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STERLING CAPITAL LIMITED

Equity Note

November 2020

Safaricom Plc

HY21 Earnings Preview Note

"Pandemic to hit mid-year earnings"

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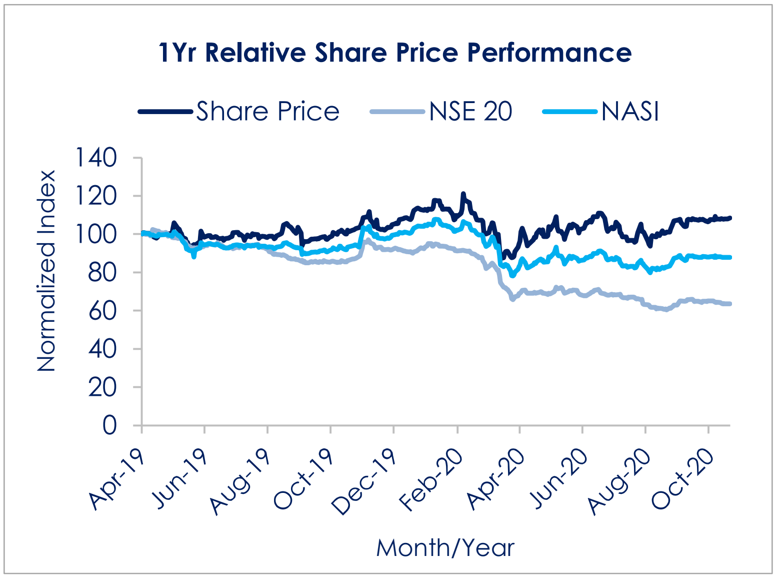
Executive Summary

- Our Safaricom (SCOM) HY21 earnings preview note is an analysis of our expectations of the company's financial performance for the half year period ending 30th September 2020.
- We note a downward revision of earnings estimates as result of poor economic performance, price competition and regulatory influences.
- The report covers in brief the expected performance of each service line for the period in focus also giving our expectations for the Full year period ending 31st March 2021 (FY21).
- In addition to the service revenue lines, we also forecast operating costs and capital expenditure.
- **We maintain a HOLD recommendation on SCOM guided by our fair value estimate of KES.32.56.**
- We conclude the report by mentioning a few risks to our earnings estimates and the valuation as well as giving a final say on SCOM's expected overall performance.

Figure.1: Share price and indices performance



Source: Nairobi Securities Exchange

Table.1. Share data

Share Data	
NSE Code	SCOM
Bloomberg Code	SAFCOM:KN
Share Price (KES)	30.25 (21-Oct-20)
Fair value estimate (KES)	**32.50**
Upside/ (Downside) (%)	↑ 7.4
Recommendation	**HOLD**
Market Cap (KES.Bn)	1,212.0
Free Float (%)	25
Price Change YOY (%)	↑ 6.3
Price Change YTD (%)	↓ 3.4
52 Week High/Low	KES.32.90 – KES.24.35
P/E	16.45
P/B	8.47
Dividend Yield (%)	4.6

Source: Source: Nairobi Securities Exchange & Sterling Capital Research

Figure.2: Historical and forecast financial performance summary

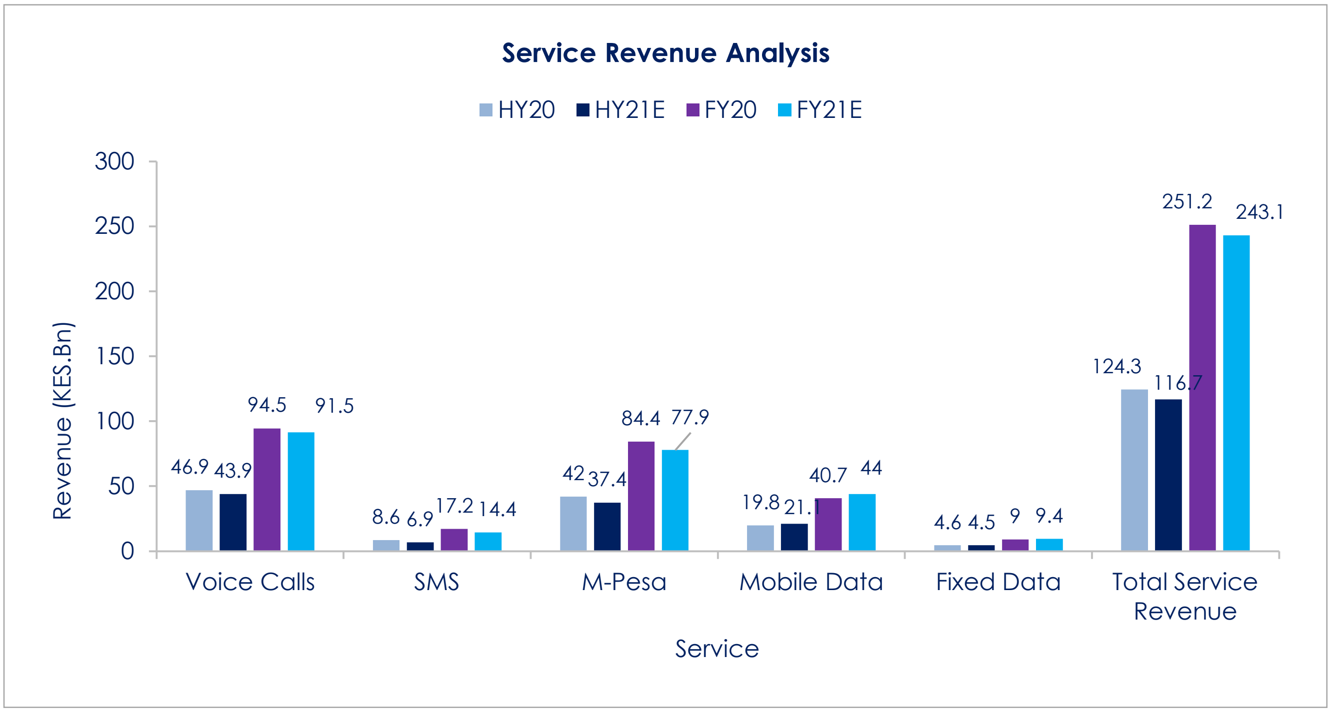
Financial Metrics	HY20 (KES.Bn)	HY21E (KES.Bn)	YoY Growth/ (Decline) (%)	FY20 (KES.Bn)	FY21E (KES.Bn)	YoY Growth/ (Decline) (%)
Voice Calls	46.9	43.9	6.4	94.5	91.5	3.1
SMS	8.6	6.9	19.8	17.2	14.4	15.5
M-Pesa	42.0	37.4	11.0	84.4	77.9	7.8
Mobile Data	19.8	21.1	6.6	40.7	44.0	8.2
Fixed Data	4.6	4.5	2.2	9.0	9.4	5.0
Total Service Revenue	**124.3**	**116.7**	**6.1**	**251.2**	**243.1**	**3.2**
Total Direct Costs	37.5	35.9	4.3	74.7	74.7	0.0
Gross Profit	**92.1**	**85.7**	**6.9**	**185.6**	**178.6**	**3.8**
Total Operating Expenses	25.6	22.9	10.5	47.6	47.6	0.1
EBITDA	66.5	62.9	5.4	138.0	130.9	5.1
EBITDA Margin (%)	51.3	51.6	0.3	52.6	51.0	1.6
EBIT	49.8	45.1	12.7	101.5	94.1	7.3
EBIT Margin (%)	38.5	37.1	1.4	38.7	37.1	1.6
Net Income	**35.7**	**34.1**	**4.5**	**73.7**	**71.1**	**3.5**
EPS	0.89	0.85	4.5	1.84	1.77	3.5

Source: Safaricom Plc & Sterling Capital Research

Financial performance - HY21 service revenue and net income estimates revised downwards

- We foresee downward pressure on most service revenues resulting in significant revisions to our earnings estimates ahead of the release of the SCOM's HY results release on 9th November 2020.
- Following a significant deterioration in economic conditions resulting in declining service demand and falling wallet share, imposed fee waiver as well as continuous threat of price competition, we forecast a 6.1% decline in Total Service Revenue to KES.116.7Bn (HY20 - 124.3Bn.
- We further forecast 5.4% and 12.7% decline in EBITDA and EBIT to KES.62.6Bn and KES.45.1Bn respectively for the reporting period.
- Our Net profit forecast HY21 KES.34.1Bn, 4.5% lower than FY20 (KES.35.7Bn).

Figure.1: HY21 service revenues expected to decline over HY20



Source: Central Bank of Kenya

1. SERVICE REVENUE ANALYSIS AND OUTLOOK

A) Voice calls

Forecast 6.4% decline in voice call revenues due to price competition and drop in demand.

- We forecast 6.4% decline in voice revenues HY21 to KES.43.9Bn (HY20 - KES.46.9Bn) as a result of declining subscriber spending as well as subdued economic activity resulting from the COVID -19 pandemic.
- We also take note of declining voice revenues in line with global industry trends due to steep competition from Over the Top services (OTT) such as WhatsApp, Skype and Telegram.
- In addition, SCOM continues to face stiff price competition from other market players, particularly Airtel Kenya which has seen a significant drop in market share during the period under review.
- Latest market share data from the Communications Authority (CA) - Q4 2020/21 (April - June 2020) gives SCOM's voice call market share at 60.3% compared to Airtel Kenya's 36.1% an increase from 56.8% (Airtel 39%) over the same period the previous year.
- This was however a significant drop from 65.7% from the previous quarter - Q3 2020/21 (Airtel 30.9%)
- We predict higher subscriber price sensitivity during difficult economic times to result in further loss of market share albeit gradually, with the company likely to offer mainly price promotions to protect market share.
- Our FY20 voice call revenue forecast is KES.91.5Bn, 3.1% lower than FY20 (KES.94.5Bn).

B) Messaging

Sharp increase in SMS not enough to reverse decline in messaging revenues

- SCOM's grip in messaging service (SMS) remains strong with the company maintaining a market share around 95% over the last two years.
- We expect a marked increase in messaging volumes during the reporting period due to increased popularity of messaging by the younger population during the pandemic and a subscriber promotion.
- Introduction of SMS promotions during this period has played a big part in increasing messaging volumes during the pandemic.
- We expect the increase in volumes to be offset by low SMS costs due to the promotions continuing declining revenue trends that has resulted from mobile data supported OTT services, price competition and the decline of gaming.
- For this reason, we forecast a 19.8% decline in revenues HY21 to KES.6.9Bn (HY20 - KES.8.6Bn).
- FY21 revenue projected at KES.14.4Bn a 15.5% decline over FY20 with an improved second half performance as economic activity gradually recovers.

C) M-Pesa

Forecast 11% decline in M-Pesa revenues to KES.37.4Bn HY21 largely due to waiver of fees.

- HY21 M-Pesa revenue projected to decline 11% to KES.37.4Bn (HY20 - KES.42Bn) due to a directive by Government waiving fees and commissions on mobile payments, person to person transfers below KES.1,000 and transfers to/from M-Pesa wallets to banks and charges for hospitals, dispensaries and other payments.
- In addition, SCOM increased transaction and mobile money wallet limits to reduce reliance on cash transactions during the pandemic.
- Data from the CA shows that this waiver had a significant impact on the volume and value of M-Pesa P2P transactions which grew 24.6% and 7.2% to 557.7Mn and KES.721.9Bn respectively in the three months to June 2020.
- During the same period total value of transactions (C2B, B2C, B2B and C2G) rose 17.2% to KES.1.8Tn from KES.1.6Tn in March 2020.
- The zero rating of these transactions is estimated to cost SCOM KES.14Bn -16.5Bn in lost revenue but derive long term benefits relating to customer loyalty once the fees are reinstated.
- "Fuliza" is emerging as a big driver of M-Pesa revenues with an estimated contribution of KES.1.8Bn in revenues HY21 compared to KES.1.3Bn HY20.
- We project FY21 M-Pesa revenues to decline 7.8% to KES.77.9Bn (FY20 - KES.84.4Bn) with contribution to total service revenues to decline to 32% compared to 33.6% FY20.
- Fuliza is expected to contribute KES.3.7Bn of M-Pesa's total revenues FY21 equivalent to 4.7%.

D) Mobile Data

Increase in mobile data due to increased demand translating to higher ARPU.

- Revenue expected to increase 6.6% to KES.21.1Bn HY21 driven by subscriber growth and increased usage during the pandemic that saw many subscribers adopt video conferencing services as they work and study from home.
- We expect SCOM to benefit from the increased demand as a result of market dominance (68.7% market share as of Q4 2020 compared to 65.3%)
- A decline in the rate per MB to KES.0.13 from KES.0.18 as a result of price promotions and introduction of non-expiry bundles coupled with an increase in active chargeable subscribers will result in an increase in Average Revenue Per User (ARPU) FY21 to KES.182 from KES.180 FY20.
- Price competition will result in further drop in in revenue per MB with increased marketing and value-added promotions employed in an attempt to stop the slide.
- FY21 revenue estimated at KES.44Bn, 8.2% growth over the previous year (FY20 - KES.40.7Bn).

E) Fixed Data

2.2% decline in HY21 revenue to KES.4.5Bn.

- HY21 revenues estimated at KES.4.5Bn a 2.2% decline HY20 driven by a shift to mobile services compared to fixed line services.
- Q4 2020 market share data shows that SCOM has assumed market leadership once again holding 33.5% compared to Wananchi at 32.5% (32.7% and 34.8% March to June 2019 respectively).
- Increased investment in infrastructure, coverage and service quality to translate to market share and revenue growth in the medium-term.
- FY21 revenues estimated to grow 5% to KES.9.4Bn driven largely by connections in Fibre To the Home (FTTH) but a decline in connection in Fibre To the Business (FTTB) as a result of the Covid-19 pandemic that has seen businesses shut down or redirect their income to necessary costs.

2. OPERATING COSTS AND CAPITAL EXPENDITURE

A) Operating Costs

- Following downward pressure on revenue and a decline in expenses related to revenue generation, we see increased focus on managing operating expenses.
- For this reason, we estimate a 4.3% and 10.5% decline in direct and operating costs respectively HY21 with M-Pesa commissions exhibiting the biggest declines.
- We however, forecast an increase in direct and total operating costs in the second half of the year resulting in almost unchanged direct and total operating costs FY21 at KES.74.7Bn and KES.47.6Bn respectively.

B) Capital Expenditure (Capex)

- Our estimated capex HY21 is KES.18.5Bn, 2.2% higher than HY20 with Radio Access and IT Capex being the main focus of the capital investment.
- FY21 capex is KES.37Bn or 2.5% higher than FY20 (SCOM refrains from providing capex guidance due to uncertainty created by the COVID-19 pandemic).
- We see FY21 capex intensity (ratio of total capital investment to sales revenue thus showing the effectiveness of capital investment) increasing to 14.3% compared to 13.8% FY20 due to the revenue decline and increase in capex.

3. Valuation

- We used the following valuation methods to arrive at our fair value estimate:
  1) Discounted Cash flow - Free Cash Flow to the Firm (FCFF).
  2) Discounted Cash flow – Free Cash Flow to equity (FCFE).
  3) Enterprise Value - EBITDA Multiple
  4) Relative valuation - Price/Earnings (P/E) multiple.

- The following assumptions were also made:
  1) Discount rate (cost of equity) -12.80%.
  2) Terminal growth rate - 8% (100bps lower than the average sustainable growth rate over the 3-year forecast period as a result of uncertainty brought by Covid-19 FY21 and expected general elections or constitutional referendum FY21 and FY22.
  3) Beta - 0.58.
  4) Risk-free rate - 9.9% (3-year T-bond).
  5) Market risk premium - 5%.

- Equal weighting was given to each of the four valuation methods (25%) to arrive at our fair value estimate.

Table.2: Valuation summary

1. FCFF				
Financial Year	**2019/20A**	**2020/21F**	**2021/22F**	**2022/23F**
EBIT	101,494	94,054	103,268	106,448
Taxes	(32,115)	(23,694)	(31,112)	(31,972)
Net EBIT	69,379	70,360	72,156	74,477
Add: Depreciation & Amortization	36,548	36,887	40,369	44,202
Less: Capex	36,099	38,185	41,976	46,146
FCFF	69,828	69,061	70,549	72,533
Time Period		0.44	1.44	2.44
Discount factor		0.95	0.84	0.75
Terminal Value				1,631,762
Terminal Value Y3 summation				1,216,471
Discounted Values		65,509	59,326	54,073
Sum of discounted values		1,395,380		
Number of outstanding shares		40,065		
Fair Value Estimate		**34.83**		
2. FCFE	69,828	69,061	70,549	72,533
Net borrowing	3,968	(95)	(98)	(101)
FCFE	73,796	68,966	70,450	72,432
Time Period		0.44	1.44	2.44
Discount factor		0.95	0.84	0.75
Terminal Value				1,629,490
PV Terminal Value				1,214,778
Discounted Values		65,419	59,243	53,998
Sum of discounted values		1,393,438		
Number of outstanding shares		40,065		
Fair Value Estimate		**34.78**		

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Table.3: Valuation summary

3. EBITDA	**138,042**	**130,941**	**143,636**	**150,651**
Enterprise Value:		1,219,979		
Average Market capitalization		1,211,979		
Add: Debt		8,000		
Add: Preferred stock		0		
Add: Minority Interest		26,760		
Less: Cash		26759.7		
EV/EBITDA (x)		8.84		
Enterprise Value		1,157,225		
Fair Value Estimate		**28.88**		
4. P/E Multiple				
Industry P/E		17.89		
EPS		1.77		
Fair Value Estimate		**31.74**		
Valuation Method	**Weighting**	**Avg. Fair Value**		
FCFF	25%	8.71		
FCFE	25%	8.69		
EV/EBITDA	25%	7.22		
P/E	25%	7.94		
Weighted Fair Value Price (KES)	**100%**	**32.56**		

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Risks to our valuation and recommendation

- Our financial estimates and valuation model are based on short and medium-term operational, economic and competitive environment forecasts.
- Any significant changes to these forecasts will have a material impact on our financial forecasts and fair value estimates for the company:

1) **Regulation** - Imposition of new regulation directly impacting business such as the waiver of fees due to a prolonged pandemic will adversely impact business revenues.

2) **Macro-Economic** - A prolonged pandemic and delay in the resumption of normal business operations and economic activity will have a negative impact of business revenues. Increased unemployment will reduce disposable incomes and subscriber wallet share. In addition, volatility of currency or increased inflationary pressure will affect revenues, operational costs and ultimately profitability.

3) **Political risks** - Slow-down or interruptions in normal business operations and economic activity due to political instability ahead of the 2022 general election or a possible constitutional referendum.

Conclusion - Pessimistic about HY21 and FY21

- We are largely pessimistic about SCOM's HY21 results particularly because of the far-reaching impact of the COVID-19 pandemic on general economic activity and subscriber incomes which directly impact the company's main business lines.
- While most revenue lines are expected to be adversely impacted by the pandemic, we see a few positives for instance increased demand for both mobile and fixed data as well as increased messaging which will help mitigate the impact of the economic downturn on business revenues.
- The expected poor performance of M-Pesa is a big hit for SCOM. We had predicted that this service revenue would emerge as the company's biggest revenue earner in the next 2-3 years.
- The financial performance of the company FY21 is largely dependent on the resumption of normal economic activity and the recovery of the Kenyan economy.

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Sterling Capital Limited recommendation guide is based on the difference between the Current Share Price (CSP), and its Fair Value (FV). Recommendation categories are defined as follow:

BUY: Fair Value (FV) 13% or greater than Current Share Price (CSP)
Hold: FV between 0% and 12.99% of CSP
Sell: FV below 0% of CSP

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