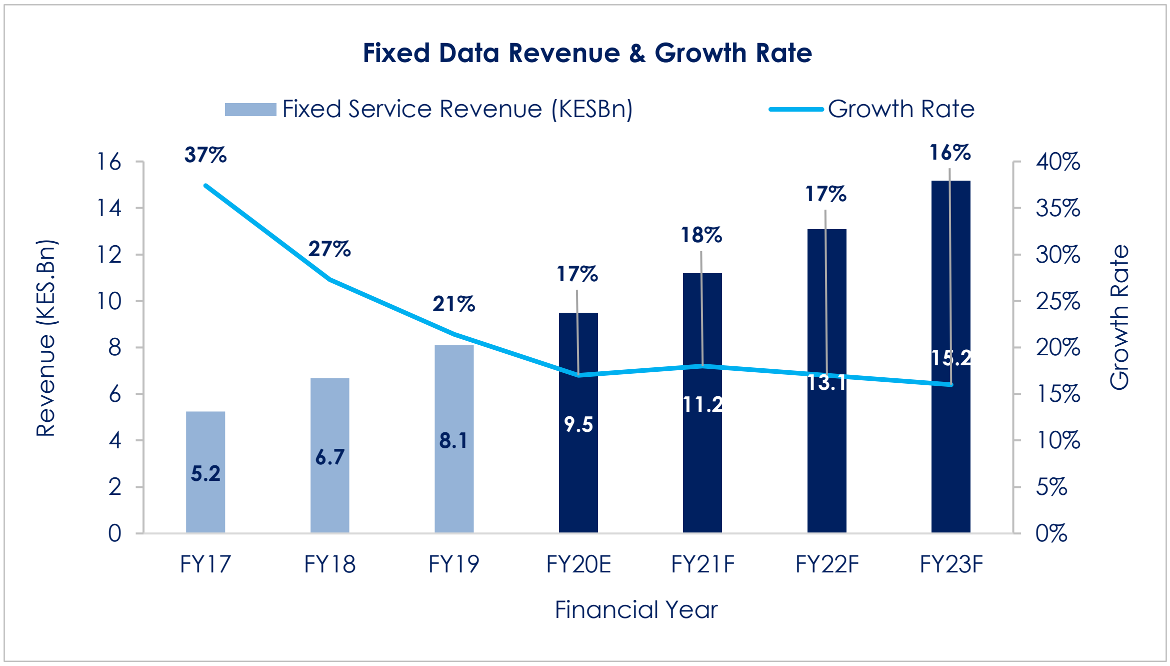
Source: Communications Authority

E) Fixed Data – Duel for market leadership to slow down revenue growth

Estimate 17% growth in Fixed Data revenue FY20 with 3.8% contribution to total service revenue.

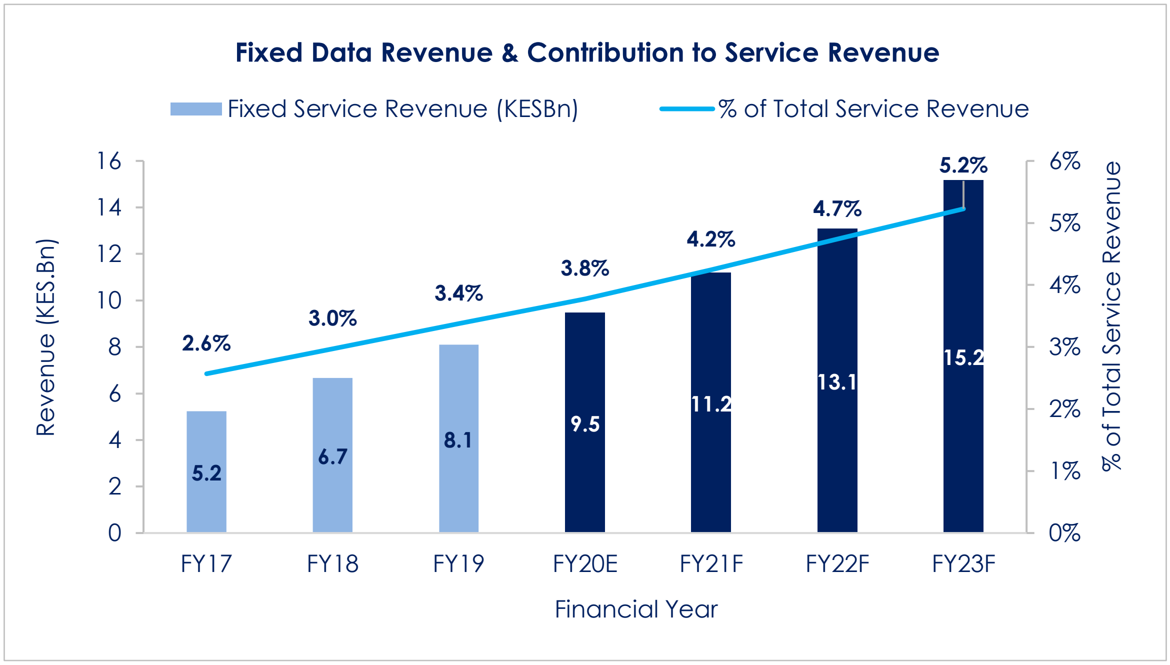
- We make slight revisions to our fixed data forecasts beginning FY20 with a 17% growth in fixed data revenue to KES.9.5 (FY19 - KES.8.1Bn) with FY21 - FY23 at KES.11.2Bn, KES.13.1Bn and KES.15.2Bn respectively (Figure.12).
- Our projected revenues will see contribution to total service revenue increase from 3.8% FY20 to 5.2% FY23 (Figure.13).
- According to management, focus will be on service quality rather than on network expansion a strategy we believe will become effective in customer satisfaction and thus retention and new subscriptions.
- Fixed data network expansion is capital intensive and expansion will be gradual with focus on the bigger towns in the country.

Figure.12: Fixed data revenue remains one of Safaricom's fastest growing income lines



Source: Company Filings & Sterling Capital Research

Figure.13: Fixed data's contribution to increase



Source: Company Filings & Sterling Capital Research

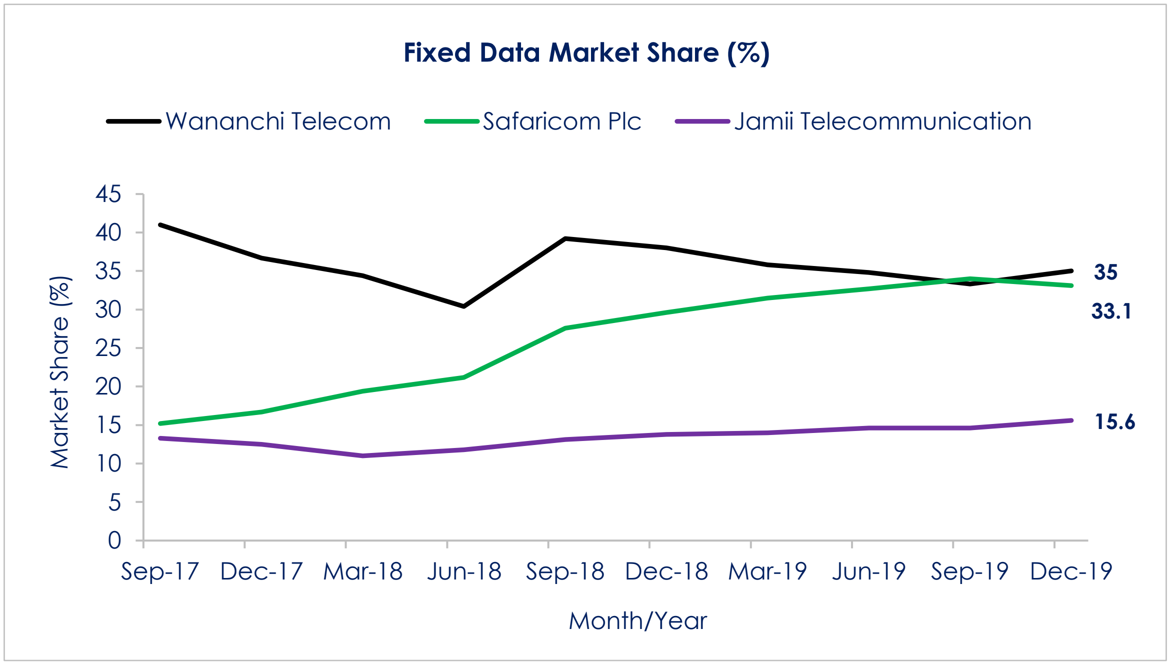
For important disclosures refer to the disclosures section located at the end of this report.

Battle for fixed data subscribers intensifies

Competition to intensify between top two fixed data providers with SCOM expected to take up market leadership.

- We had predicted in our last report that SCOM would emerge as the market leader in fixed data in the next 3 - 5 years based on our growth projections at the time.
- However, rapid subscriber growth and network expansion has resulted in the company increasing its market share at a faster rate than we expected (Figure.14).
- Although Wananchi took back market leadership in December 2019, we believe that its position is under threat and SCOM is likely to assume market leadership FY20.
- Competition is largely on the basis of service quality rather than pricing as prices are almost similar an area where SCOM has excelled in the recent past.
- In March 2020, SCOM doubled its subscribers' internet speeds at no extra cost for 90 days in response to the Government's COVID -19 pandemic directive that Kenyans work and stay at home.
- We anticipate this to be an effective customer acquisition strategy and support its move to becomes the market leader.
- The Airtel-Telkom merger poses no immediate threat to SCOM as they are small players in fixed data business.
- Airtel has rolled out a home fibre product and Telkom is a relatively strong player in the data business and the merger could result in a revamped market expansion and customer acquisition strategy in the medium to long-term.

Figure.14: Fixed data revenue remains one of Safaricom's fastest growing income lines



Source: Company Filings & Sterling Capital Research

Valuation

- We used four valuation methods to arrive at our fair value estimate: **1) Free Cash Flow to the firm 2) Free Cash flow to Equity 3) EBITDA Multiple - Enterprise Value 4) Price/Earnings (P/E) Multiple)** and made the following assumptions:

    1) Discount rate (cost of equity) - 14.48%.
    2) Terminal growth rate - 10.30% (average internal growth rate over the 3-year forecast period)
    3) Beta - 0.69
    4) Risk-free rate - 11.03% (4-year bond).
    5) Market risk premium - 5%.

- We gave equal weighting (25%) to each of the four valuation methods above to arrive at our fair value estimate:

Financial Year	**FY18**	**FY19**	**FY20E**	**FY21F**	**FY22F**	**FY23F**
1. Free Cash Flow to the Firm (FCFF)						
EBIT	79,266	88,973	99,420	105,815	111,184	115,922
Taxes	(24,620)	(28,727)	(30,898)	(32,799)	(34,391)	(36,985)
Net EBIT	54,646	60,246	68,522	73,016	76,793	78,937
Add: Depreciation & Amortization	33,568	35,331	35,113	37,186	40,763	44,701
Less: Capex	36,422	37,253	35,749	39,239	43,076	47,301
FCFF	51,792	58,324	67,886	70,963	74,479	76,337
Time Period			0.94	1.94	2.94	3.94
Discount factor			0.88	0.77	0.67	0.59
Terminal Value						1,814,295
Present Value (PV) of Terminal Value						1,065,257
Discounted Values			59.806	54,608	50,063	44,821
Sum of discounted values			1,274,554			
Number of outstanding shares			40,065			
Fair Value Estimate KES)			**31.81**			
2. Free Cash Flow to Equity (FCFE)						
FCFF	51,792	58,324	67,886	70,963	74,479	76,337
Net Borrowing	(12,504)	(8)	(94)	(95)	(98)	(101)
FCFE	39,288	58,316	67,792	70,868	74,380	76,236
Time period			0.94	1.94	2.94	3.94
Discount factor			0.88	0.77	0.67	0.59
Terminal Value						1,811,895
Present Value (PV) of Terminal Value						1,063,848
Discounted Values			59,723	54,535	49,997	44,762
Sum of discounted values			1,272,864			
Number of outstanding shares			40,065			
Fair Value Estimate (KES)			**31.77**			

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Financial Year	FY18	FY19	FY20E	FY21F	FY22F	FY23F
3. Enterprise Value (KES)						
EBITDA Multiple	112,834	124,304	134,533	143,001	151,947	160,623
Average Market capitalization			1,151,881			
Add: Debt			7,660			
Add: Preferred stock			-			
Add: Minority Interest			-			
Less: Cash			20,030			
EV/EBITDA (x)			8.47			
Enterprise Value:			1,139,511			
Number of outstanding shares			40,065			
Fair Value Estimate (KES)			**28.44**			
4. Price/Earnings (P/E) Multiple						
EPS	1.38	1.56	1.80	1.91	2.00	2.05
Trailing & Forward P/E (x)	16.85	17.63	17.89	14.92	14.23	13.87
Industry P/E (x)			17.89			
Fair Value Estimate (KES)			**32.19**			

Valuation Method	Weighting	Avg. Fair Value
FCFF	25%	7.95
FCFE	25%	7.94
EV/EBITDA	25%	7.11
P/E	25%	8.05
Fair Value Price (KES)	**100%**	**31.05**

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Risks to our financial forecasts, valuation and recommendation

- Our financial estimates, forecasts and assumptions are based on current and medium-term business operational and economic conditions.
- This means that significant changes in these conditions could have significant implications on the financial performance of the company and therefore our valuation estimates:

A prolonged pandemic, competition, regulation, macro-economic and socio-political risks could impact financial forecasts and valuation.

1) **Prolonged pandemic** - It is assumed that the impact of the COVID -19 pandemic will be most felt in FY21 before gradual resumption of normal business and economic conditions in FY22 and FY23.

   However, a prolonged pandemic will have far reaching implications on various sectors of the economy and SCOM's business and this will have a negative impact on overall financial performance.

2) **Competition** - The Airtel-Telkom merger is expected to progress within FY21 subject to the entity meeting several conditions and without undue advantage to the competition.

   However, the merger could present a bigger challenge than initially forecasted especially if it is able to roll out an effective competitive strategy also taking into account its spectrum advantage over SCOM.

3) **Regulation** - New regulation on competition, mobile lending, taxation and other legislation could negatively impact business operations and business revenues.

4) **Macro-economic risks** - Not necessarily limited to the impact of the pandemic but also significant distortions on economic influences such as inflation, currency depreciation and overall economic performance impacting the cost of doing business and household disposable income.

5) **Political/Socio-Economic risks** - Disruptions to normal business activity as a result of political and socio-economic instability will affect business operations and incomes.

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BUY: FV above13% of CSP

Hold: FV between 0% and 12.99% around CSP

Sell: FV less than 0% below CSP

NB: The recommendation guide may change depending on the risk-free rate.