Equities

16 April 2012 | 55 pages

Vodacom Group Limited (VODJ.J)

The Early Bird Catches The Worm – Sell

- Company Update
- Rating Change
- Target Price Change
- Estimate Change

- **Downgrade to Sell** — We cut our DCF TP for Vodacom to R85 (prev R90) and downgrade our rating to Sell from Neutral. Despite an attractive dividend yield (6.4%), we are cautious on the company's outlook given: (i) a more challenging medium-term consumer landscape, (ii) a maturing sector, and (iii) rising competition.
- **Turning tide** — SA consumers' spending power is under pressure, with real wage growth slowing to 0% by mid-11 and inflation having picked up to over 6% (Dec-11). Priority expenditures such as food, transport and utility costs (c60% of the consumer basket) are rising sharply, which could dampen spend in other areas like telecoms.
  - **The subscriber profile has deteriorated** — Telcos are now scrapping for customers who might spend R60-70/mo on telecoms vs established higher-end ones who average cR635/mo. This means ARPU dilution for VOD and has margin implications as the company still needs to invest in access for this demographic.
  - **A maturing telecom market** — in SA makes it tough to sustain high pricing and growth. MTR cuts of c55% (2011-13) pave the way for increased price competition especially as network capacity ramps up in the next 12-18 months. We currently factor in APPM declines of 12% pa in the med-term, which may not be offset by rises in MOU. We see ARPU down c11% in '12 and at least a further 10% by '14.
  - **Increased competition** — could make it worse. The wildcard is the extent of increased competition and Cell C is an important factor here. Cell C targets a market share of c25% (11-12% increase) in the next 3 years, which, if achieved, implies some market share losses for the likes of Vodacom. The prospect of a sharp increase in competition compounds the risks to ARPU and earnings forecasts.
- **The main problem** — with our Sell thesis is that Vodacom's 6.4% DY provides strong underpin to the share; the scope for special dividend compounds this. The timing of when our concerns might play out is also uncertain, which could delay any de-rating in the share, so we may be a little early with our call. We argue, however, that the risks facing VOD have somewhat risen and the stock's current valn is unmerited in this light.
- **Valuation risk** — VOD's CY12E PE of 13.9x and EV/EBITDA of 7.2x reflect premia of 15% and 50% to EM averages. We believe that VOD's share price and valn should start to better reflect its increased risks as they become clearer over the next 12m.

Sell	**3**
from Neutral	
Price (13 Apr 12)	R107.14
Target price	R85.00
from R90.00	
Expected share price return	-20.7%
Expected dividend yield	6.4%
Expected total return	**-14.2%**
Market Cap	R159,419M
	US$20,254M

Price Performance
(RIC: VODJ.J, BB: VOD SJ)

Vodacom Group Limited (ZAR)

Year to 31 Mar	2010A	2011A	2012E	2013E	2014E
Sales (RM)	58,535.0	61,197.0	66,868.7	71,271.1	72,487.6
Net Income (RM)	7,562.0	9,626.0	10,554.0	11,806.7	11,651.6
Diluted EPS (¢)	509	656	719	804	794
Diluted EPS (Old) (¢)	509	656	709	743	841
PE (x)	21.1	16.3	14.9	13.3	13.5
EV/EBITDA (x)	8.8	8.3	7.4	7.0	6.9
DPS (¢)	285	460	622	691	705
Net Div Yield (%)	2.7	4.3	5.8	6.5	6.6

Thato Motlanthe
+27-11-944-0834
thato.motlanthe@citi.com

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

VODJ.J: Fiscal year end 31-Mar — **Price: R107.14; TP: R85.00; Market Cap: R159,419m; Recomm: Sell**

Profit & Loss (Rm)	2010	2011	2012E	2013E	2014E
Sales revenue	58,535	61,197	66,869	71,271	72,488
Cost of sales	-26,774	-27,600	-30,341	-32,724	-33,670
Gross profit	31,761	33,597	36,528	38,548	38,817
Gross Margin (%)	54.3	54.9	54.6	54.1	53.6
EBITDA	**19,765**	**20,594**	**22,786**	**23,903**	**23,833**
EBITDA Margin (%)	33.8	33.7	34.1	33.5	32.9
Depreciation	-4,348	-4,515	-5,005	-5,513	-5,814
Amortisation	-809	-840	-932	-1,026	-1,082
EBIT	**14,608**	**15,239**	**16,849**	**17,364**	**16,937**
EBIT Margin (%)	25.0	24.9	25.2	24.4	23.4
Net interest	-1,478	-755	-571	-416	-212
Associates	-21	0	0	0	0
Non-op/Except	-4,181	-1,846	0	0	0
Pre-tax profit	**8,928**	**12,638**	**16,278**	**16,948**	**16,725**
Tax	-4,745	-4,659	-5,931	-5,372	-5,302
Extraord./Min.Int./Pref.div.	-4	266	207	232	228
Reported net profit	**4,179**	**8,245**	**10,554**	**11,807**	**11,652**
Net Margin (%)	7.1	13.5	15.8	16.6	16.1
Core NPAT	7,562	9,626	10,554	11,807	11,652
Per share data	**2010**	**2011**	**2012E**	**2013E**	**2014E**
Reported EPS (¢)	281	562	719	804	794
Core EPS (¢)	509	656	719	804	794
DPS (¢)	285	460	622	691	705
CFPS (¢)	1,092	1,090	1,096	1,258	1,259
FCFPS (¢)	674	651	597	683	725
BVPS (¢)	924	1,064	1,153	1,257	1,336
Wtd avg ord shares (m)	1,486	1,468	1,468	1,468	1,468
Wtd avg diluted shares (m)	1,486	1,468	1,468	1,468	1,468
Growth rates	**2010**	**2011**	**2012E**	**2013E**	**2014E**
Sales revenue (%)	5.6	4.5	9.3	6.6	1.7
EBIT (%)	20.4	4.3	10.6	3.1	-2.5
Core NPAT (%)	21.7	27.3	9.6	11.9	-1.3
Core EPS (%)	21.9	28.9	9.6	11.9	-1.3
Balance Sheet (Rm)	**2010**	**2011**	**2012E**	**2013E**	**2014E**
Cash & cash equiv.	1,061	870	2,025	3,505	1,454
Accounts receivables	9,283	10,773	11,214	11,755	11,754
Inventory	707	799	873	931	946
Net fixed & other tangibles	21,869	22,271	23,671	25,596	26,554
Goodwill & intangibles	6,673	5,215	5,215	5,215	5,215
Financial & other assets	2,098	1,507	1,502	1,498	1,494
Total assets	**41,691**	**41,435**	**44,500**	**48,498**	**47,417**
Accounts payable	9,119	10,292	11,165	11,997	12,323
Short-term debt	3,349	3,114	1,861	5,971	2,262
Long-term debt	9,786	7,280	8,030	4,390	4,460
Provisions & other liab	4,801	4,569	6,168	7,572	8,868
Total liabilities	**27,055**	**25,255**	**27,224**	**29,930**	**27,912**
Shareholders' equity	13,738	15,622	16,926	18,449	19,614
Minority interests	898	558	351	120	-109
Total equity	**14,636**	**16,180**	**17,277**	**18,568**	**19,505**
Net debt	**12,074**	**9,524**	**7,866**	**6,856**	**5,267**
Net debt to equity (%)	82.5	58.9	45.5	36.9	27.0

Valuation ratios	2010	2011	2012E	2013E	2014E
PE (x)	21.1	16.3	14.9	13.3	13.5
PB (x)	11.6	10.1	9.3	8.5	8.0
EV/EBITDA (x)	8.8	8.3	7.4	7.0	6.9
FCF yield (%)	6.3	6.1	5.6	6.4	6.8
Dividend yield (%)	2.7	4.3	5.8	6.5	6.6
Payout ratio (%)	56	70	86	86	89
ROE (%)	30.1	56.2	64.9	66.8	61.2
Cashflow (Rm)	**2010**	**2011**	**2012E**	**2013E**	**2014E**
EBITDA	19,765	20,594	22,786	23,903	23,833
Working capital	1,056	-293	-360	311	320
Other	-4,584	-4,306	-6,342	-5,745	-5,669
Operating cashflow	**16,237**	**15,996**	**16,083**	**18,469**	**18,484**
Capex	-6,222	-6,441	-7,315	-8,444	-7,845
Net acq/disposals	0	-33	0	0	0
Other	-107	-107	-107	-107	-107
Investing cashflow	**-6,329**	**-6,581**	**-7,422**	**-8,551**	**-7,952**
Dividends paid	-5,200	-4,241	-6,816	-9,250	-10,284
Financing cashflow	**-9,840**	**-9,077**	**-7,507**	**-8,438**	**-12,582**
Net change in cash	**-136**	**223**	**1,155**	**1,480**	**-2,050**
Free cashflow to s/holders	**10,015**	**9,555**	**8,769**	**10,025**	**10,639**

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For definitions of the items in this table, please click here.

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Summary

Three reasons to Sell Vodacom

R85 TP, downgrade to Sell

We downgrade our rating on Vodacom to Sell, from Hold, and cut our price target to R85 from R90. In our view, the stock's valuation is unsubstantiated in the face of deteriorating fundamentals. In particular, we believe that Vodacom now faces a more challenging consumer landscape in a maturing telecom market. With rising competition as a key factor, we see increased risk to Vodacom's prospective earnings and cash flows.

1) The tide has started to turn

A tougher consumer environment

A tougher consumer environment is dampening spending, including on telecoms. We highlight some worrying dynamics that suggest that telcos will have to fight much harder for a share of the consumer's wallet.

Slower wage growth and rising inflation weigh on spending

Slower wage growth

Real wage growth had slowed to 0% by mid-2011, where this had averaged nearly 4% in the last 2-3 years. Although wage demands in SA are quite sticky, a stuttering economic recovery and stubbornly high unemployment could keep this in check.

Rising inflation

Inflation has picked up, rising from a low of 3.2% y-y in Q3 10 to 6.1% by the end of 2011. Inflation expectations have also risen, with Q4 11 data pointing to a level of over 6% for 2012 and '13. In particular, priority costs such as food, transport and utilities (c60% of the consumer basket) continue to spike, which erodes consumers' ability to spend on more discretionary items. Meanwhile debt-disposable income (75%) has also been slow in subsiding, leaving consumers vulnerable to sharp rises in interest rates.

Spending power under pressure, including telecom spend

Spending power has thus been eroded and consumers are likely to manage their spending patterns more carefully, in our view. We believe that this could also impact telecom spend and put pressure on ARPU's.

New subscribers offer less

Telcos are now chasing a lower-quality subscriber. For instance, the higher LSM consumer segments boast cellphone penetration of 78-95%; the lower segments are only at 25-60%. In terms of numbers, therefore, subscriber growth should stem mainly from the lower-end.

Growth in lower-end subs points to further ARPU dilution

The problem is that where the upper segments can spend around R635/m on communications, the lower-end might spend R60-70/m. Not only does this point to further ARPU dilution, but it will also require infrastructure to be put in place, which will push costs up and put margins and returns under pressure.

No more easy pickings in a maturing sector

Penetration growth has provided a powerful tailwind to the rise of the SA telecom sector from its earlier years to now. The market has, however, become more saturated, meaning that subscriber growth should slow and, as mentioned, the quality of new subscribers is also now much lower.

High prices and growth harder to sustain in a mature market

In our view, this means that high pricing will become more difficult to sustain, especially in light of the above-mentioned consumer landscape and legislated MTR cuts (-55% over a three year glide path to 2013). Against this backdrop, we think Vodacom's pricing in SA could decline by c12% pa, and possibly more, over the medium-term, while MOU growth may be hamstrung for now by the factors described above (tough consumer environment, lower-quality subscribers).

We factor in lower ARPU in SA, but it could be worse

In all, this translates to an 11% decline in Vodacom's blended ARPU (SA) in FY 12, followed by further declines of c5% pa to FY 14 on our forecasts. Coupled with a likely slower subscriber outlook, this spells slower top-line growth, while cost pressures are likely to remain. In our opinion, it could be even worse depending on how competition evolves.

2) Rising competition

SA's competitive landscape has been largely benign, allowing for elevated prices while penetration has grown. A maturing market has, however, seen a rise in competitive pressures over the past 12-18 months, and we expect this to continue.

Cell C a key piece in the competition puzzle

In particular, Cell C could shake things up, with former Vodacom CEO Alan Knott-Craig recently appointed to the helm. One of the key challenges and reasons for Cell C posing a relatively weak competitive threat has been its inability to effectively roll out its network and distribution channels. Knott-Craig believes this can be easily fixed in the next 12 months, which will put Cell C on a stronger platform to compete, including on its tariffs.

The 12% increase in market share targeted by Cell C likely to come from competitors

Cell C aims to increase its market share by 11-12% to c25% in the next three years which, if achieved, implies some market share losses for incumbent Vodacom. Importantly, the funding for Cell C to pursue its objectives is in place and the competitive environment looks poised to intensify.

3) It's expensive

Earnings could reverse by FY 14

We have nudged up our FY 13 forecast for Vodacom largely due to factoring in the change in dividend tax regime in SA. We have, however, reduced our FY 14 forecast by 5%, which puts this number c10% below consensus. We thus forecast HEPS to grow by 9.4% to R7.19 in FY 12 and 11.8% in FY 13, before a reversal of c1% in FY 14. We include a more detailed discussion of forecasts on page 39.

Figure 1. Vodacom HEPS Forecasts

	FY 11	FY 12E		FY 13E		FY 14E	
R/sh		New	Prev	New	Prev	New	Prev
Citi HEPS	**6.57**	**7.19**	**7.09**	**8.04**	**7.43**	**7.94**	**8.41**
% Change, y-y		9.4%		11.8%		-1.1%	
Consensus HEPS	**6.57**	**7.32**		**8.03**		**8.81**	
% Change, y-y		11.4%		9.7%		9.7%	
Citi DPS	**4.60**	**6.22**	**5.60**	**6.91**	**5.86**	**7.04**	**6.64**
% Change, y-y		35.1%		11.2%		2.0%	
Consensus DPS	**4.60**	**5.81**		**6.62**		**7.14**	
% Change, y-y		26.3%		13.9%		7.9%	

Source: CIRA Estimates, I-Net Consensus

Vodacom valuation unwarranted given increased risks to earnings can cash flow

We believe the pressure on earnings could be worse, as our assumptions are arguably mild depending on what the competitive environment unfolds. This embodies our main contention that Vodacom's valuation — forward PE of 13.9x and EV/EBITDA of 7.2x — looks unwarranted given the increased risks to prospective earnings and cash flow. The stock's dividend yield of over 6% undoubtedly presents some appeal, however, our argument highlights the capital risk to the share.

For context, Vodacom's valuation reflects a premium of 15% on PE and c50% on EV/EBITDA compared to EM aggregates; and Vodacom would look even more expensive if our concerns pan out.

R85 TP, Sell

We have cut our price target to R85 (rounded), which corresponds to a 6x EV/EBITDA on FY 13E. Our new price target implies c21% downside to spot and translates to an expected total return of -14.2% after adding in a gross DY of 6.4%. We downgrade our rating on Vodacom to Sell, from Hold.

Figure 2. Vodacom DCF Valuation

Country	WACC	Terminal growth rate	100% Valn, Rm	Ownership, %	Proportionate Valn, Rm	Valn % of Total	EV/EBITDA 13E
SA	10.6%	2.0%	130,461	94%	121,981	94%	5.9
Tanzania	12.4%	3.5%	6,337	65%	4,119	3%	6.7
DRC	17.0%	3.0%	2,080	51%	1,061	1%	5.1
Lesotho	14.3%	3.0%	2,324	80%	1,859	1%	6.8
Mozambique	12.4%	5.0%	1,384	98%	1,356	1%	6.6
Gateway	-	-	0	100%	0	0%	-
TOTAL					**130,376**		**6.0**
Net debt (consolidated)			(6,856)	FY13F			
Valuation - equity			123,519				
			16,360	USD m			
Per share			**84.14**				

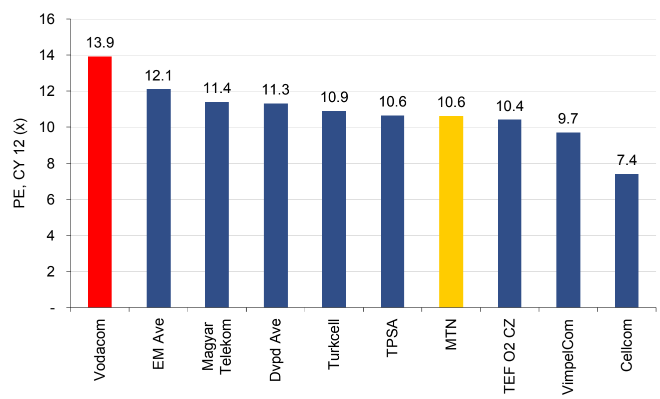
Source: CIRA Estimates

Big premium

Vodacom's CY 12 EV/EBITDA if 7.2x a 50% premium to EM peers

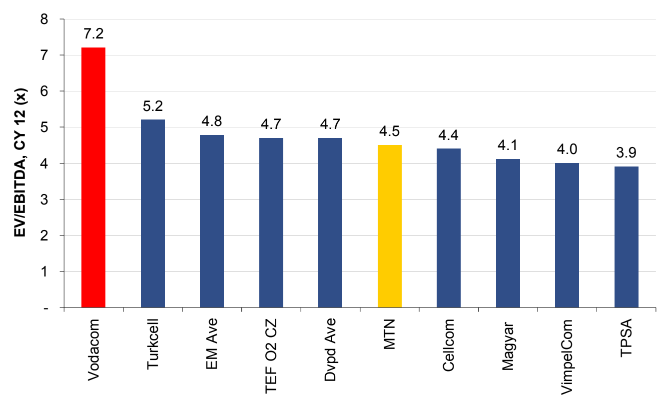
Vodacom's share price currently hovers around all-time highs and reflects a significant premium to its peers, with its CY 12E PE of 13.9x and 7.2x EV/EBITDA sitting right at the top-end of comparisons, as shown in the two charts below. As shown in Figure 2, our target valuation implies an EV/EBITDA of 6x, which is still above most of its peers.

Figure 3. Peer Group PE Comparisons, CY 12 (x)



Source: CIRA Estimates

Figure 4. Peer Group EV/EBITDA Comparisons, CY 12 (x)



Source: CIRA Estimates

Addressing the dividend conundrum

Does valuation really matter given the attractive dividend?

Vodacom's forecast dividend yield (DY) of 6.4% is probably the biggest risk to our investment case: i.e. if one is getting that yield, does the valuation really matter? This is a fair question, but our argument centres on the capital risk around that dividend.

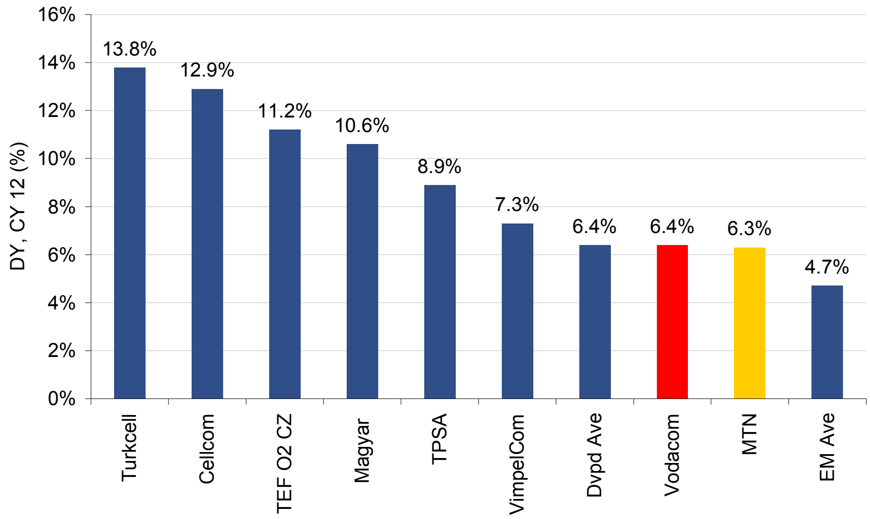
We think it does for Vodacom because risks have increased

Our contention is that Vodacom's earnings and cash flow face increasing risks over the next few years against the backdrop of a tougher medium-term consumer environment and a maturing market. We expect competition to intensify in this

context, which could culminate in significant downside in Vodacom's key growth drivers, and ultimately to its yield prospects.

We do not believe that Vodacom's current valuation can be justified in light of these risks and a de-rating in the stock is warranted. For further context, Figure 5 shows that many of Vodacom's EM peers offer similar or better dividend yields at more palatable valuations (Figure 3 and Figure 4).

Figure 5. Peer Group DY Comparisons, CY 12E (%)



Source: CIRA Estimates

Catalysts

KPI's over the next 12 months should start to reflect the increased

Admittedly, Vodacom could produce some decent results in the nearer-term which could be supportive. However, our thesis on the macro and competitive environment may begin to manifest over the next 12-18 months making the risks to Vodacom a little clearer. This should start to reflect in Vodacom's share price and valuation before it starts coming through in results.

Poser: asset sales could fuel prospects of special dividends

Linked to the argument around Vodacom's dividend, the company could pay out special dividends in light of its underleveraged balance sheet, as well as the possible disposal of operations like DRC and Gateway. While the latter may not yield much, our valuation for DRC could see a distribution of cR2bn (or cR1.40/sh) if this was realised in any potential sale (and assuming the company pays the proceeds out to shareholders). This adds an additional spin to the timing of any potential de-rating in the Vodacom share price, though over time

Key Risks

With specific regard to our Sell rating on Vodacom, we highlight the following risk factors that could work against our recommendation:

- The **timing** of how and when our concerns play out and how Vodacom is able to manage or delay these is uncertain. We may be early with our call as it may take some time for the factors we highlight to play out and manifest.

- We believe that **competition** is a key variable in some of our assumptions. To date this has been relatively mild, enabled by a relatively benign regulatory environment. We expect this to intensify but, again, how and when this plays out remains uncertain at this stage.

- A strong pick-up in the **economic and consumer outlook** would also boost telecom spend and shield against some of the downside risk factors.

- Vodacom's **dividend** is attractive and remains well-supported. Although we believe that this is not enough to justify the stock's premium rating given our view of a turning tide and increased risks for telcos, Vodacom's share price may remain supported by its yield, particularly if our concerns take longer to materialise. Special dividend payout is also a possibility that would support the share price.

- Vodacom could stave off the impacts of a deteriorating macro environment by focusing on **costs and margins**, which would help support earnings and cash flow. We discuss some of these factors, such as interconnect, distribution and network costs, starting on page 36 of this report.

More generally, Vodacom faces the following sector and company risks:

- The impact of falling interconnect rates on revenues may be difficult to recover as termination rates continue to decline over the next few years.

- Competition could become more aggressive; particularly from Cell C, whose new CEO is the former head of Vodacom.

- Diminishing returns from capex, as Vodacom may need to continue investing only to yield lower returns in revenues.

- Increasing regulation, which has had a limited impact on SA so far in our opinion.

In this report

We have focused this report on SA as it is the main component of Vodacom's earnings and valuation; in particular we look at the consumer condition and telco market evolution. The three parts to our discussion in this report include (i) an examination of the consumer landscape in SA and implications for telecom spend; (ii) a contextualization of SA's telecom life cycle and Vodacom's key growth drivers in this context; and (iii) the potential impact of increased competition as a key ingredient in our investment case for the SA telecom outlook.

Our analysis includes various cross-market comparisons and detailed scenarios, based on the EM European companies summarised in Figure 6, of some of Vodacom's KPI's, which help build our story.

Figure 6. Companies We Use In Our Comparison and Scenario Analysis

	Vimpelcom	TPSA	TEF O2 CZ	Turkcell (TCELL)	Magyar (MTEL)	Cellcom
Country	Russia	Poland	Czech Rep	Turkey	Hungary	Israel
ARPU (USD)	11.4	13.8	24.6	12.3	18.4	29.6
APPM (USD)	0.05	0.08	0.16	0.06	0.11	0.09
MOU	251	164	151	222	175	346

Source: Company Reports

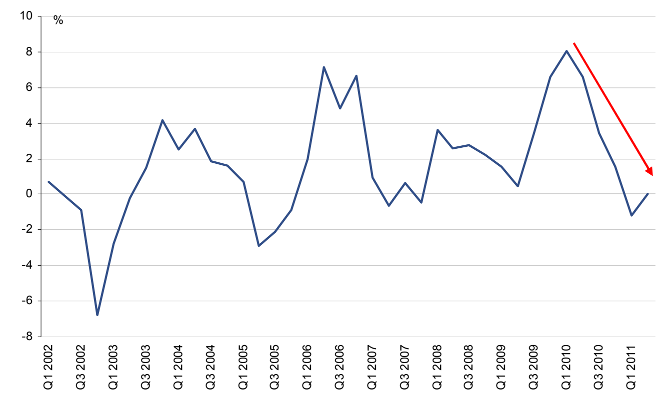
The battle for consumer wallet share

The SA consumer now presents a tougher terrain for telcos

Real wage growth and consumer confidence starting to wane

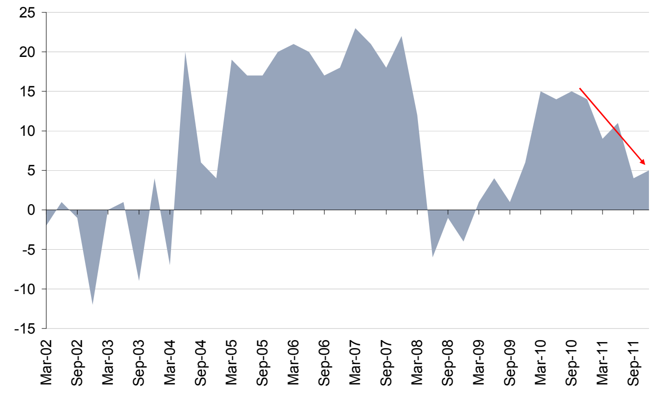
The consumer is facing a less favourable outlook. This was flagged in a 16 September retail report. Reversals in key trends are starting to emerge, with real wage growth, for instance, subsiding, while consumer confidence is also coming off.

Figure 7. Real Wage Growth (Quarterly, y-y)



Source: Stats SA, CIRA

Figure 8. Consumer Confidence



Source: BER, CIRA

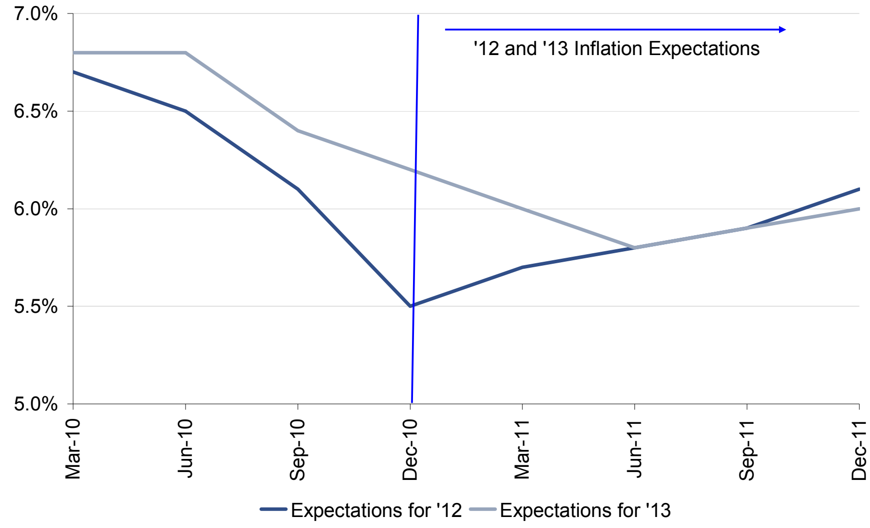
No real growth in wages

Having topped out in the first quarter of 2010 after a strong upwards trajectory, y-y growth in real wages has receded, even breaching parity to record a negative reading in Q1 11 (-1.2%). The trends in real wages are generally a leading indicator and thus a forerunner to the consumer condition.

Consumer confidence now at 5 points, significantly down on the 15 points averaged during 2010

Consumer confidence data (coincident indicator) depicted in Figure 8 mirrors the real wage trends, with a peak in the former occurring roughly six months later in Q3 10, following which confidence has been in decline. Whereas the index averaged in the mid-teens through 2010, it now sits at 5 points. This is probably not a disaster yet but does highlight heightened caution and the increased pressure being felt in the consumer space.

Figure 9. Trend In 2012/13 Inflation Expectations



Source: BER, I-Net Bridge

Inflation expectations for 2012 and '13 have also ticked up during the course 2011

We believe that this could persist over the next 12-18 months as economic growth continues to stutter even as inflation concerns have started to escalate — Figure 9 portrays how inflation expectations for 2012 and 2013 edged up during the course of 2011.

We anticipate an impact on discretionary spending patterns, including on communications which could spur more intense competition among operators

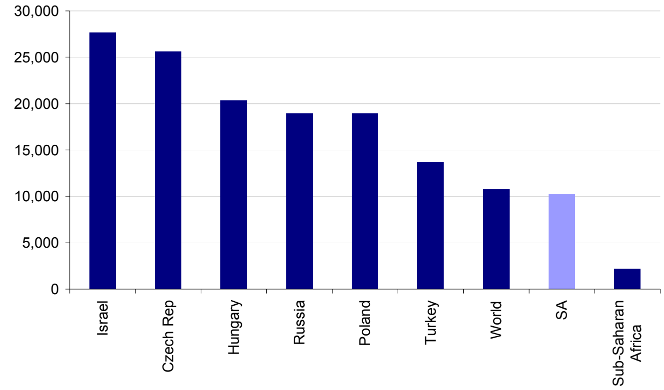
In our view, this will in turn impact negatively on spending patterns, particularly on discretionary spending, including on communication. Consequently, we believe this could fuel the competition amongst operators even further. Both Vodacom and MTN have noted over the past year that customers are increasingly conscious of different value propositions, which is manifesting through more considered spending tendencies.

Its hard to spend what one does not have

SA compares unfavourably in the GDP per capita stakes

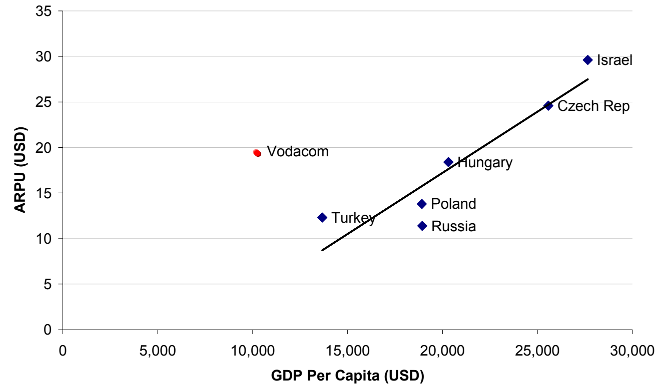
The issue of affordability is an important one. A comparison of selected countries' GDP per capita data reveals that SA fares quite poorly in the wealth/affordability stakes. In fact, SA's GDP per capita is lower than all the European markets we use in our analysis (later in this report) and more than 20% short of the nearest peer (Turkey) — see Figure 10. In other words, SA faces some structural hurdles in terms of the "size of the spending pie" compared to some of its peers.

Figure 10. GDP Per Capita



Source: UNDP Human Development Report 2011

Figure 11. ARPU vs GDP Per Capita Correlation



Source: UNDP, Company Data, CIRA. *Regression line excludes 'outlier' Vodacom*

Vodacom's ARPU looks out of kilter with SA's GDP per capita

Interestingly, the Figure 11 shows up Vodacom, which we have not factored into the regression line calculation, as an outlier in terms of the GDP per capita to ARPU correlation. Intuitively one would expect countries with higher GDP per capita (better wealth/affordability) generally enjoy higher ARPU's from a telecom perspective. Note that the ARPU element of the analysis in Figure 11 is based on the corresponding companies in Figure 6 (page 8).

Highlights downside risk in our opinion

On the other hand, Vodacom looks somewhat out of kilter and sports an uncharacteristically high ARPU given SA's GDP per Capita and SA appears to be punching above its weight from this viewpoint. As discussed in later sections of this report, we believe this has to do with the wealth inequality and high pricing in SA, as well as a function of where the country sits relative to some of the countries on the maturity curve. We believe that this status quo is unsustainable and highlights the downside risk to Vodacom's ARPU, as we argue later.

"Diminishing marginal subscriber"

Communication spend is skewed heavily to the upper end

We have examined spending patterns by LSM

We have distilled the respective segments of the consumer markets that make up mobile operators' focus areas. In this respect, we examine the breakdown of household spending by income decile (Figure 13). The Stats SA nomenclature differs, however; our analysis going forward assumes that these breakdowns roughly match LSM (living standards measure) categories in SA, of which there are also 10.

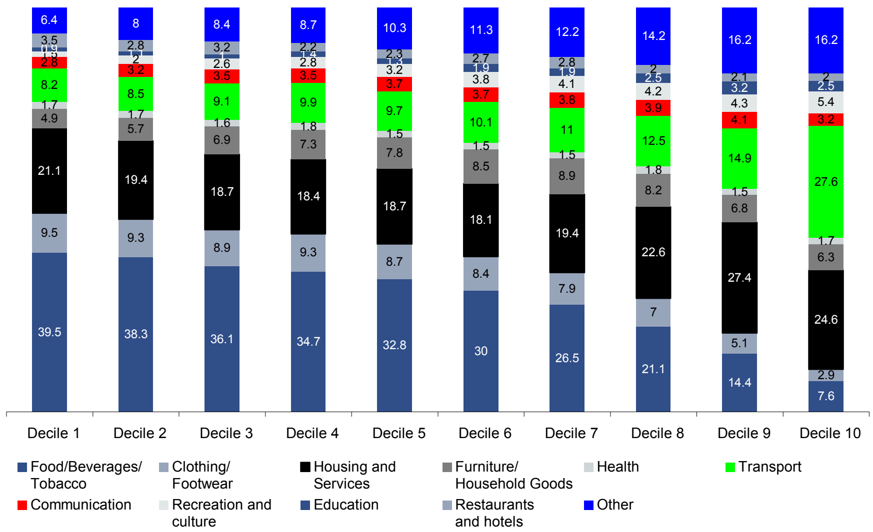
A further limitation worth noting is that some of the data we use is only collated and released every five years and so may be a little dated — we use what we can. Nevertheless we believe that it does help lay the platform for us to evaluate the quality of incremental subscribers operators are likely to be scrapping for, particularly as the market matures.

Figure 12. LSM Categorisation

	Lower	Middle	Upper
Segments	LSM 1-4	LSM 5-7	LSM 8-10

Source: StatsSA and CIRA

Figure 13. Breakdown of Household Expenditure (2006)



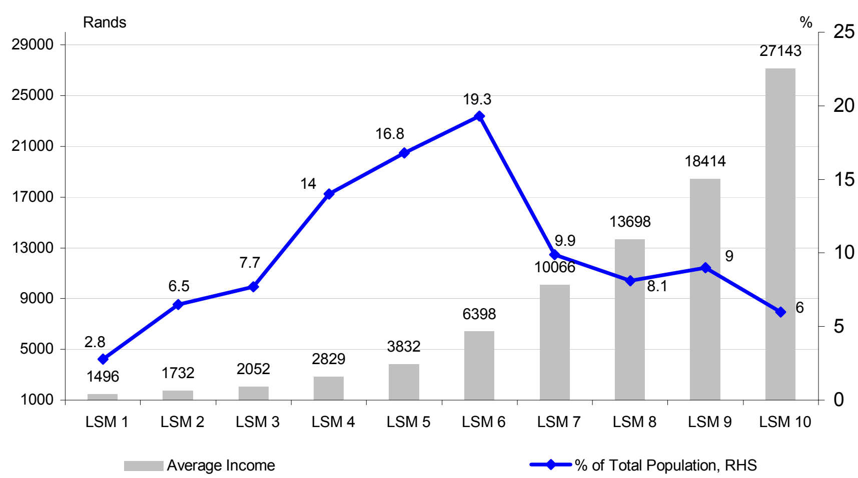
Source: StatsSA

Higher LSM's spend a higher proportion of income on communication than the lower-end

Around 3.5% of the consumer's expenditure is on communications on average. Interestingly, Figure 13 shows that the proportion of spend is actually less among the lower LSM's (average 3.2% for LSM 1-4) than it is in the middle (5-7) and upper LSM's (8-10), which both average c3.7%. This is despite the notable disparity in incomes between the categories as depicted in Figure 14.

In a telecoms context, the upper LSM's would constitute market segments that are highly penetrated and consist mostly of postpaid and higher-usage prepaid subscribers. Conversely, the lower and middle LSM's are less penetrated but communications spend holds a lower priority, perhaps unsurprisingly given the greater importance of food and housing.

Figure 14. Breakdown of Ave Income & Population Split by LSM (2010)



Source: SAARF

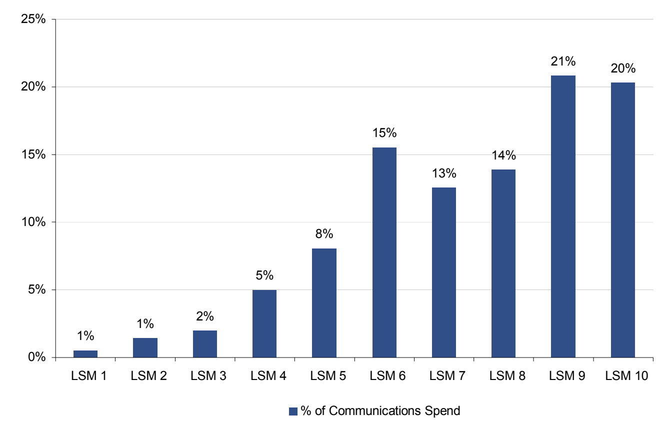
… Means that communication spend is heavily skewed to the upper end

Still on Figure 14, we note that LSM's 1-5 makes up nearly half the population but only 17% of overall income. This illustrates the point that consumer spend on communications is heavily skewed to the upper end and it will require larger numbers from the lower LSM groups to generate continued growth in revenues.

c70% of communication spend comes from less than a third of the population

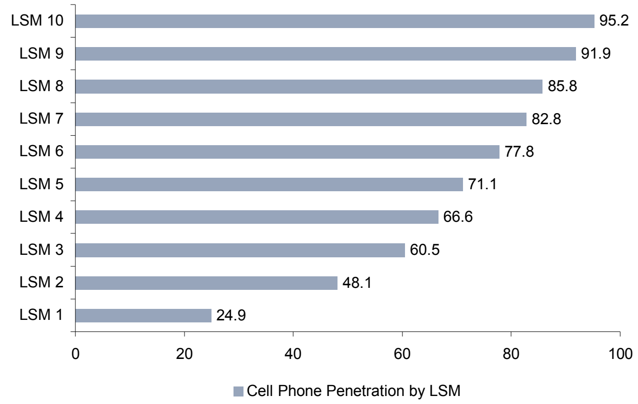
Our analysis in Figure 15 combines apples and pears somewhat, but is still handy in our view. Using the splits and data from Figure 13 and Figure 14, we derive an estimate of how overall communications spend can be broken down across the different LSM's. In other words, Figure 15 gives a sense of how overall communications spend is distributed across the different LSM groups. Nearly 70% of communications spend comes from LSM's 7-10, which make up less than a third of the population.

Figure 15. Proportion of Spend on Communications (% of Total, 2010)



Source: SAARF

Figure 16. Cell Phone Penetration by LSM (2010)



Source: SAARF

Operators will need to compete harder to grow

The preceding discussion highlights the dual-market nature of the SA telecom sector; i.e. a prepaid segment comprising mostly lower and some middle-end customers, and predominantly upper-end postpaid segment. Our observations here raise two problems for the likes of Vodacom and its peers in SA:

1. In terms of numbers, the biggest growth potential in resides in the lower-end where, as Figure 16 shows, cell phone penetration is estimated at between 25-67% (2010) and there is still scope for this to increase. However, the spending power of is also much lower in this segment (Figure 14), making pricing and affordability key issues.

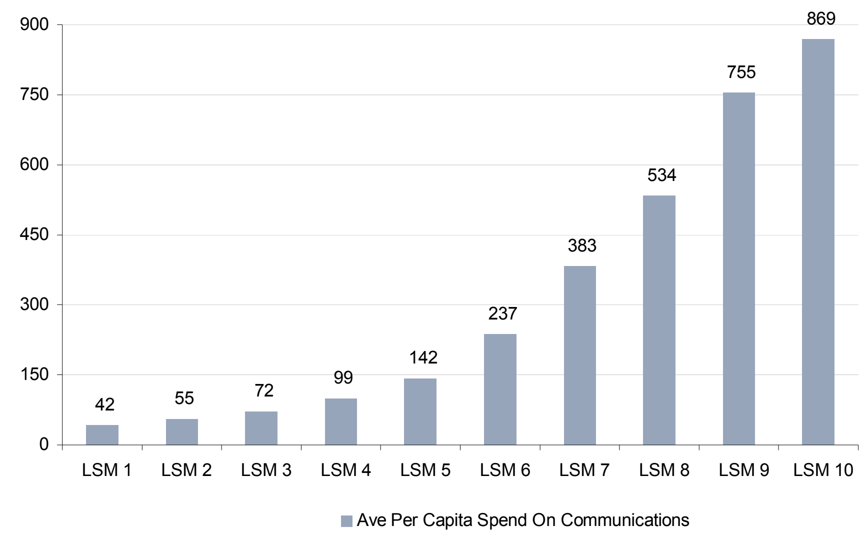
2. The upper-middle and top-end consumers are more stable and reflect an already mature market; the challenge for telecoms will be to retain these customers as a starting point, while growing this segment implies trying to take customers from competitors. The implication is for more heated competition in our view.

Struggling lower-end begs for lower prices

Spending power is much weaker in the lower-end, and spending priorities still lie away from communications at this stage

The profile of the lower-end consumer makes it more price-sensitive. Spending priorities are very different, as highlighted in Figure 13 on page 12; where the proportion of communication spend actually declines even as income levels drop. In Figure 17, we have inferred per capita communication spend broken down by LSM by combining the information in Figure 13 and Figure 14.

Figure 17. Average Monthly Per Capita Spend on Communications By LSM



Source: SAARF, CIRA

Growth in the lower-end is all about numbers for now and affordability/pricing is likely to be a key driver in our view

We again note the vast gap in communications expenditure in the lower- versus the middle- and upper-income segments. It is, thus, very much a numbers game in the lower-end at this point, so affordability will be a key driver of penetration growth, in our opinion. Vodacom, in its Q3 quarterlies, acknowledged that it has indeed been actively pursuing the lower-end (rural) market. The company noted that ARPU's are around R50, which is actually consistent with the very low-end in Figure 17 data, although the bases are different.

Translates to downward pressure on ARPU and upward pressure on subscriber acquisition costs

Also in context of our earlier point on spending priorities, we believe that there would be further downward pressure on prices, as well as an upward push on acquisition costs in order to drive growth in this market. Consequently, the direction for ARPU is likely to be down and Vodacom also conceded that payback periods for this segment are longer given its very low level of communication spend and the costs to acquire customers in this bracket. Vodacom also indicated that competition is also quite intense here as well.

Stickier higher-end demands lower prices

Higher-end is more sophisticated in its usage patterns

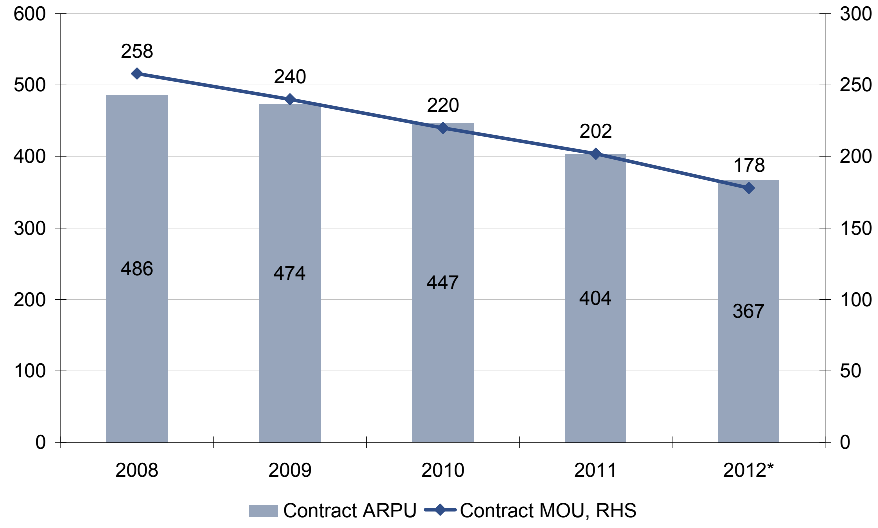
The middle and upper LSM's — skewed more to postpaid customers, as mentioned — are more saturated (Figure 16) and consequently more stable. This segment is typically stickier in terms of migrating across networks (in part due to contracts) and arguably more settled in their usage patterns. In fact, this segment has become more sophisticated and active in managing its telecom spend with the onset of recessionary economies a key catalyst — this is a trend that has been repeatedly highlighted by Vodacom over the past year or so.

…Has been active in managing down communication usage/cost with the onset of recessionary economies

While there has been an element of prepaid customers upgrading to postpaid at lower incremental ARPU; Vodacom (and MTN for that matter) have specifically noted that postpaid users have progressively reduced their out-of-bundle use and are even migrating to lower usage packages when renewing contracts. The companies have specified these factors as key reasons for declining postpaid ARPU. Even though effective pricing in postpaid has remained comparatively resilient, therefore, ARPU's have still come down on the back of falling MOU — see

Figure 18. Vodacom's postpaid MOU has fallen at an average of c9% p.a. since 2008, which has contributed to a 7% p.a. decline in ARPU over the same period.

Figure 18. Vodacom – SA Contract ARPU Has Fallen On Declining MOU



Source: Company Data, CIRA. **FY 12 average to date.*

The push by customers to reduce their mobile costs has brought down ARPU's

So users have managed their effective pricing (by increasingly staying in-bundle) and brought down their usage. This highlights a greater awareness by middle and higher segment customers about different value propositions in the market, who are increasingly taking advantage of opportunities to reduce their mobile costs when possible. It comes back to falling ARPU.

It is trickier to grow this market because it is more settled; issues like network quality are key considerations

The significance is that in order to grow this — more lucrative — segment, operators will need to claw into each others subscriber bases. Network quality is probably an important factor in this segment, which is arguably less price-sensitive. However, most operators are continuously improving their networks and so the ultimate lever to pry higher-end subscribers from competitors may be through pricing.

To compete on price, cuts would need to be significant in order to claw into rivals subscriber bases and even then operators would defend their turf

Because of the stickier nature of this segment, price cuts would need to be quite significant to have an impact. In a worst-case scenario, price wars would ensue as operators are more than likely to defend their respective turf, which would be hugely damaging to ARPU's. A likely increase, in this scenario, of customer acquisition and retention costs would further compound matters in terms of the impact on margins.

Leaders Vodacom and MTN do not have much incentive to compete aggressively in this segment

Arguably, therefore, leaders and Vodacom and MTN probably don't have much incentive to battle it out too aggressively on this front, as maintaining status quo is a more desirable scenario than the aforementioned "price war" environment.

… But the smaller players could drive the pressure

The pressure would probably need to come from lower tier rivals such as Cell C and 8ta. We believe that the outlook for the postpaid market (ARPU and growth) would thus be flat at best, with downside risk, especially if current trends continue.

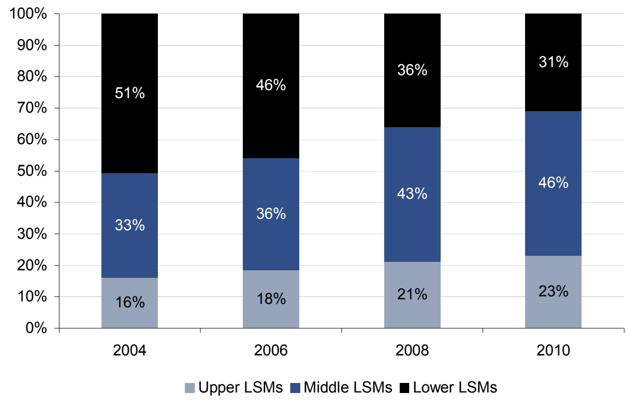
There might be some optimism for the longer-term

Consumer spend can increase, but that's a longer-term story

People "move up" the LSM's over time

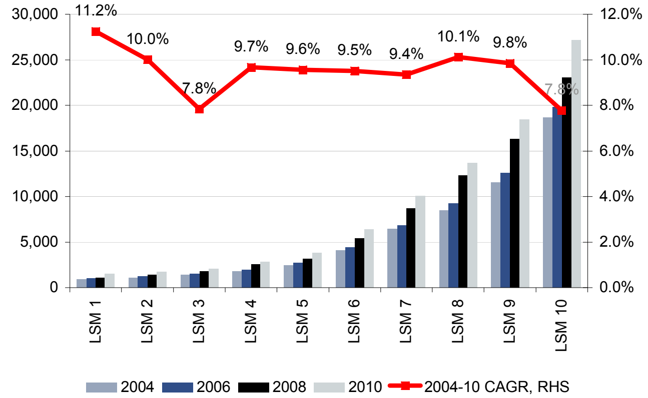
We have looked at how the consumer profile has evolved over time and how this may have impacted on telecom spending patterns. As time passes and economies improve, people move up the LSM's as living standards also improve. Figure 19, for instance, shows how the lower LSM's once (2004) made up just over 50% of the adult population in the survey, while it now sits at only 31%. All the while, the middle segment more recently makes up 46% of the population, having swelled from 33% in 2004; the upper LSM's have increased from 16% of the population in 2004 to 23% in 2010.

Figure 19. Evolution of Population Split by LSM



Source: SAARF, CIRA

Figure 20. Evolution of Average HHI Split by LSM (R/mo, LHS)



Source: StatsSA, SAARF, CIRA

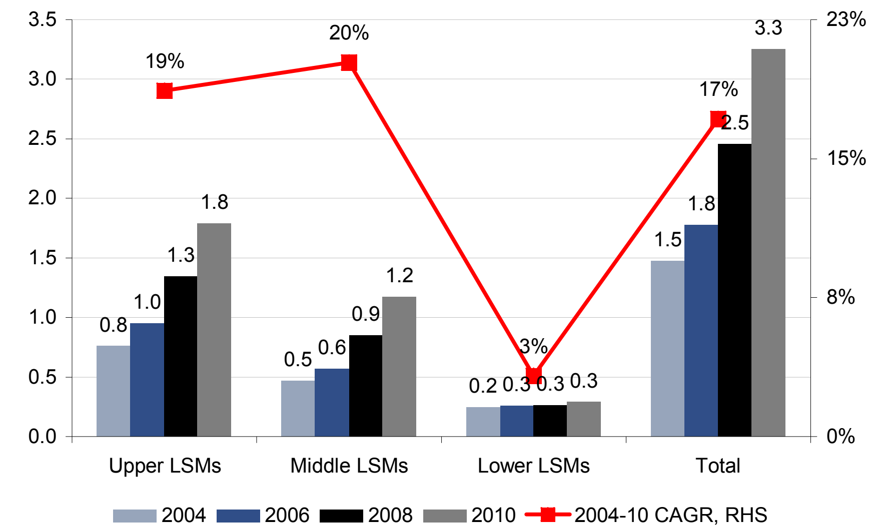
As does average income in each LSM

Figure 20 shows that the average household income in each LSM has also increased between 2003 and 2009, by 7-10% pa. Put differently, not only are living standard improvements reflected in movement up the LSM curve over time (Figure 19), but also through better incomes within the respective LSM's.

Aggregate HHI has more than doubled between 2004-10

Combining the two dynamics implies that the aggregate income of households has more than doubled (c17% p.a.) between 2004 and 2010. Perhaps unsurprisingly, the middle and upper LSM's are again shown in Figure 21 to be the thrust of overall growth, whereas the lower-end has been comparatively muted. The latter trend arises in part from the 'graduation' of people into higher LSM's

Figure 21. Movement In Aggregate HHI (Rtr) By LSM



Source: SAARF, CIRA

By implication, expenditure on communications has also risen quite a lot – more than 125% between '04-10

If one simplistically assumes the same proportion of communication spend in each LSM group as laid out in Figure 13 (page 12) over the years, the upshot is that communication spend may have increased by c125% between 2004 and 2010. As a sanity check, Vodacom's SA revenues increased by c150% and MTN by 137% over the same period.

There appears to have been some gearing in communication spend to income growth

This was in context of a c120% estimated rise in household incomes over the same period, which indicates some gearing benefits to communication spend from income growth, particularly if the proportion of communication also increased over the period. This is possibly corroborated by the higher growth seen in Vodacom and MTN's SA revenues.

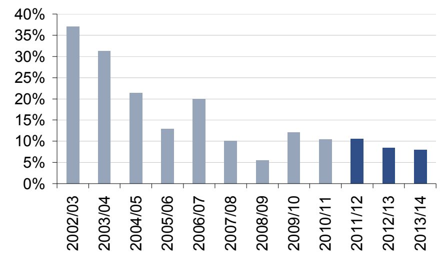
So that was then, but where are we now?

But tougher times beckon for now

Times have somewhat changed

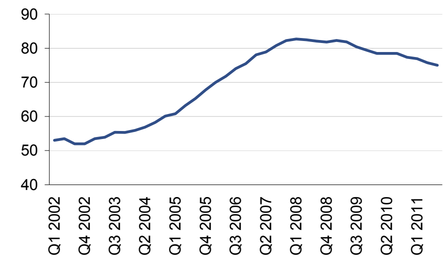
We highlight two key factors that differ in the current environment versus the circumstances that prevailed over the favourable period just discussed. Firstly, a more mature SA telecom market means that penetration growth is no longer a significant driver. Secondly, the general consumer landscape is less sanguine than it was between 2004 and '10; let's look at what's different.

Figure 22. Growth In Social Grants



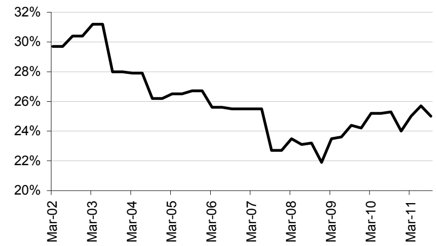
Source: 2012 Budget

Figure 23. Household Debt-Disposable Income



Source: SARB

Figure 24. SA Unemployment Rate



Source: StatsSA

Budgeted social grants are projected to slow to single-digits, compared to earlier growth of the mid-20%

- We already spoke about a softening income growth environment earlier (page 9), and this is echoed in social grant trends. More pertinent to the lower-end, growth in social grants was very strong and averaged c24% pa between 2002 and '07. Having subsequently slowed to roughly 10% pa from 2008-11, budget projections have these slowing even further into the single-digits over the medium-term (Figure 22).

This slowdown, coupled with rising inflation could pressurise communication spend

This trend (including slower income growth) coupled with rising inflation will put discretionary spending under pressure, which is likely to impact expenditure on communication as well, over the medium-term.

Low indebtedness has also helped drive discretionary spending in the past, including on telecoms

- Figure 23 demonstrates how indebtedness rose from low levels between 2002 and '07, helping to spur increased discretionary spending even as interest rates fell (from 2002 to mid-06). After rising again between '06 and '08, rates have since come down to historical lows, but indebtedness remains stubbornly high.

But current high indebtedness and upside risk to interest rates portend negatively for discretionary spending going forward

The country's debt to disposable income ratio of 75% is not very far of the 82% peak nearly three years after the fact, although, to be fair, that the ratio is improving bodes well in the longer-term. In the nearer-term the risk of interest rates rising from historical lows — although consensus is for these to stay put for now — also threatens discretionary spending given the implied increase in debt servicing costs.

Unemployment has deteriorated since 2008

- Again, the consumer frenzy of 2002-07 was aided by employment growth, with the unemployment rate dropping from its peak of 31% in mid-03 to 22% by the end of 2008. Over the past two to three years, this kicked back up to nearly 26% and has reversed; unemployment now sits at 24%.

… A further negative indicator for consumer spending

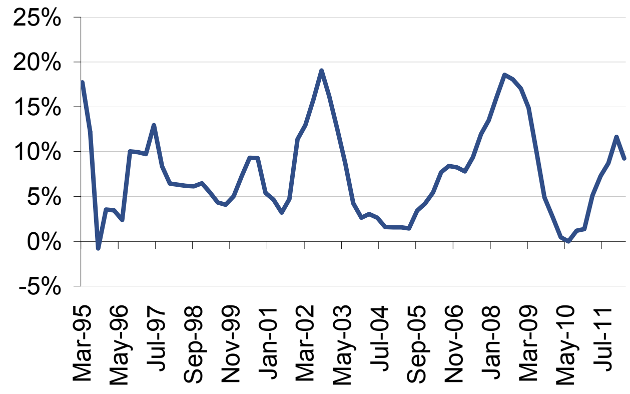
The recent trend is encouraging, but with the economy still struggling to pick up again, the prognosis for employment isn't particularly great. High unemployment exacerbates confidence levels and dampens spending. In turn, telecom spend will also be affected as consumers tighten their purse strings.

A turning tide

Telco's will need to battle each other, as well as other areas of spending, for a share of the consumer's wallet. Inflation has accelerated over the past year

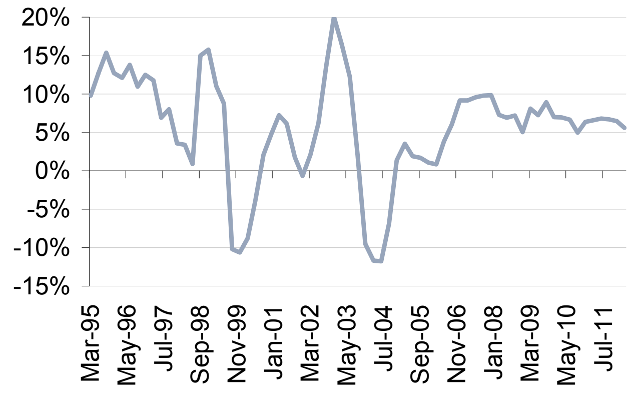
Vodacom faces a more difficult outlook where the pressures on the consumers are increasing. With the consumer's wallet feeling the pinch, telcos will not only need to compete with each other in this regard, but also against other areas of consumers' expenditure. General inflation, for instance, has accelerated from the 3.2% level of H2 10 and ended 2011 at 6.1%, above the upper end of the Reserve Bank's target range. In particular, Figure 13 shows that food makes up between 30-40% of expenditure in the middle and lower segments, while housing & services averages c20% of expenditure across all segments.

Figure 25. Food Inflation



Source: National sources and Citi Investment Research and Analysis

Figure 26. Housing & Utilities Inflation



Source: National sources and Citi Investment Research and Analysis

Food inflation, 30-40% of the consumer basket, has risen to over 9%

During the course of 2011, food inflation has risen from 0% in March to 9.2% at the end of the year. This could remain elevated depending what happens with the rand and will contribute to a squeeze on more discretionary spending given the large proportion food makes up in the consumer's expenditure portfolio.

Inflation in housing & services has also remained relatively elevated in a 5-9% band in the last three years

Housing & services is another key element, as mentioned, and inflation in this component has ranged between 5-9% since the end of 2008. Significantly, real wage growth has only averaged c3% since then. Eskom and government recently announced that electricity prices will increase by c16%, less than the 25% originally penciled in, but still well ahead of general inflation and income growth.

The consumer backdrop is, therefore, not as favourable as it was in Vodacom's earlier growth years. We believe that the telecom sector is entering a phase of the cycle in which growth will become more difficult to achieve and that the likes of Vodacom will have to battle harder, and on more fronts, to protect and grow its position.

The consumer and market backdrop has changed for the worse

While the company previously enjoyed the tailwinds of a favourable consumer environment, strong subscriber and usage growth as the industry grew from almost nothing, pricing stability, and a benign competitive environment, we believe that many of these factors are turning.

We expect these pressures to tell on Vodacom in due course

In our view, the change in the SA consumer landscape, as discussed, is compounded by the SA telecom sector itself starting to mature. We see this resulting in increased competition and a plateauing of key growth drivers. In due course, therefore, we believe that Vodacom will enter a phase where the effects of an unfavourable cycle will be harder felt and company's scrap for growth will significantly intensify.

Maturity – fine wine, or rotten grapes?

The problem with mobile operators…

In "Winds of Change?" (19/08/11), we touched on the major stages of mobile operators' life cycles (Figure 27). To recap:

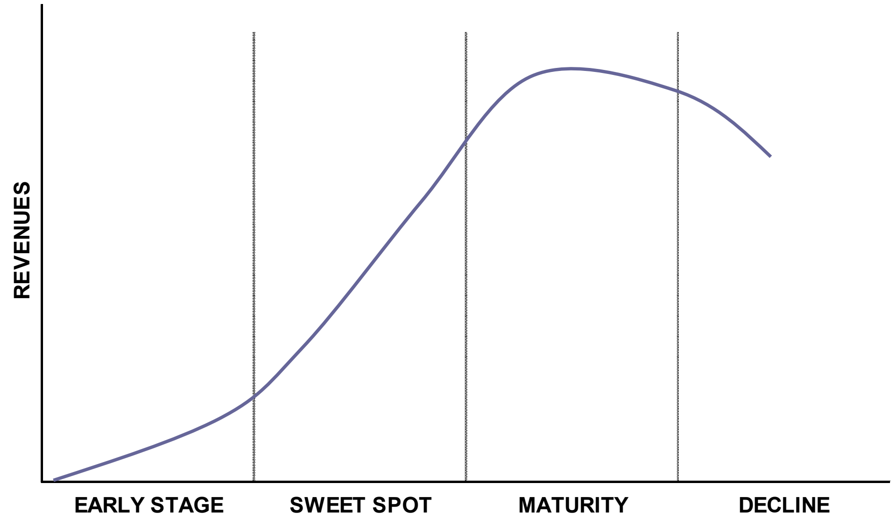
3. **Early stage growth/investment:** here, companies enjoy the early growth of their markets during which subscriber bases grow rapidly from a low base, tariffs are high and profitability grows with the scale of the businesses. Cash is absorbed to fund investment, but investors typically don't mind too much because of the attractive growth profile.

4. **Sweet spot/harvest stage:** in this phase, operators have gained some scale but are still achieving above-average growth. Investment continues but networks have been sufficiently rolled out allowing companies to increase dividend payouts. Growth and dividends — happy days!

5. **Maturity:** now growth is more difficult to achieve. Increased bases, slower subscriber growth, pricing pressure from competition and regulation. Options for how cash can be deployed are fewer, although this does mean that dividend yields can improve.

6. **Decline:** revenues in decline under pressure from innovation, with competition as fierce as ever. Slowing/declining growth also puts cash flows under the cosh, and consequently the ability to pay out cash to shareholders. Telco's are forced to adapt — e.g. be part of the innovation — and try to roll back the life-cycle.

Figure 27. Telecom Industry Life Cycle



Source: CIRA

SA market entering maturity; we wonder if this is being priced in or if valuations are still looking for growth

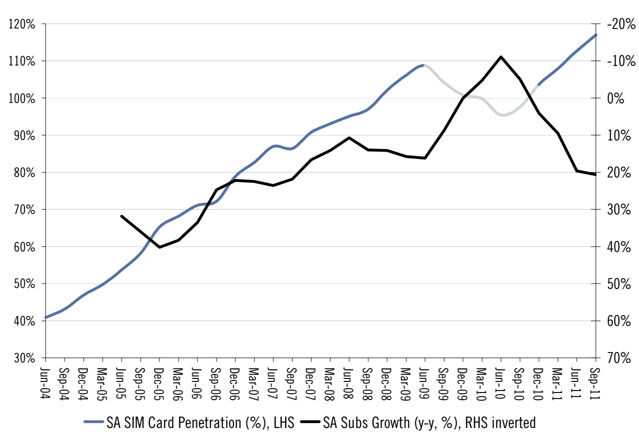
We believe that the SA market in general, and Vodacom in particular, is passing through the sweet spot and entering a more mature phase of its life cycle. In our opinion, the question around Vodacom should, thus, revolve around whether the stock's valuation is still pricing in optimistic growth prospects or if it has started to reflect the company's transition into maturity.

Subs may yet grow, but quality is deteriorating

Mobile penetration is up; customer growth may continue but the rate should slow and while "quality" of new adds deteriorates

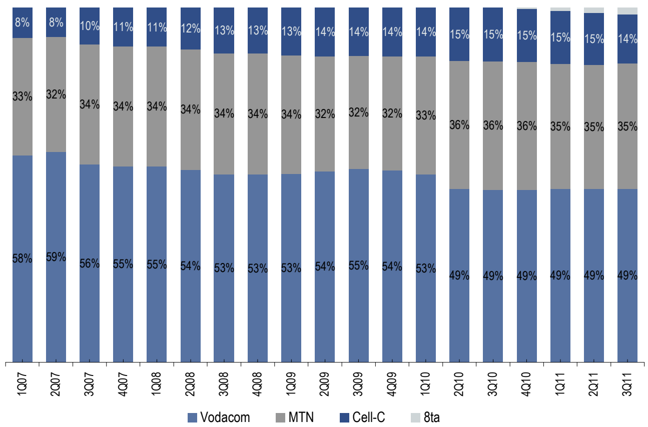
With mobile penetration having broken through the 100% mark in Q3 08 after a steep upward curve, subscriber growth rates should wane going forward, while the marginal benefit of new adds is also worsening. Figure 28 illustrates how quarterly y-y subscriber growth has abated over time from the 30-40% range in earlier years to the mid-teens just before RICA was introduced (note that the graph for growth in Figure 28 is inverted).

Figure 28. Mobile Penetration in SA



Source: Company Data, CIRA

Figure 29. Mobile Market Share in SA



Source: Company Data, CIRA

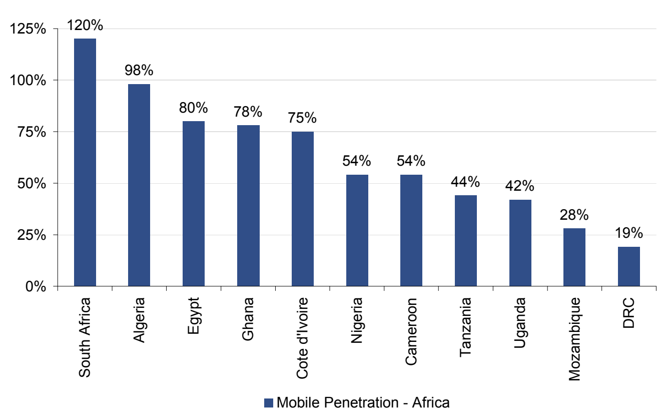
RICA has distorted subscriber trends in the past 18 months or so; we expect trends to slow again after normalising

RICA has been a specific dynamic at play from mid-09 through to the first half of 2010, and resulted in SIM card disconnections, which distorted industry subscriber trends. Quarterly y-y growth has thus been quite resurgent of late after dipping into negative territory in the first three quarters of CY 10. As mentioned, we believe that growth should slow again after this normalisation.

Stable market share a further indication of a maturing market

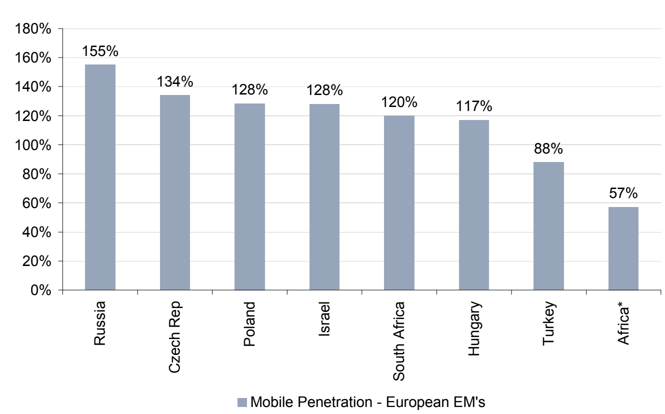
Figure 29 illustrates how market shares have also somewhat stabilised in recent quarters, with the exception of the impact of new player 8ta (Telkom's mobile operator). Vodacom for instance has held its market share comparatively steady at around 50% since Q2 10; reinforcing the notion of a more stable and maturing market.

Figure 30. Mobile Penetration Rates – Selected African Markets



Source: Company Data, CIRA

Figure 31. Mobile Penetration – Other Selected European EM's



Source: Company Data, CIRA. *Simple average, excludes SA.*

Mobile penetration can, however, increase to well beyond 100%

At c120%, South Africa's mobile penetration is the highest among African markets (Figure 30). It does, however, trail some of the European EM peer group (Figure 31) — the likes of Russia and Czech Republic, for instance, sit at mobile penetration rates of 155% and 134%, respectively. This means that there is still scope for subscriber bases to grow.

Still growing, but subs becoming a blunter weapon in the push for revenue growth

As seen in the cases of Russia, Czech Republic and Poland, shown in Figure 31, penetration of well above 100% is quite possible. This means that subscriber growth is likely to continue in SA (and for Vodacom), though we expect it to be a less powerful driver of revenue growth than it has been in the past:

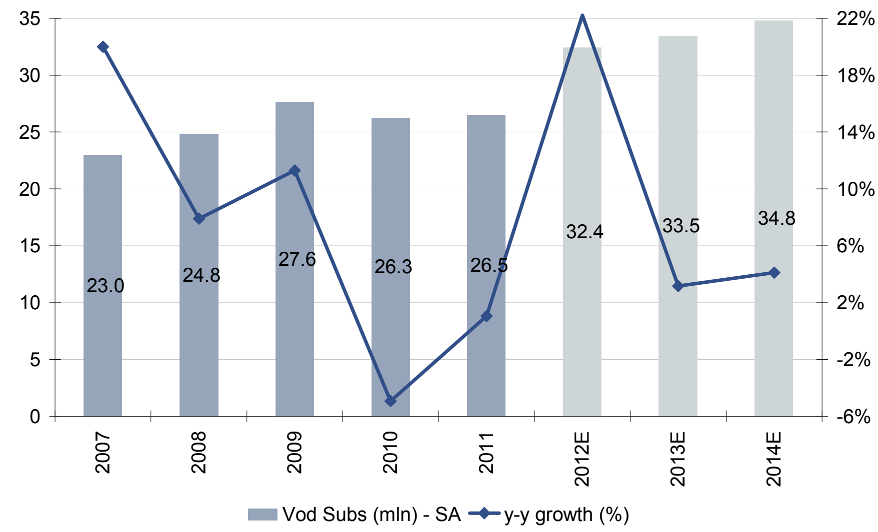
- The maturing status of the SA market, and subsequent high base, means that growth is likely to be slower in the medium-term than it has been in the past.
- We expect the incremental ARPU of new subs to be much lower as more lower-end/spending customers are added to the networks.
  - Importantly, as we have discussed, the underlying ARPU's of existing subscribers could also come down as (i) customers manage their spending patterns more closely as tighter economics bite, and (ii) the fight for wallet share intensifies, which could push growth in multi-SIM's and increasingly split mobile spend across competing operators.

Vodacom's subscriber growth should decelerate after FY 12

We expect Vodacom's customer growth to subside after a punchy FY 12

We project growth of 22% in Vodacom's subscribers to 32.4mln in SA, boosted by a particular spike in connections during Q3 (+11% q-q). This is also helped by a base affected by RICA and changes to disconnection rules over the past couple years. Indeed, our forecast for FY 12 infers average customer growth of around 5.5% p.a. since 2009. We expect slower growth in Q4 (to Mar-11) due to the higher base and a seasonal pick-up in churn as the effects of previous promotional activity "wears off". Churn does tend to increase following a spike in connection growth, which is also a factor in our slower subscriber growth thesis for the medium-term.

Figure 32. Vodacom SA Subscriber Growth Projections



Source: Company Data, CIRA estimates

We look for 3-4% average growth p.a. to 2014, after +22% in FY 12

This recent spell of strong growth may have also seen a slight uptick in Vodacom's market share, which could reverse in the coming few quarters. We thus expect Vodacom's subscriber growth to slow down to the 3-4% range after 2012, which would put Vodacom's SA subscribers at c34.8mln by 2014 on our forecasts. The main thrust of growth is likely to continue coming from the prepaid segment, which presently makes up 83% of Vodacom's subscriber base.

A potential rise in competition could also make it more difficult for market leaders to grow customers

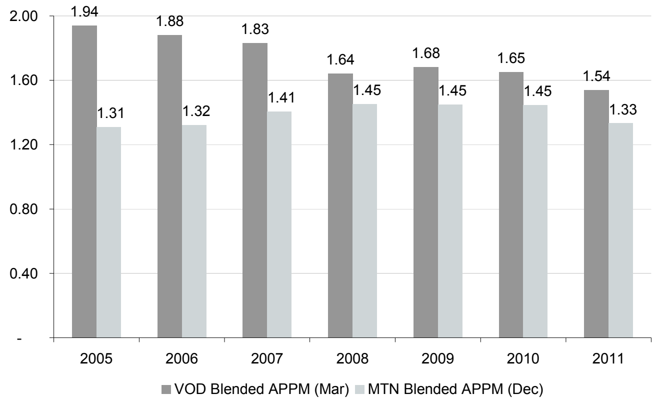
Telkom's mobile wing, 8ta, aims to build up its customer base quite aggressively and is gunning for a 12-15% market share in SA (2015/16 target). SA's number 3, Cell C, may also derive some impetus from its new CEO (previous head of Vodacom) and make it even more challenging for leading incumbents Vodacom and MTN to grow customers in a maturing market.

High prices to finally come down

Pricing in SA has been resilient until recently

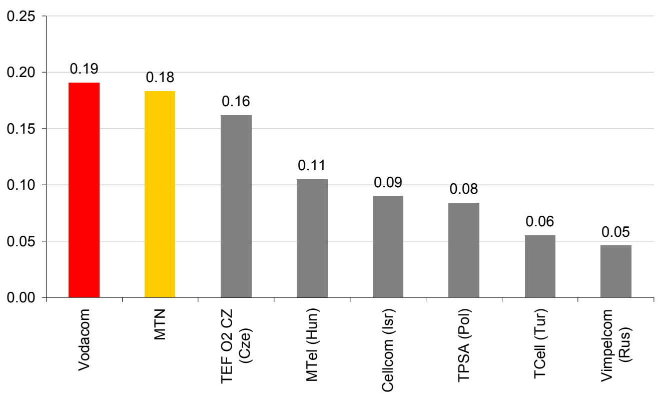
Where tariffs have come down significantly in many countries across the globe, South African pricing has remained comparatively sticky, particularly in recent years. For instance, Figure 33 shows that average pricing for the likes of Vodacom has been quite resilient since 2008, holding up above R1.65, and has only come down (-7% to R1.54) in the past year, coinciding with the commencement of MTR reductions.

Figure 33. South African Pricing (Historic Blended APPM, R/min)



Source: Company Data, CIRA.

Figure 34. Blended APPM Comps, SA vs Selected Eur EM's (USD)



Source: Company Data, CIRA

SA could follow more mature markets in terms of downside to pricing

Figure 34 shows that average SA pricing sits at the top-end of comparison tables versus many emerging European markets; this highlights the downside risk, in our view. As discussed earlier, most of the comparison European markets are further along the maturity path, with pricing having already come down to comparatively low levels, and we believe that there is a strong argument that SA could follow.

A less favourable consumer and competitive environment, along with I/C cuts could spur price reductions

In our view, the difficult consumer environment, discussed earlier, along with increased competition (we discuss later), sets the stage for prices in SA to come down. The legislated reductions in interconnection (I/C) rates, meanwhile, could be the enabler.

Cut interconnection rates and prices should follow

High MTR's have contributed to propping up prices in SA; but regulator has cut this by c55% over a 3-year glide path

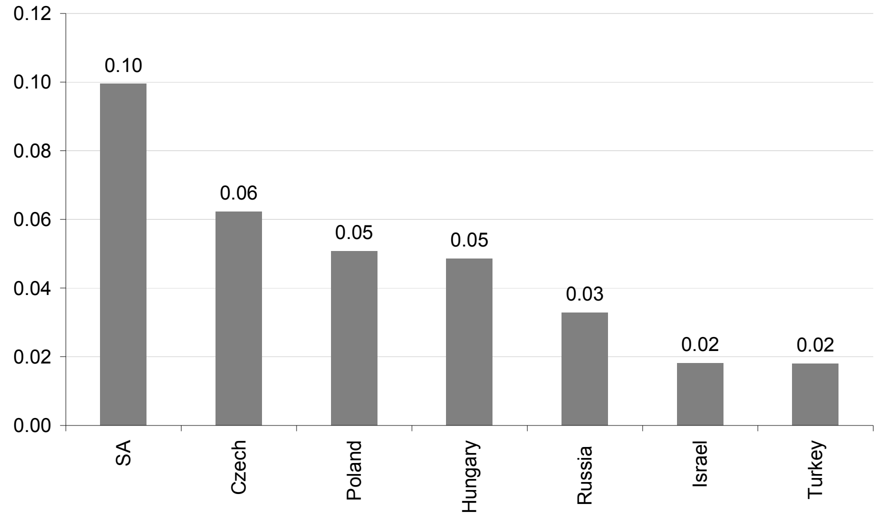
Elevated termination rates are a factor in SA's comparatively high pricing relative to other markets. SA's mobile termination rate (MTR), for instance, ranks highest in our emerging market sample (Figure 36), which has contributed to propping up pricing in the country. The Independent Communication Authority of SA (ICASA) has, however, taken aim at high pricing in the telecom industry, with the express purpose of stimulating more competition, by imposing a three-year glide path, which has been in effect from Mar-11; see Figure 35.

Figure 35. I/C Glide Path

ZAc/min	2010	2011	2012	2013
MTR	89	73	56	40
FTR	27	20	15	12

Source: ICASA

Figure 36. EM Peak MTR's (USD) – SA Remains High In Global Context



Source: Company Data, CIRA

MTR cuts pave the way for price reductions

This means that MTR's are set to come down to 40c by Mar-13; an implied 55% reduction on the pre glide path level of 2010. SA would thus be more in line with the prevailing levels of markets such as Poland and Hungary. Not only does this bring down interconnect revenues, but it also paves the way for operators — as intended by the regulator — to compete more aggressively on prices and drop their underlying tariffs.

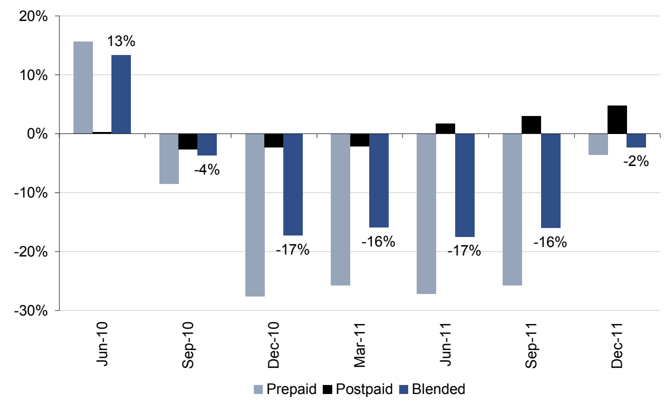
Operators could resist passing on the full extent of MTR cuts in terms of their own pricing. The MTR reductions do, however, afford the likes of 'third' and 'fourth' operators — Cell C and 8ta — better scope to reduce their pricing and compete more aggressively on price; particularly once they have rolled out their networks.

Price declines to continue in the medium-term

APPM could decline by c12% p.a. over the medium-term

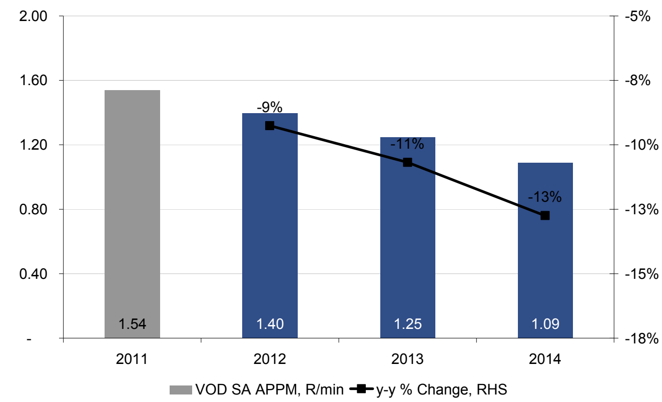
With I/C rates in SA set to drop by a further 45% following 2011's reduction, effective prices should also come down further over the medium-term. Our forecasts infer a decline of c9% in Vodacom's blended APPM for FY 12, after which the rate of decline could accelerate to 13% by FY 14 on our assumptions (Figure 38).

Figure 37. Recent Quarterly Trends In Vodacom's APPM (y-y)



Source: Company Data, CIRA

Figure 38. Vodacom SA APPM Assumptions



Source: Company Data, CIRA estimates

Ingredients in place for further price declines: MTR cuts and increased competition (Voice and Data)

As already mentioned, termination rate reductions and the impact on Interconnect revenues will be a key driver, along with further anticipated price declines in Data. We also expect headline tariff reductions in Voice to play a part. Vodacom indicated that its tariffs in voice came down by c8% in 2011, which could worsen in the next 12-18 months — the key is that the competitive landscape needs to continue to liven up.

Prepaid likely the main drag on prices for now

We expect greater price reductions in the prepaid space, which is less stable and probably more competitive. Postpaid pricing may prove to be more resilient until competition becomes more aggressive and, within our blended assumptions, we project a more measured decline of c3% p.a. (FY 12-14).

Our forecasts infer a c30% overall reduction in Vodacom's APPM, '11-14

Our forecasts, thus, suggest that Vodacom's effective price could be down by c22% by FY 14, following a projected decline of 9% in '12 — in all, a total reduction of more than 30% from 2011.

Peer-based scenarios: Could it be worse?

Possibly a benign assumption; how the competitive environment evolves will be a key factor

Our assumptions could well be undercooked if the examples in some peer markets (Figure 34, page 24) are anything to go by. We include some scenarios on the potential impact of different APPM's on ARPU in some of the pages that follow. Figure 39 shows some sensitivities of Vodacom's implied ARPU under difference APPM scenarios.

Figure 39. Vodacom ARPU Under Different APPM Scenarios

USD	APPM Scenarios^, USD						
	0.19	0.16	0.11	0.09	0.08	0.06	0.05
Vodacom ARPU (USD)	19.1	16.0	11.0	9.0	8.0	6.0	5.0
% Difference from current	-	-16%	-42%	-53%	-58%	-68%	-74%

Source: Company Data, CIRA estimates. **Current level for Vodacom. ^Based on EM comp companies*

Vodacom's pricing is well above many of its EM peers in Europe

Holding MOU constant, we have used to the prevailing APPM of some of Vodacom's European peers (Figure 34) to derive implied ARPU scenarios for the SA company. Vodacom's average pricing stands 19% above the next market (Cesky of Czech Republic) in USD terms, and nearly four times the likes of Vimpelcom in Russia.

The downside on this basis ranges between 16% and 74%, depending on the yardstick market

As shown in Figure 39, the potential downside to ARPU's could be material if Vodacom were to trend toward some of its peers on this basis. So in the "best case scenario" in the table, the downside to Vodacom's ARPU could be a further 16% from its prevailing level. Should SA move towards other markets over the next few years, the potential downside in pricing and ARPU could range between 42% and 74% on our scenarios. This highlights the risk to current levels and our forward assumptions for the company.

MOU may not compensate

Lower tariffs should stimulate minutes of use (MOU). Bear in mind, however, that (i) elasticity in this regard needs to be greater than one in order to negate the impact of any price cuts, (ii) price reductions need to be quite meaningful in order to stimulate a notable improvement in usage, and (iii) the benefits of elasticity are blunted in a tougher economic environment.

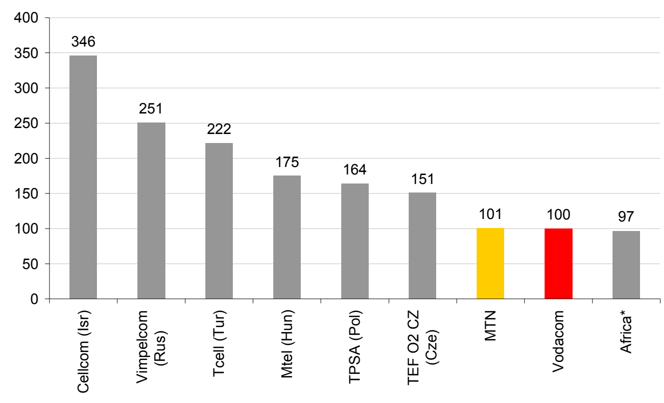
We, thus, believe that the declining price environment we envision in the sector may not be adequately compensated by increased MOU given our view on the consumer outlook.

Cross-market comps does hint at upside potential for Vodacom MOU

Vodacom sits at the bottom of the MOU range

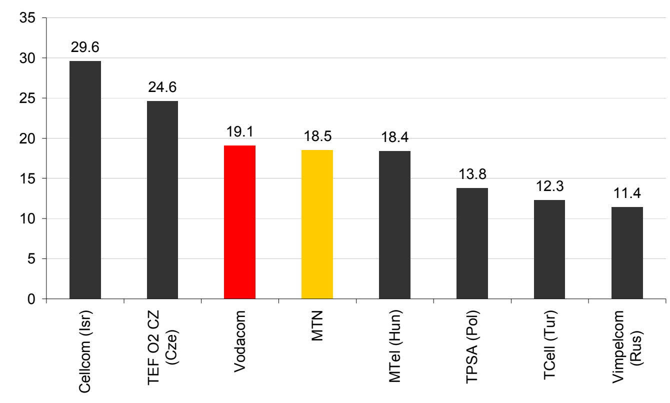
To be fair, MOU in SA are quite low compared to many European EM peers. Figure 40 shows Vodacom's blended MOU of c100 minutes per month sits at the bottom end of the spectrum compared to its emerging European counterparts, which range between 151-346 minutes per month. Arguably, therefore, there is upside potential in Vodacom's MOU, which could help it combat the drawbacks of a maturing market.

Figure 40. Blended MOU Comps (Minutes per Month)



Source: Company Data, CIRA. *Based on latest available*

Figure 41. Blended ARPU Comps (USD)



Source: Company Data, CIRA. *Based on latest available*

Highlights upside potential to Vodacom MOU based on EM peers, between c53-250%

In other words, the flipside of our argument around Vodacom's ARPU — i.e. the fact that pricing in SA is comparatively elevated — is that MOU are low. So in the evolution of the SA telecom sector, we should see contrasting trends in pricing (down) and MOU (up).

Per the analysis in Figure 41, Vodacom's ARPU is not quite the highest in the comps and sits behind Cellcom (Israel) and Cesky of the Czech Republic. Based on the comparative numbers, we have compiled Figure 42, which indicates the potential impact on Vodacom's ARPU if the company were able to achieve the MOU's enjoyed by some of its European peers (APPM unchanged).

Figure 42. Vodacom ARPU Under Different MOU Scenarios

	MOU Scenarios^						
	*100	151	164	175	222	251	346
ARPU	19.1	28.8	31.3	33.4	42.3	47.9	66.0
% Difference from current	-	51%	64%	75%	122%	151%	246%

Source: Company Data, CIRA estimates. *Current level for Vodacom. ^Based on EM comp companies*

Based on Figure 42, Vodacom's could realise a more than threefold improvement in its blended ARPU on a best-case scenario increase in MOU. Even on the other scenarios, the upside potential is quite material (50-150%) in scenarios in which we use peer group MOU's for Vodacom and hold pricing the same.

But MOU upside may be more difficult in the current SA environment

MOU should rise on natural underpins like inflation

Two key drivers of MOU are price reductions and improvements in consumer economics. In other words (i) lower prices will result in higher usage if subscribers simply spend the same, and (ii) inflation and real growth in incomes should naturally push increased usage as consumers have more money to spend.

… But an unfavourable cycle could make this tougher in our view

It is, however, important to assess where the cycle is in this regard as elasticity holds better under more favourable economic conditions. Our thesis around a tougher consumer environment, therefore, suggests that achieving the upside in MOU postulated above may not be straightforward. To recap:

Incremental MOU from new prepaid subscribers likely to be much lower and "MOU-dilutive" on the base in the medium-term

- We have argued that growth in new prepaid subscribers is likely to increasingly stem from poorer income or LSM brackets. This means that incremental usage patterns are likely to be much lower as well. Improvements in living standards should provide some impetus to MOU over time, as mentioned, but we expect this to be stifled by the difficult economy in the nearer to medium-term given our view on the cycle.

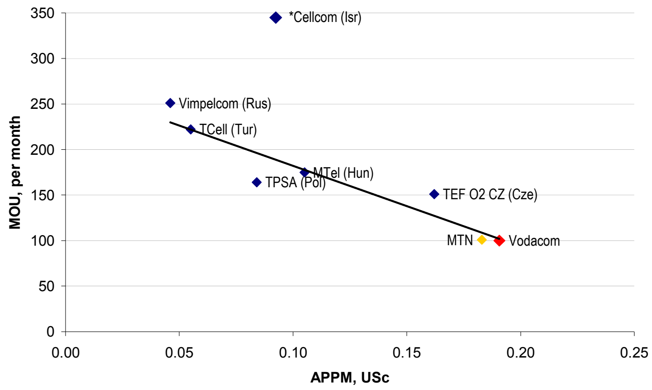
Prices stickier in the postpaid market, which could inhibit MOU growth in current consumer environment

- Underlying MOU in the postpaid segment are probably more stable, in our opinion. Prices in this segment appear to be sticky at the moment, on which basis we believe MOU growth could be relatively muted. As noted earlier, income growth could see increased MOU but this is unlikely to be material in the absence of price reductions, in our view. Competition is, therefore, a key variable in this regard and we may see more pricing pressure if this (competition) intensifies over the next 12-18 months, which could boost MOU; though, again, the economic environment will be another key variable.

For MOU to rise significantly prices must come down and the economy must improve

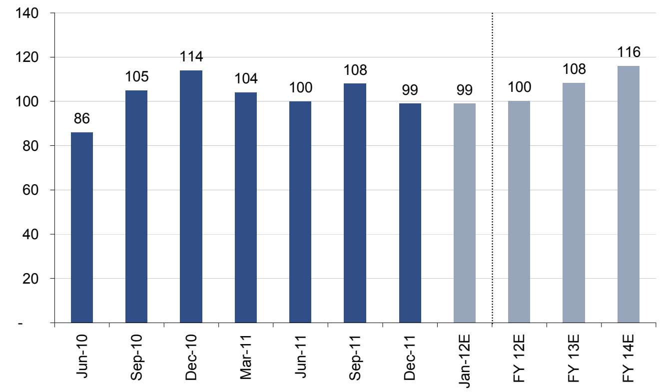
We have already highlighted that the average wealth levels in SA are well short of most of the comparison countries (GDP per capita analysis, page 11), which further contextualises our points above. In our view, Vodacom's MOU growth is likely to be subdued until we see bigger price declines and the consumer picture improves again.

Figure 43. Scatterplot of Blended MOU vs APPM



Source: Company Data, CIRA. *Outlier Cellcom excl from the regression calculation*

Figure 44. Vodacom SA MOU Projections (min/month)



Source: Company Data, CIRA estimates

It is worth repeating that the extent of price declines is an important factor in how much MOU's rise; i.e. reductions need to be quite meaningful to stimulate significantly higher usage, in our opinion. Our scenario analyses highlighted the big gaps in pricing (to the downside) and MOU (to the upside) between Vodacom and some of its EM peers.

Comparison with other markets hint at the outlook for MOU and pricing for Vodacom

Figure 43 illustrates the correlation between pricing and MOU — the lower the price, the higher the MOU. As shown, prices in SA need to be much lower if Vodacom is to move up the MOU curve on this analysis — this perhaps underscores our earlier point about the negative outlook for pricing in SA.

MOU to grow, but may be muted in the medium-term

+8.5% pa growth in MOU on our forecasts, FY 12-14

We expect Vodacom's blended MOU (Figure 44) in FY 12 to be flat at c100, which is in line with average FY to date. We assume an average increase of c7.5% pa to around 116 by FY 14, while reiterating our concerns around medium-term headwinds in this regard. Prepaid subs should be the main driver of upside in overall MOU over the medium-term on larger anticipated price reductions in this segment; though we think this will be diluted by lower-usage incremental subs.

Margin risk from traffic grows

Increased traffic pushes up costs; an additional risk to margin given our bearish view on pricing

It is worth noting that rising traffic will increase the pressure on Vodacom's network. Our subscriber and MOU assumptions imply a nearly 20% pa increase in total traffic on Vodacom's network, which is already under some strain. This means that Vodacom will need to continue investing to satisfy this demand, which would also push up network capex and opex. This could also put pressure on Vodacom's margin, especially given our argument around the pricing outlook.

Bringing it together – ARPU to suffer

Bringing together APPM and MOU scenarios

We have put together Figure 45, which combines the scenario analyses for APPM and MOU for the comparative markets discussed in the previous section. The table summarises the implied ARPU, in USD, under of different APPM and MOU assumptions. In particular, it reflects the percentage difference in each scenario relative to Vodacom's current ARPU.

Figure 45. Vodacom SA – Up/(down)side From Current ARPU, APPM & MOU Scenarios

APPM (USD)	MOU *100	151	164	175	222	251	346
*0.19	0%	51%	64%	75%	122%	151%	246%
0.16	-16%	27%	38%	47%	86%	111%	190%
0.11	-42%	-13%	-5%	1%	28%	45%	100%
0.08	-53%	-29%	-23%	-17%	5%	18%	63%
0.09	-58%	-37%	-31%	-27%	-7%	5%	45%
0.06	-69%	-52%	-48%	-45%	-30%	-21%	9%
0.05	-74%	-60%	-57%	-54%	-42%	-34%	-9%

Source: CIRA Estimates. Company Data, CIRA estimates. **Current level for Vodacom*

Vodacom would need to increase its MOU by some margin to offset forecast price declines

Perhaps a more specific way to look at these scenarios is in Figure 46, where we summarise the implied MOU that Vodacom needs to offset the potential negative impact pricing declines could have on its ARPU — if you will, the "breakeven" MOU required to hold ARPU constant (at current levels) under different APPM scenarios. So benchmarking APPM against some of its European peers, Vodacom's MOU would need to increase by at least 19%, in a "best case" scenario, and as much as nearly threefold in a more extreme case of price declines in order to maintain its current ARPU.

Figure 46. Implied "Breakeven" MOU For Vodacom SA To Maintain Current ARPU

	APPM Scenarios (USD) *0.19	0.16	0.11	0.09	0.08	0.06	0.05
Implied Vodacom MOU	100	119	173	212	238	318	381
% Difference from current	-	19%	73%	112%	138%	218%	281%

Source: Company Data, CIRA estimates. **Current level for Vodacom*

… Which will prove a tall ask in our view

We have already noted that it may prove more difficult for Vodacom to realise a significant increase in its MOU in the current environment. On our base-case implied APPM projections (-22% FY 12-14), we estimate that Vodacom's MOU would need to increase by c36%, or average c17% p.a. '12-14, for the company to maintain its prevailing ARPU. Our base case for Vodacom is for MOU to increase by a lesser 18% by FY 14 (see Figure 44).

Calling on subscribers

What impact on growth expectations subscriber numbers make?

Extrapolating the analysis to simple revenues, we now assess what effects subscriber numbers might have on Vodacom's growth against a backdrop of possible ARPU decline. Here we measure what Vodacom's top line in SA could look like under different subscriber and ARPU scenarios. For consistency and to keep things simple, we have used the ARPU of comparison markets (Figure 41, page 27) and flex the subscriber scenarios by 5% increments from Vodacom's current base.

Figure 47. Impact On Simple Revenue – Subscriber and ARPU Scenarios

Subscriber Scenarios (mln)	ARPU Scenarios (USD)						
	*19.1	29.6	24.6	18.4	13.8	12.3	11.4
*31.7	0%	55%	29%	-4%	-28%	-36%	-40%
33.3	5%	63%	35%	1%	-24%	-32%	-37%
34.9	10%	71%	42%	6%	-20%	-29%	-34%
36.7	16%	80%	49%	12%	-16%	-25%	-31%
38.5	22%	89%	57%	17%	-12%	-22%	-27%
40.5	28%	98%	65%	23%	-8%	-18%	-24%
42.5	34%	108%	73%	29%	-3%	-14%	-20%
44.6	41%	118%	82%	36%	2%	-9%	-16%

Source: Company Data, CIRA estimates. **Current level for Vodacom*

Figure 47 demonstrates how Vodacom can offset ARPU regression by growing its subscribers. For instance, a relatively benign decline of 4% in Vodacom's ARPU to, say USD18.4 (Hungary benchmark), can be negated by a 5% increase in subscribers to maintain revenues roughly flat.

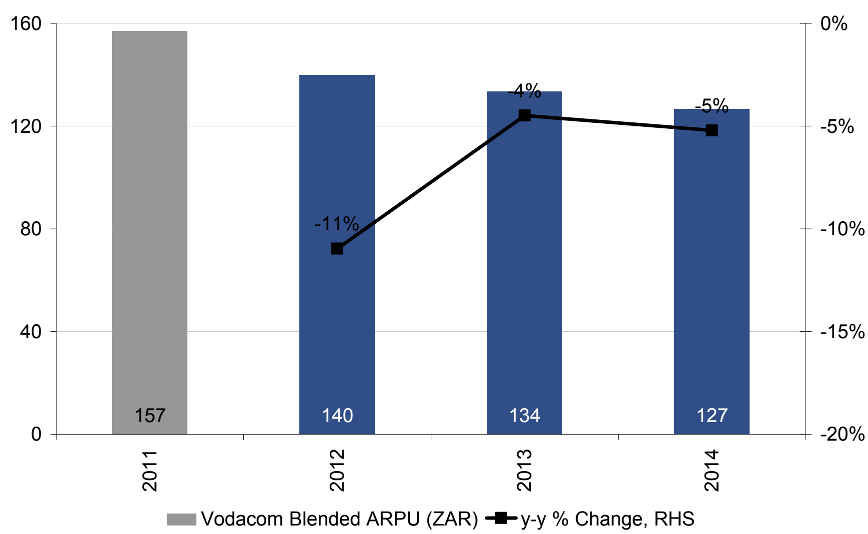
Clearly it gets a bit trickier when the ARPU declines are large,r which, as we've argued, will be an important challenge facing Vodacom over the medium-term. It is worth noting that the relationship is somewhat circular, which makes the task for Vodacom even more difficult. In other words, an increase in subscribers (in itself) is arithmetically negative for ARPU and is made worse when incremental ARPU's are materially lower, as is our thinking.

Lower ARPU

We see Vodacom's ARPU down 11% in FY 12, and -7% p.a. thereafter

Our current forecasting implies an 11% y-y decline in Vodacom's blended ARPU in FY 12 to R140. Subsequently we expect ARPU to fall by a further 4% in FY 13 and -5% to R127 by FY 14 in context of our preceding discussions. In USD, this pitches Vodacom's ARPU at cR16.5 on spot R/$, which is between TPSA (Poland) and MTel (Hungary) in our peer group analysis (Figure 41, page 27).

Figure 48. Vodacom Blended ARPU Forecast (FY)



Source: Company Data, CIRA estimates

Competition could be a key variable in our view

As a reminder of the underlying trends, the expected decline in Interconnect revenues remains an important driver of the forecast downside. We have potentially been lenient in terms of the underlying assumptions for Vodacom's prepaid and postpaid subscribers. From our ARPU scenarios (Figure 45), the downside could be more severe than our forecasts presently imply, especially from a pricing point of view. We believe that the key variable in this regard will be how the competitive landscape evolves.

The competition catalyst

Two became four

It has been relatively easy going for Vodacom and MTN in terms of the competitive landscape; the mature is now more mature, with more players

Competition amongst SA's incumbents looks set to intensify as MTR reductions lay the platform for effective price cuts in a maturing market. The earlier stages of the SA telecom life cycle (mid to late 90's) was played out between two main operators in a market growing from a low base, with rapidly rising mobile penetration and stable pricing. With the number of operators having now grown to four — Cell C in 2001 and 8ta in 2010 — and a maturing market, the battle for market and wallet share looks set to intensify.

Its happened before

The case of Israel telecoms is laid out in 7-Jul-11 report, which highlights the challenges faced by operators there. The market in Israel appears to have similar characteristics as SA, where the easier days of growth have passed and competition is heating up and starting to drag down ARPU's. A 74% cut in MTR led to ARPU pressure and increased churn (also driven by the scrapping of early contract exit fees).

New entrants into a market have typically been a catalyst. The report alludes to the French example, where ARPU's have been dropping by c4-6% y-y on a quarterly basis since Q1 08 even ahead of the entry of new player Iliad (Jan-12). In SA, we are already seeing an increase in the attractiveness of promotional activity and ever-improving value offerings from networks, which translate into pricing and ARPU pressure.

The 7-Jul report looks at case studies from other European examples such as UK, Italy, Poland and Spain. We highlight the following interesting points:

- New MNO's market shares gains average c6% by the end of year three.
- ARPU declines averaging -20% in Spain, Italy and Poland by the end of year three.
- Like SA, Israel actually has higher mobile penetration than the European examples, making it tougher for newer competitors to win new subscribers — this could spur even fiercer price and ARPU pressure.
- Relatively high pricing made Spain particularly susceptible to a discounting strategy — SA is in a similar position in terms of pricing.
- The UK was one market where ARPU did not suffer and was perhaps helped by comparatively lower penetration of c85% and a market that was still growing when a new player entered in 2003.
- More generally, how these markets evolved has depended on how prepared the newcomers were to take short-term losses. In the UK and Italy, for instance, the "number three" gained market share relatively rapidly by investing in subsidised handsets and discounting

Stand up numbers three and (maybe) four

The "problem" in SA is that the competition for the leaders Vodacom and MTN has been relatively weak. A "status quo" approach appears to have been adopted over the past few years, where competition has not been that aggressive — see earlier points about market share and pricing stability in SA.

To be fair, the SA telecom market has been growing and demand has exceeded supply, while termination rates have also been high as mentioned previously. Newer competitors have been roaming on the market leaders' networks, which has compounded supply bottlenecks and increased their costs, making it difficult for them to cut prices. The landscape has changed.

- We have highlighted that the market is maturing, meaning that operators will need to increasingly try and take subscribers from each other.
- The regulator has brought interconnect rates down with the express view of bringing down prices and making the sector more competitive.
- Numbers three (Cell C) and four (8ta) are working feverishly to expand their own respective networks and distribution channels. Cell C is particular could make the competitive environment a lot less comfortable for the leading incumbents, as it can benefit from having the same spectrum and much less traffic, which would potentially enable the company to offer better service once the network is up to speed.

  Cell C's new CEO has indicated that getting the network and distribution right can happen quite quickly and potentially within the next 12 months. This would also enable CEO to have better influence on its tariff strategies and could — along with MTR — cut open the path for more meaningful price competition.
- A new CEO in Alan Knott-Craig (former head of Vodacom) could reinvigorate Cell C as a competitive force. In particular, Knott-Craig has said that Cell will need to increase its market share by 11-12% (to c25%) in the next 2-3 years for the company to be sustainable. Admitting that the market is saturated, he has also indicated that the simple mathematics of it imply that this share will have to come from other operators.

We believe that these factors could make SA a more competitive telecom market. The various operators are likely to defend their market shares and customer bases, which we believe could trigger more robust price competition and ultimately lead to further pressure on ARPU and profitability. The key is for the third and fourth operators to be more relevant as competitive forces. Admittedly the first step, as mentioned, may be to get the infrastructure (network, distribution) right rather than compete aggressively on price but we believe that this will come.

Fighting Back

Operators can fight back

The timing of when our thesis on the SA telecom market might play out is uncertain. Operators can deploy some of its own weaponry to combat the turning cycle to fend off, or at least delay, its effects. Here we briefly look at some of Vodacom's options in this regard, which we premise on the two broad pillars of top line and margin.

Some of the factors discussed here — parts of which do reflect on topics discussed previously in this report — could perhaps be the more detailed focus of separate reports; our main purpose here is, thus, primarily to highlight and contextualise some of them in our overall discussion.

Top-line tactics

In an environment of pricing and ARPU pressure, we highlight three of the main tools at Vodacom's disposal from a revenue growth perspective. These are (i) try push up MOU, (ii) subscriber growth, and (iii) driving new revenue streams (e.g. data). Acquisitions are another option, but we believe that significant opportunities for Vodacom are fairly limited.

How far can elasticity be stretched?

We test what sort of elasticity is required to offset potential pricing declines

We explored elasticity earlier in the report and presented some permutations of the impact on Vodacom's ARPU and revenue of different price and MOU scenarios. We now take our previous APPM scenarios (based on peer comps) and estimate the implied impact on ARPU's under different elasticity scenarios — i.e. a slightly different slant on testing MOU sensitivities.

Figure 49. Implied Up/(down)side From Vodacom's Current ARPU; APPM & Elasticity Scenarios

			Elasticity							
	**		0.5	0.6	0.7	0.8	0.9	1.0	1.1	1.2
APPM (USD), % diff from current	-16%	0.16	-9%	-8%	-7%	-5%	-4%	-3%	-1%	0%
	-42%	0.11	-30%	-28%	-25%	-23%	-20%	-18%	-15%	-13%
	-53%	0.09	-40%	-38%	-35%	-33%	-30%	-28%	-25%	-23%
	-58%	0.08	-46%	-43%	-41%	-39%	-36%	-34%	-31%	-29%
	-69%	0.06	-58%	-56%	-53%	-51%	-49%	-47%	-45%	-43%
	-74%	0.05	-64%	-62%	-60%	-58%	-56%	-54%	-53%	-51%

Source: CIRA Estimates. ** *% Difference from current level of 19USc*

We find that only "unrealistic" elasticity assumptions could negate the implied ARPU erosion of major price reductions (based on peer comps)

We are hard-pressed to find a scenario — based on comparison market APPM assumptions — with a realistic implied elasticity that would offset price cuts. For instance, we find that Vodacom's ARPU erosion would only be offset under a relatively gentle price decline scenario (16%) and very high elasticity of 1.2. Our forecasts to FY 14 imply an APPM consistent with the 16USc (or -16% from spot) scenario in Figure 49. In all our other scenarios there would likely be a negative impact on Vodacom's ARPU.

In other words, in the current environment we do not believe that elasticity can be stretched very far in offsetting price declines

In reality, price reductions would need to be quite significant in order to stimulate any meaningful kind of elasticity. Even so, we do not believe that elasticity in SA is strong enough to completely mitigate against ARPU's falling. Indeed Vodacom has itself acknowledged — although this has not been thoroughly tested recently — that elasticity is relatively poor.

Strength in numbers?

The other part of the equation in terms of revenue impact is subscriber numbers. For completeness, we have put together Figure 50, which indicates, roughly, the required growth in SA subscribers Vodacom needs in order to maintain its revenues under the APPM and elasticity scenarios introduced in Figure 49.

Figure 50. SA Subs Growth Needed to Maintain Revenues; APPM & Elasticity Scenarios

APPM (USD), % diff from current		Elasticity							
**		0.5	0.6	0.7	0.8	0.9	1.0	1.1	1.2
-16%	0.16	10%	9%	7%	6%	4%	3%	1%	0%
-42%	0.11	43%	38%	34%	30%	26%	22%	18%	15%
-53%	0.09	68%	61%	55%	49%	44%	39%	34%	30%
-58%	0.08	85%	77%	69%	63%	57%	51%	45%	41%
-69%	0.06	137%	125%	115%	105%	97%	89%	81%	74%
-74%	0.05	179%	164%	152%	140%	129%	119%	111%	102%

Source: CIRA Estimates. ** *% Difference from current level of 19USc*

It appears that elasticity would need to be reasonably high and price declines on the more benign end of the spectrum for subscriber growth to realistically mitigate against revenues going backward. Our FY 14 assumption is for Vodacom's subscribers in SA to grow by 3.6% p.a. or 7.4% altogether (on our FY 12E level).

Subs growth would need to be (perhaps unrealistically) high in order to continue driving growth if pricing falls materially

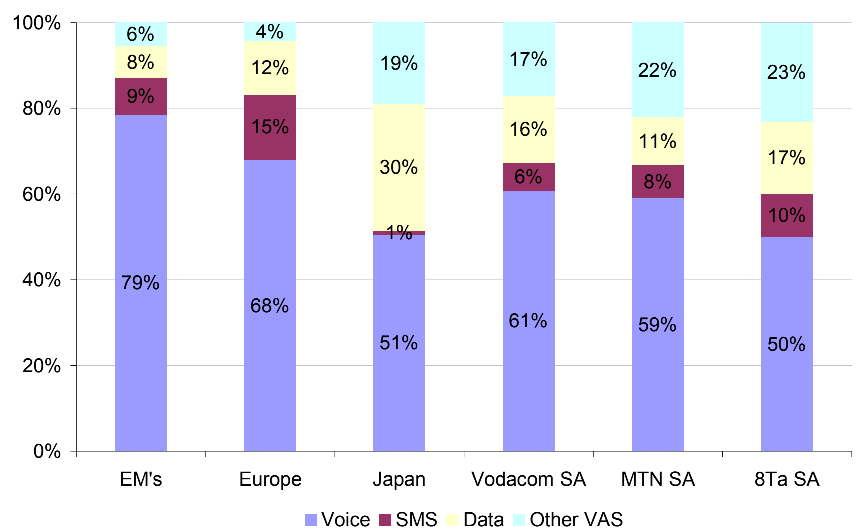
On this example, the table would suggest that — taking a two-year horizon to FY 14, say — Vodacom could "stomach" a decline in pricing of 16%, although elasticity would need to be around c0.7 in order for revenues to be maintained. Subscriber growth would otherwise need to be materially higher in order to support continued top-line growth under our other scenarios where pricing falls.

The Data difference?

Data is a growing theme globally. Based on other, more advanced, markets there could be upside in the contribution of data to Vodacom's revenues

Data is a theme that is gaining global traction and possibly represents the next frontier of growth for SA telco's — we touched on this in Data – A Glimpse Into The Next Frontier (17/11/11). Figure 51 contrasts the SA operators' service revenue mix to EM, Japan and European averages. For Vodacom, data presently makes up 15.7% of service revenues in SA; this is higher than even European markets, so the company looks comparatively well advanced in this regard.

Figure 51. Split of Mobile Operators' Service Revenue



Source: Company data, Delta Partners

But Data growth needs to be really strong to move the needle in terms of overall growth; especially if other concerns materialise

Clearly there is upside to Vodacom's data contribution if Japan is used as a yardstick where this amounts to c30% of revenues. That said, a key challenge for the company is that at c16% of SA, Data revenue growth needs to be very strong to make a difference to overall growth; especially if our concerns around Vodacom's other service revenues materialise. For instance, assuming other service revenues remain flat, Data would need to grow by at least 33$ in order to drive a c5% increase in overall service revenues.

Figure 52. Vodacom Data Revenue Growth Scenarios

	Data % of Total SA Service Revenue						
	*16.4%	17.5%	20.0%	22.5%	25.0%	27.5%	30.0%
Upside from '12E Total Rev	-	2.0%	5.2%	8.6%	12.3%	16.1%	20.3%
Upside from '12E Data Rev	-	12.9%	33.1%	54.6%	77.5%	102.0%	128.2%

Source: CIRA Estimates. **Current proportion as per Citi FY 12 forecast*

Assumptions around Data growth need to be quite aggressive to have a meaningful impact on overall growth

On a similar basis (i.e. all else held equal), a high road scenario could see the contribution from Data increasing to c30% of service revenues (in line with Japan, Figure 51). This, however, would imply a 128% (compound growth of 20% pa over five or six years) increase in Vodacom's Data revenues; resulting in a 20% boost to aggregate service revenues. We highlight two challenges:

Volume growth constrained by, and contributing to, network bottlenecks

- The potential for volume growth is clearly massive, but it is probably constrained by networks in SA where 3G coverage and general network capacity need to improve.

Aggressive price competition a headwind to the data growth story

- Monetising the volume growth will be key given the fluidity of data customers in the space. On the latter point, network bottlenecks should be supportive of data prices, but this has not proved to be case in SA. Vodacom, for instance, indicated that the company had average price cuts of c22% in 2011 and this pressure looks poised to continue as operators continue, which we are seeing with promotions being launched with increasing regularity.

Game of margins

In the near-term, Vodacom may be able to counteract the slowdown in revenue growth by managing its margin. We touch on some of the company's options below.

Interconnect and on-net traffic

MTR cuts help reduce interconnect costs, as does higher on-net traffic

Vodacom's margin stands to benefit from cuts in termination rates, which have been legislated down. This benefit can be magnified by increasing on-net traffic, which would further reduce interconnect costs. Having more competitive on-net (versus off-net) tariffs is the main mechanism of driving higher on-net traffic, and the lower resultant pricing should be offset by the saving on the interconnect costs payable to other operators.

But Vodacom's on-net traffic already at c70%; a less useful tool in driving margins

Vodacom's on-net traffic is already around 70%. We believe that the scope to increase this may be limited, which in turn curbs its usefulness in efforts to enhance margins. At the same time, Vodacom arguably has a strong incentive to maintain this as high as possible, which could result in on-net tariffs feeling more pressure if the competitive landscape continues to intensify.

Scale back on Equipment sales

Handset sales are typically subsidized and margin-dilutive. We estimate an c8% enhancement to SA EBITDA margin if equipment sales were completely eliminated

Handset sales are typically discounted and margin-dilutive as they are largely subsidised. Vodacom, which currently derives 13.6% of total SA revenues from equipment — higher than MTN's c9% and an average c5% for European EM peers — could thus boost profitability by reducing the contribution from this source. Keeping other revenues unchanged, we estimate that Vodacom could boost its EBITDA margin by up to 7.9pp if it completely eliminated Equipment sales from its mix. Our calculations are based on an assumed -13% margin on handset sales.

Figure 53. Impact On Vodacom's SA Margin

	Equipment % of sales					
	***13.6%**	**11.1%**	**8.6%**	**6.1%**	**3.6%**	**0.0%**
SA EBITDA margin	37.3%	38.8%	40.2%	41.7%	43.1%	45.2%

Source: CIRA Estimates. **Current proportion (FY 12E)*

…However, eliminating Equipment sales will be difficult given the importance of handsets (especially smartphones) to growth in Data and subs

The difficulty Vodacom faces is that handsets are a key subscriber acquisition tool, while smartphones are a key avenue for pushing Data revenue growth. For instance, the growth rate of smartphone data traffic is ten times that of dongles and other modems according to Vodacom.

The company's Q3 to Dec-11 update showed that the fast pace of Equipment revenue growth was unabated at 19.4% y-y in SA. Equipment sales growth should slow going forward, but is likely to keep growing, meaning that the impact on margin is still likely to be felt.

Focus on distribution

Reducing agency commissions could help drive margin

Non-managed subscribers represent a layer of margin-depressing costs, and Vodacom has highlighted this as a key focus area in its drive to control costs. There are two elements to this: (i) upfront commissions paid to independent distributors for signing up new customers, and (ii) ongoing commissions based on revenues generated from those subscribers. One way Vodacom can boost its profitability, therefore, is to reduce the amount it pays to distributors; another way is to try migrate non-managed subscribers in-house.

The bulk of Vodacom's customer base is managed by independents, while we estimate that commissions paid to independents in SA sums to c8% of revenue. This computes to an annual per capita cost of R143 per subscriber based on FY 11 numbers. Vodacom can, therefore, manage this cost either by reducing its non-managed customer base and/or lowering the amount it pays out per customer. On this basis, we have constructed Figure 54 below to give an indication of the potential EBITDA benefit Vodacom might enjoy under various cost-saving scenarios.

Figure 54. Potential Boost to EBITDA From Reducing Commissions to Agents

			% of Non-managed Subs					
			***90.0%**	**87.5%**	**85.0%**	**82.5%**	**80.0%**	**77.5%**
Cost per Sub	**	***143**	-	0.6%	1.2%	1.7%	2.3%	2.9%
	-5%	**136**	1.0%	1.6%	2.1%	2.7%	3.2%	3.8%
	-10%	**129**	2.1%	2.6%	3.1%	3.6%	4.2%	4.7%
	-15%	**122**	3.1%	3.6%	4.1%	4.6%	5.1%	5.6%
	-20%	**114**	4.2%	4.6%	5.1%	5.5%	6.0%	6.5%
	-25%	**107**	5.2%	5.6%	6.1%	6.5%	6.9%	7.4%

Source: CIRA Estimates. *Based on FY 11. *Current stats. ** % Change from current level*

Holding everything else the same, we estimate that Vodacom could boost its EBITDA by, say, 2.3% if the company were able to reduce its non-managed customers from the current 90% to 80%. Purely from reducing the actual commission per sub to agents, Vodacom could boost EBITDA by c1% for every 5% it claws back from distributors. Bear in mind that there are two elements to the commission paid, as explained above, though these would be more difficult to isolate.

Vodacom has already started to reduce the amount it pays on upfront commissions, though it has acknowledged that managing down the ongoing cost is a little trickier. In terms of managed subscribers, Vodacom has said that it is actively targeting higher-ARPU prepaid customers, in particular with a view to bringing them in-house

Self-provisioning – save on network costs

Eliminating transmission rental costs could boost EBITDA by up to c9%

Vodacom continues to invest in its network, including in transmission, in line with its objective to self-provide. On FY 11 numbers, Vodacom paid cR1.9bn in transmission and data lines rental. Roughly on this basis, the company could boost its EBITDA margin by up to 3.1pp and overall EBITDA by as much as 9% if it managed to completely eliminate this cost.

Figure 55. Potential Boost to Vodacom EBITDA On Transmission Rental Savings

	Saving on transmission rental cost						
	0%	5%	10%	25%	50%	75%	100%
Implied EBITDA margin	*33.7%	33.8%	34.0%	34.4%	35.2%	36.0%	36.7%
Implied boost to EBITDA	0.0%	0.5%	0.9%	2.3%	4.6%	6.9%	9.1%

Source: CIRA Estimates. **FY 11*

Having its own infrastructure will bring different costs for Vodacom, but Figure 55 gives a rough indication the potential boost the company could realise keeping everything else the same.

International turnaround

Although the primary focus of this report is on Vodacom's SA operations, an improvement in its international operations could boost the group's growth outlook. Specifically, the margin of Vodacom's international operations — 14.6% at H1 — is well short of SA (37.3% FY 12E) levels, for instance. The main cause is Gateway, which continues its long-running underperformance.

Figure 56. Potential Upside If International Margins Improve

	International Ops Margin Scenarios					
	*14.6%	17.1%	19.6%	22.1%	24.6%	^35.9%
Upside to Grp EBITDA	-	1.1%	2.1%	3.2%	4.3%	9.1%
Boost to Grp EBITDA margin	-	0.4%	0.7%	1.1%	1.4%	3.0%

Source: CIRA Estimates. **H1 12 Intl EBITDA margin, scenarios in 2.5% increments. ^SA Scenario*

Arithmetically for instance, Vodacom could boost its group EBITDA by as much as 4.3% if it manages to increase its International margin to around the 25% level. A more sanguine assumption of c36% (SA level) could add 9.1% to group EBITDA.

"Sorting out" international operations could boost group EBITDA by c3%

The key is sorting out the Gateway situation, as we believe that underlying profitability of the International operations is currently sits in the 22-23% region if Gateway is stripped out. Vodacom believes that underlying EBIDTA margin could

improve to the 30-35% range, which is consistent with our “SA” scenario in Figure 56. This could add c3% to Vodacom’s EBITDA if achieved.

Forecasts

We forecast a decline in FY 14 earnings

Figure 57 captures our operational and bottom-line forecasts. We expect a recovery in International operations to cushion the EBITDA impact of a weaker SA, but after EBITDA growth of 10.8% in FY 12, we forecast a slowdown to 1.7% in FY 13 and then a reversal of 2.5% in FY 14.

Figure 57. Vodacom Forecast Summary

Rm	2011	2012E	% change	2013E	% change	2014E	% change
Revenue	**61,197**	**66,869**	**9.3%**	**71,271**	**6.6%**	**72,488**	**1.7%**
SA	53,371	57,005	6.8%	60,037	5.3%	60,139	0.2%
International	8,196	10,262	25.2%	11,655	13.6%	12,772	9.6%
Corporate	-370	-399		-421		-424	
EBITDA	**20,594**	**22,822**	**10.8%**	**23,939**	**4.9%**	**23,870**	**-0.3%**
SA	19,653	21,294	8.4%	21,984	3.2%	21,633	-1.6%
International	840	1,518	80.7%	1,947	28.3%	2,229	14.5%
Corporate	101	10		9		8	
EBITDA margin %	**33.7%**	**34.1%**		**33.6%**		**32.9%**	
SA	36.8%	37.3%		36.6%		36.0%	
International	10.2%	14.8%		16.7%		17.4%	
Corporate	-	-		-		-	
Citi HEPS	**6.56**	**7.19**	**9.6%**	**8.04**	**11.8%**	**7.94**	**-1.4%**
Consensus HEPS	6.56	7.28	11.0%	8.03	9.7%	8.81	9.7%
Citi Gross DPS*	**4.60**	**6.22**	**35.1%**	**6.91**	**11.2%**	**7.05**	**1.9%**
Consensus DPS	4.60	5.76	25.2%	6.62	13.9%	7.14	7.9%

Source: CIRA Estimates, I-Net Consensus. **Before withholding tax*

Tax boost to earnings

At the bottom-line, we forecast HEPS growth of 9.6% to R7.19, which is also supported by lower finance costs and just shy of consensus. We expect further growth of 9.7% in FY 13, though this is largely due to the benefit of STC being scrapped from that year — as mentioned, our underlying growth for ’13E is c5% as reflected in our EBITDA forecast. We believe that HEPS could decline (-1.4% on our forecasts) by FY 14, putting our number for that year c10% below consensus.

We assume an increase in payout; DPS to grow

We forecast a 35% increase in gross DPS in FY 12 to R6.22; this is before applying withholding tax. We have assumed that Vodacom will increase the dividend to compensate for withholding tax of 15% in the hands of shareholders. This will make Vodacom’s effective payout in FY 12 higher on our estimates, as the company does not benefit from the STC being scrapped in the current year, but still raises the dividend (on our assumption) to the benefit of shareholders. Our FY 12E dividend would be around R5.67 after withholding tax.

Figure 58. Forecast DPS Before and After Withholding Tax; Implied Yields

R/sh	FY 11	FY 12E	FY 13E	FY 14E
DPS before w/h tax	4.60	6.22	6.91	7.05
Implied payout	70%	86%	86%	89%
Implied DY		5.7%	6.4%	6.5%
DPS after w/h tax	4.60	5.67	5.87	5.99
Implied DY		5.2%	5.4%	5.5%

Source: Company Data, CIRA estimates. *Based on share price of R108.75*

We assume a payout ratio of c86% in FY 12 and '13, which we see rising to nearly 90% in FY 14. The latter year is consistent with the company paying out its entire free cash, as indicated in Figure 62 below.

Operating summary

SA – Slowing service revenues and cost pressures

We give the breakdown of our projections for SA in Figure 59. Overall we forecast top-line growth of 6.8% for FY 12 and total Service Revenue to rise by 5%. This translates to EBITDA growth of 8.4% on our margin assumption of 37.4% for SA — an improvement from the 36.8% of FY 11. Profitability should be boosted by a recovery from rebranding costs in the prior year, though perhaps blunted somewhat by increased subscriber acquisitions costs (SAC's).

Figure 59. Vodacom SA Operational Forecast Summary

Rm	2011	2012E	% change	2013E	% change	2014E	% change
Voice	28,584	29,449	3.0%	30,884	4.9%	30,734	-0.5%
Interconnect	6,755	6,152	-8.9%	5,514	-10.4%	4,422	-19.8%
Messaging	2,962	3,135	5.9%	3,405	8.6%	3,479	2.2%
Data	6,180	7,701	24.6%	8,681	12.7%	9,454	8.9%
Other Service Rev	1,911	2,284	19.5%	2,386	4.5%	2,489	4.3%
Service Revenue	**46,392**	**48,721**	**5.0%**	**50,870**	**4.4%**	**50,577**	**-0.6%**
Equipment sales	6,343	7,520	18.6%	8,404	11.7%	8,798	4.7%
Non-service revenue	636	763	20.0%	763	0.0%	763	0.0%
Total Revenue	**53,371**	**57,005**	**6.8%**	**60,037**	**5.3%**	**60,139**	**0.2%**
EBIDTA	**19,653**	**21,294**	8.4%	**21,984**	3.2%	**21,633**	-1.6%
EBITDA Margin %	36.8%	37.4%		36.6%		36.0%	

Source: Company Data, CIRA estimates

We currently forecast Service Revenue growth of 4.4% in FY 13, which we subsequently expect to be slightly down (-0.6%) in FY 14, with the main drag from Interconnect and Voice revenues. We forecast overall EBITDA margin to soften to 36% by FY 14 as cost pressures compound the impact of slower/lower revenues.

- **Voice** revenues increased by 3.3% in the first three quarters of FY 12 and our projections imply a slight y-y deceleration in Q4 resulting in growth of 3% for the full year. FY 12 should benefit from higher average customers, mitigated by slightly lower MOU and prices, which we also expect to boost FY 13 (+4.9%). We then, however, project slightly lower Voice revenue in FY 14 as the pressures on ARPU come to bear.

- **Interconnect** revenues are coming down on the back of legislated termination rate cuts. Mar-11's cut (impacting FY 12) of 19% will be followed a further 23% reduction impacting in 2013 and we forecast Vodacom's Interconnect top line to decline by 8.9% in FY 12 and 10.4% in FY 13. The final termination rate in the glide path —a cut of c29% — will push Interconnect revenues down even further (-20%) in FY 14 on our projections.

- We forecast a 24.6% rise in **Data** revenues for FY 12 on continued growth in active data users and usage, though this is tempered by price declines in the space. We factor in a further slowing in Data turnover growth over the medium-term on base effects and continued price competition. For FY 13, we forecast growth of 12.7% slowing further to 8.9% in FY 14.

- Growth in **Equipment** revenue will be strong in the current year, as already evidenced in the average increase of c20% for the first three quarters of FY 12. Vodacom has faced strong competition on this front and had to be aggressive in the fight for retail customers, which resulted in continued strong handset sales. We expect the rate of growth to abate, however, and we see this perhaps settling around the 4-5% p.a. level after FY 13 (+11.7% forecast).

International – Forecast to improve, underperformers to be disposed

Our country forecasts for Vodacom's international operations are summarised in Figure 60. We expect a strong top line in FY 12, +25%, on strong customer growth in most markets, as well as boosts from currency translations in the second half of the year. Most of the markets have also been more stable, which has allowed for better pricing and propped up ARPU's in some case. We project more modest top-line growth at an average of c12% p.a. after FY 12 on more tempered customer growth expectations and a resumption of competitive pressures on prices in some of the markets.

Figure 60. International Revenue and EBITDA Forecasts

Rm	2011	2012E	% change	2013E	% change	2014E	% change
International Revenue	**8,196**	**10,262**	**25.2%**	**11,655**	**13.6%**	**12,772**	**9.6%**
Tanzania	2,048	2,690	31.3%	3,205	19.1%	3,425	6.9%
DRC	1,641	2,044	24.5%	2,281	11.6%	2,562	12.3%
Mozambique	738	1,322	79.1%	1,455	10.1%	1,547	6.3%
Lesotho	579	649	12.0%	721	11.2%	781	8.3%
Gateway	3,190	3,559	11.6%	3,993	12.2%	4,457	11.6%
EBITDA	**840**	**1,518**	80.7%	**1,947**	28.3%	**2,229**	14.5%
EBITDA Margin %	10.2%	14.8%		16.7%		17.4%	

Source: Company Data, CIRA estimates

In terms of profitability, we factor in an improvement in the FY 12 EBITDA margin to 14.8%, consistent with the H1 level. We see this improving to 17.4% by FY 14, with Gateway remaining a drag. Excluding Gateway, we forecast an underlying EBITDA margin of 26.3% by FY 14, from c21% (on the same basis) in FY 11 on our estimates. We believe that improvements in the profitability of DRC and Mozambique (on more stable conditions there) are key factors in this regard. We touch on some of the top-line trends in the larger operations below.

- In addition to robust subscriber growth (+31% y-y on our forecasts) aided by accelerating M-Pesa uptake, **Tanzania** has benefited from improved local currency and ZAR ARPU's in FY 12. This has stemmed from relatively steady MOU patterns, while pricing has picked up more recently following a spell of sharp decline. As a result, we expect punchy overall revenue growth of c31%, and 37% in local currency, for the year. The market appears to be showing some stability for the time being, which could also see a little more constancy in the pricing environment at a lower base. We forecast average revenue growth of c12.8% p.a. between FY 12-14, with further subscriber growth as a key driver.

- The **DRC** market has been helped by more stable pricing, thanks to regulated floor prices, but a decline in MOU's over the past 12 months has seen ARPU come down on a like-for-like basis. In FY 12, this is being offset by strong customer growth (+26%-E), which we expect to spur a c25% increase in Revenue. Going forward, pricing pressure could resume and curb a potential recovery in Vodacom's DRC unit. The company is presently reviewing these

operations, which could include a disposal; MTN has been reported in the press as a potential buyer.

- The KPI's in **Mozambique** indicate a very sharp acceleration in y-y growth momentum in recent quarters, from an already high rate of growth in Q1. This has been driven by strong ARPU gains mainly on better pricing. We thus forecast revenue growth of 79% for FY 12, although a comparatively moderate rate of c43% in local currency. With the launch of a new operator, however, we expect growth to subside over the medium-term.

- **Gateway** remains a problematic operation for Vodacom. The company is looking to dispose of the business, which could happen within the next 6-12 months.

Consolidated forecasts

P&L summary

Our consolidated P&L forecasts for Vodacom are summarised in Figure 61.

Figure 61. Vodacom P&L Summary

Rm	2011	2012E	% change	2013E	% change	2014E	% change
Revenue	**61,197**	**66,869**	9.3%	**71,271**	6.6%	**72,488**	1.7%
Op Profit	**13,696**	**16,849**	23.0%	**17,360**	3.0%	**16,931**	-2.5%
Op Margin %	22.4%	25.2%		24.4%		23.4%	
Net finance costs	-1,058	-571		-417		-216	
PBT	**12,638**	**16,278**		**16,943**		**16,716**	
Tax	-4,659	-5,931		-5,371		-5,299	
Tax rate	36.9%	36.4%		31.7%		31.7%	
Minority	266	207		231		228	
Net Profit	**8,245**	**10,554**	28.0%	**11,804**	11.8%	**11,645**	-1.3%
Headline Earnings	**9,626**	**10,554**	9.6%	**11,804**	11.8%	**11,645**	-1.3%
Headline EPS	6.56	7.19	9.6%	8.04	11.8%	7.94	-1.2%
Gross DPS	4.60	6.22	35.1%	6.91	11.2%	7.05	2.0%

Source: CIRA Estimates

- We have Vodacom's finance costs coming down to cR570m in FY 12, which is nearly 50% lower than FY 11 and boosts overall expected earnings growth. Further de-gearing, as we touch on below, should result in even lower finance costs in FY 13 and '14 on our estimates.

- The FY 12E tax rate remains elevated by increased STC and non-deductible items though the shift to dividend withholding tax, and scrapping of STC, enhancing our bottom-line forecasts for FY 13 and '14. Overall we still expect the tax rate at c36.4% in FY 12, but then to fall to 31.7% in following years with the change to withholding tax as mentioned.

Cash flow and gearing

Overall free cash boosted by change in dividend tax regime

We have summarised our cash flow forecasts for Vodacom in Figure 62. Our projections indicate a 5.4% increase in free cash in FY 12, which we see accelerating to 7.6% in FY 13 helped by lower STC outflows (STC scrapped) and continued reduction in finance costs. On our forecasts, lower capex and finance costs should see an 8.3% increase in free cash in FY 14.

Figure 62. Vodacom Cash Flow Summary

Rm	2011	2012E	% change	2013E	% change	2014E	% change
EBITDA	20,594	22,822	10.8%	23,939	4.9%	23,870	-0.3%
less Capex	-6,333	-7,315		-8,444		-7,845	
OpFCF	**14,261**	**15,507**	8.7%	**15,496**	-0.1%	**16,024**	3.4%
Less tax	-4,659	-5,931		-5,372		-5,302	
Less Finance Costs	-1,058	-571		-416		-212	
EFCF	**8,544**	**9,005**	5.4%	**9,707**	7.8%	**10,510**	8.3%
ECFC Yield		5.6%		6.0%		6.5%	

Source: Company Data, CIRA estimates

Capex to continue at c11% of revenue

Vodacom is expected continue to invest in its networks, with particular focus on network and capacity upgrades, as well as transmission as part of the self-provisioning plan in SA. In its international markets, Vodacom aims to continue investing in the expansion of its voice and data coverage. Our forecasts imply a capex intensity ratio of 10-11% of revenues over the medium-term.

Gearing to come down further, dividends well-supported

We expect Vodacom's gearing to reduce to 0.34x net debt/EBITDA in FY 12, from 0.5x in 2011, as the company continues to generate cash and capex potentially levels out, though, as touched on earlier in the report, a strong pick-up in traffic could push capex up again. Our current forecasts see net debt/EBITDA falling to 0.22x by FY 14. Vodacom has established a R10bn domestic medium-term note (DMTN), which gives the company added flexibility should it need further funding. Its gearing outlook does give Vodacom scope to further increase its dividend payouts — i.e. over and above offsetting higher withholding tax — which means that dividends should be well supported in our view.

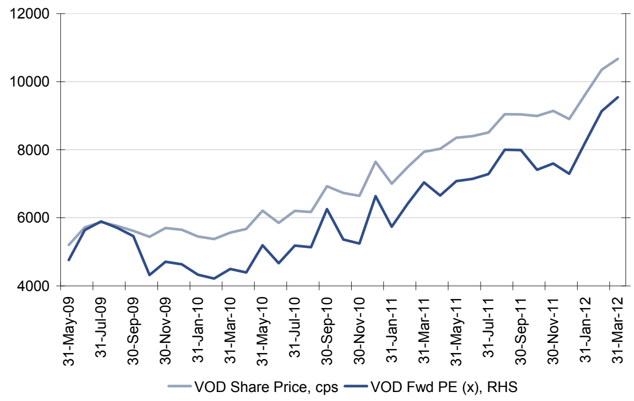
Valuation discussion

Outperformer

Strong outperformance reflects significant re-rating

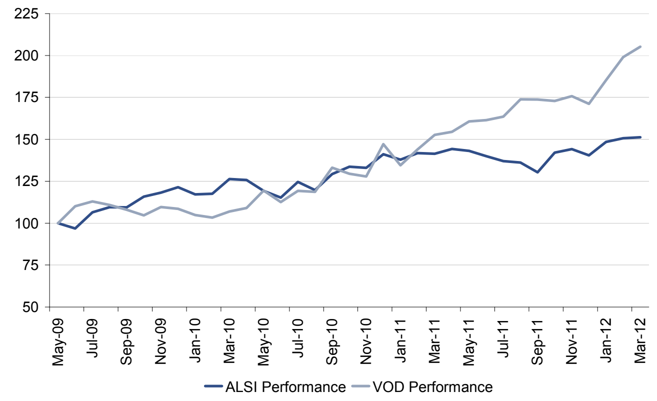
The Vodacom share price has performed strongly over an extended period of time and has more than doubled since its listing in 2009 (Figure 63). At the same time (Figure 64), Vodacom has outperformed the ALSI by over 50%. Consequently, the stock's forward PE has re-rated significantly from around 9x to its current level of 13.5x.

Figure 63. Vodacom Share Price and Forward PE



Source: I-Net Bridge, CIRA

Figure 64. Share Performance Indexed to 100; Vodacom vs ALSI



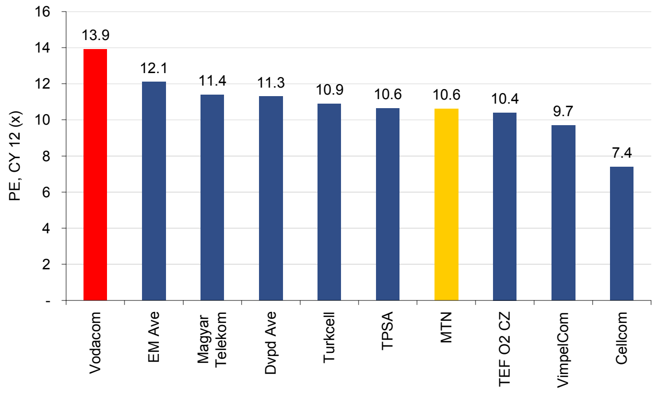
Source: I-Net Bridge, CIRA

Very expensive

c30% PE premium to MTN, and 15% premium vs overall EM telco average

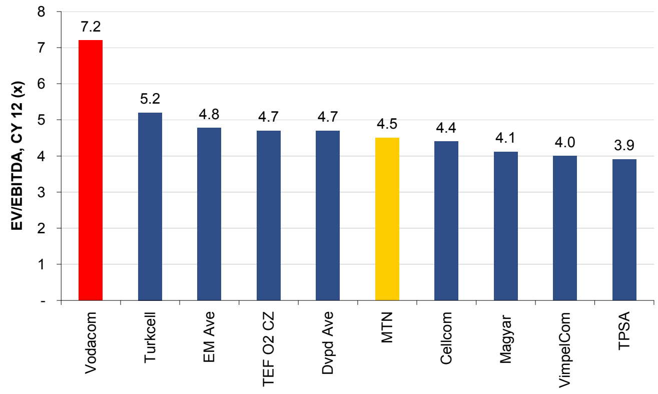
Vodacom trades at a premium to its global telco peers. On a PE basis, for instance, Vodacom's multiple of 13.9x (Dec-12) on our forecasts reflects a 31% premium versus its SA sector-mate MTN and c15% compared to the EM telco average of 12.1x (Figure 65).

Figure 65. Peer Group PE Comparisons, CY 12 (x)



Source: CIRA Estimates

Figure 66. Peer Group EV/EBITDA Comparisons, CY 12 (x)



Source: CIRA Estimates

Vodacom premium on EV/EBITDA metric is around 50%

The stock's EV/EBITDA premium is even bigger (see Figure 66). At 7.2x, Vodacom's EV/EBITDA implies an eye-watering premium of 50% compared to both the EM and developed market Telco average. The premium is even wider (50%) compared to MTN.

Not justified by medium-term growth outlook in our view

Vodacom does offer slightly better growth than most peers over the coming 12 months; on Citi forecasts Vodacom EPS growth for CY 12 is c11% (boosted by changes in the tax regime, remember) compared to the EM average of c7%. This, however, does not warrant the stock's current premium in our opinion, especially given our view that earnings are poised to reverse by FY 14.

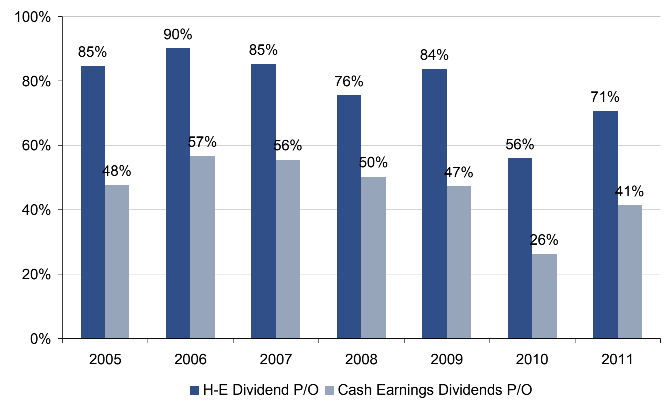
Good yield, but at what price?

Higher dividend prospects appealing

Strong argument for dividends to increase; a key risk to our investment case

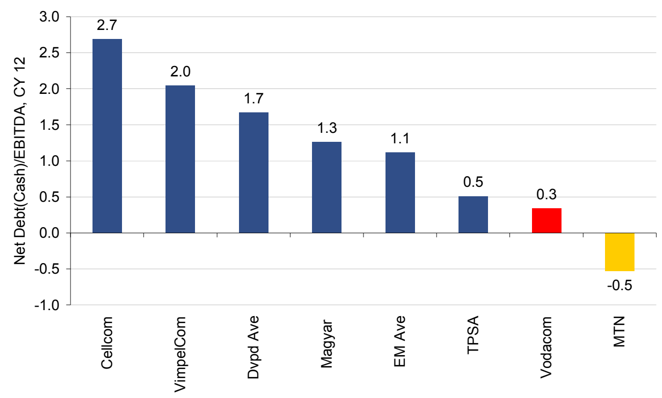
A major attraction of Vodacom is its above-average yield, especially in a South African context; at over 6% before tax, its dividend yield is well above the market average of 3-3.5%. Indeed, some of the company's stats suggest that there is scope for further upside in its dividend payout, underpinned by lack of meaningful acquisition prospects and the prospect of capex leveling out or even declining. For consistency and simplicity, we use Vodacom's pre-tax dividend as the basis for the analysis that follows.

Figure 67. Dividend Payout History; Headline vs Cash Earnings Bases



Source: CIRA Estimates

Figure 68. Peer Group Net Debt/EBITDA Comparisons, CY 12



Source: CIRA Estimates

Vodacom's dividend payout still relatively low on cash earnings basis

Figure 67 for instance shows that although Vodacom's payout has risen to c70% in 2011, from 56% in 2010: (i) it is still below pre-listing levels of c85-90%, and (ii) the payout on a cash earnings basis remains very low at c40%. Also, Figure 68 illustrates how low Vodacom's gearing (c0.3x debt/EBITDA on our '12 forecasts) compared to its EM peers, which average c1.1x. Vodacom, thus, looks quite underleveraged on this analysis and the company is comfortable with a ratio of closer to 2x.

Figure 69. Dividend Yield Scenarios Based on Cash Earnings Payout

	Payout Based on Cash Earnings (FY 13E)				
	60%	70%	80%	90%	100%
Implied gross DPS (R/sh)	7.40	8.63	9.86	11.10	12.33
Implied yield	6.8%	7.9%	9.1%	10.2%	11.3%

Source: CIRA Estimates

DY could increase by even more if Vodacom paid out of its equity

Our current dividend forecasts imply a gross yield of 6.4% (after withholding tax) for FY 13 to March, which equates to a payout of c87% on headline earnings and c55% on cash earnings. For an indication of the potential upside, Figure 69 shows what could happen to Vodacom's dividend and implied yield under different cash

earnings payout scenarios. As shown, Vodacom's yield could increase to as much as 11.3% tax if the company paid out all of its cash earnings.

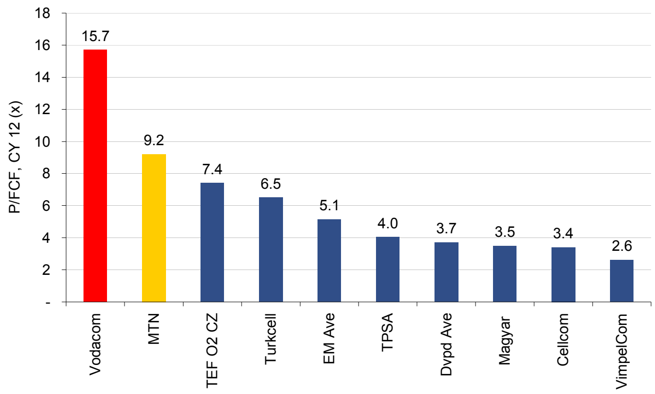
This would imply paying out of equity, where Vodacom reported retained earnings of R18.2bn at Sep-11. Our current forecasts imply that Vodacom pays out the equivalent of its free cash flow.

But context is important

Vodacom lags its peers in the FCF yield stakes

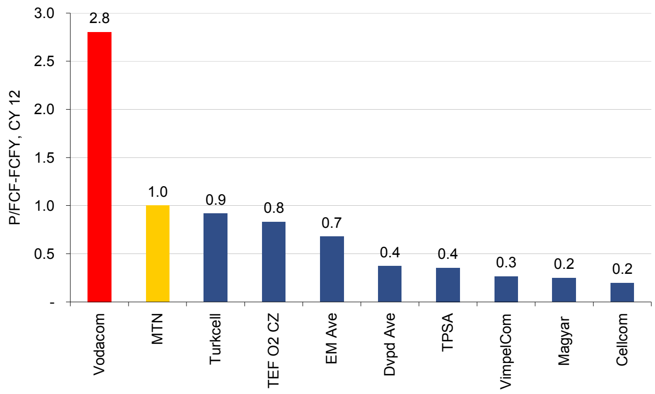
Vodacom's cash generation is good but not spectacular when compared to its telecom peers. For instance, the company's free cash flow yield of c5.6% is below MTN (c9%), and EM (8%) and developed market (10%) averages. Consequently, at the current share price, the market appears to be placing a disproportionately high multiple on Vodacom's cash flow.

Figure 70. Peer Group P/FCF Comparisons, FY 12 (x)



Source: CIRA Estimates

Figure 71. Peer Group P/FCF-to-FCFY Comparison, CY 12



Source: CIRA Estimates

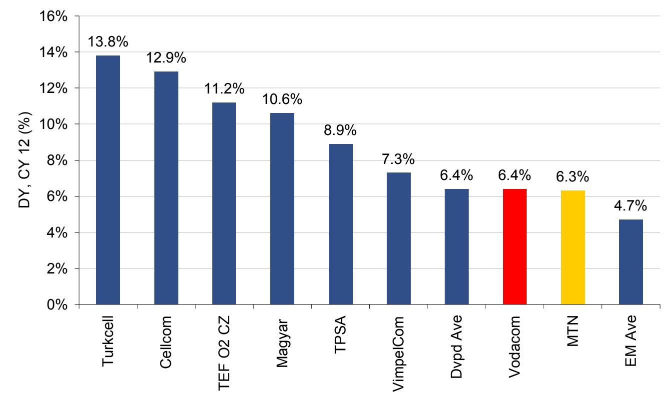
Vodacom on a threefold premium to peers on P/FCF analysis

Figure 70 shows that Vodacom is on a 16.2x P/FCF multiple compared to peers, which average c5x; this is more than a threefold premium. Combining the multiple with forecast free cash flow yields, Figure 71 shows that Vodacom's ratio (P/FCF to FCF yield of 2.6x) sits well above its peers as well, confirming, in our view, that the stock's premium is unwarranted.

Vodacom's DY compares favourably to the broader EM average, but short of most other individual peers

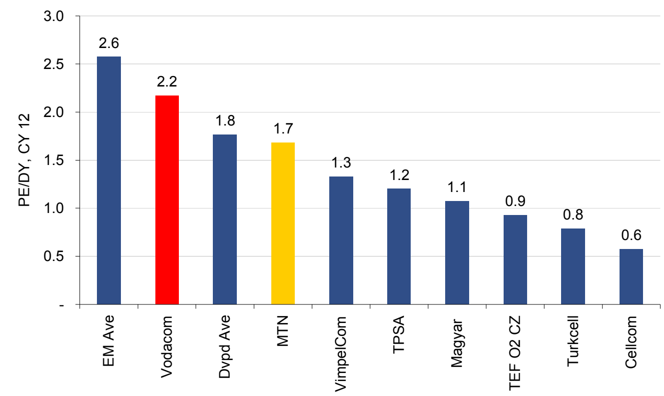
Returning to dividend yield, our forecasts suggest that Vodacom offers a slightly better yield than the broader EM average. As shown in Figure 72, however, Vodacom's DY is lower than all the individual stocks in our sample apart from MTN, which offers a similar yield.

Figure 72. Peer Group DY Comparisons, CY 12 (%)



Source: CIRA Estimates

Figure 73. Peer Group PE/DY Comparisons, FY 12 (x)



Source: CIRA Estimates

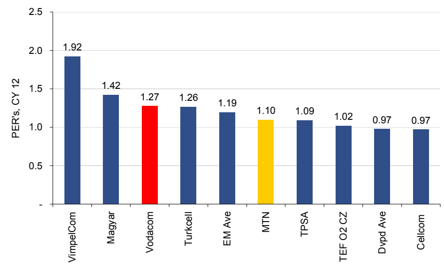
But this appears more than priced in

We capture comparative PE/DY ratios in Figure 73. Again, Vodacom is right at the top-end of the analysis versus the individual peers we use in this analysis, even though its ratio of 2.2x is just below the broader EM average. We have already shown in the absolute PE comparison (Figure 65) that Vodacom trades at a premium compared to most stocks, which does not appear to be justified by the stock's current yield. We alluded earlier to the upside potential Vodacom's dividend.

Dividend payouts should rise as markets mature

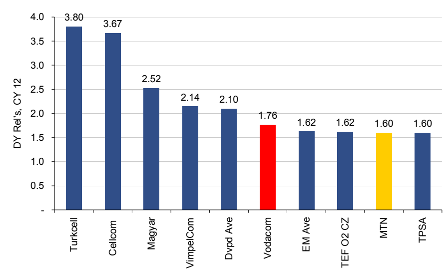
When markets mature, with growth slowing, a lack of acquisition opportunities and capex subsides, as is typical with telcos, the expectation for higher dividends increases. So the market should arguably already be expecting this. We believe that this is helping to drive the Vodacom share price. Indeed in a South African context, we mentioned earlier that Vodacom's DY is comfortably above the market average of 3-3.5% and this probably appeals to the market, especially if there is scope for further upside.

Figure 74. PE Relatives to Local Markets



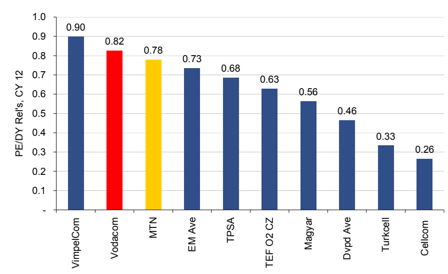
Source: MSCI, CIRA

Figure 75. DY Relatives to Local Markets



Source: MSCI, CIRA

Figure 76. PE/DY Relatives to Local Markets



Source: MSCI, CIRA

The intelligence on this is a little mixed when looking at cross-market comparisons. We have made a, possibly obscure, attempt to evaluate how Vodacom stacks up on this basis.

- **Figure 74**: This chart maps the CY 12E PE's of each company relative to their respective local market index. Most of the companies currently trade close to par or at premiums to their local indices. Vimpelcom/Russia is maybe a special case, where the market index is distorted down by very low multiple oil companies which dominant in the make-up — the Russian market trades on a forward PE of 5.7x, for example, which is nearly half of Vimpelcom's PE. Be that as it may,

Vodacom once again does not screen well and is among the higher premium telcos relative to its market at 27% compared to the EM average of c20%, for instance.

- **Figure 75**: Here we calculate a "DY relative", again mapping each company's DY against its respective market index DY. On this metric, Vodacom falls closer to the middle of the analysis, and much in line with the lower rated companies and averages. In other words, even though Vodacom's DY is ahead of the market, some telcos fare even better relative to their markets.

- **Figure 76**: Combining PE and DY relatives (ie PE relative over DY relative), we derive Figure 76. This is a gauge (similar to Figure 73) that seeks to evaluate how much, on a market-relative basis, an investor is paying for each company's respective DY. Vodacom is once again the most expensive in the peer group, save for a "distorted" Vimpelcom/Russia ratio.

As with many analyses, this has its limitations, however, we believe that it provides an interesting guide on the point we are making, that Vodacom's valuation does not appear to be justified by its yield, attractive as it may be, at current levels.

Remember also that our investment case on Vodacom is that the environment is likely to get tougher. In our view, our current assumptions probably factor in a relatively mild extent of what could happen with the company's earnings and cash flows over the next few years. Again, competition — and how this evolves — is the main wildcard and could be a lot worse, as illustrated in our scenario analysis. The thrust of our message is that Vodacom looks very expensive in this context and carries significant capital risk if our view pans out.

Companies mentioned:

Vodacom (VODJ.J; R107.14; 2)
Turkcell (TCELL.IS; TL8.92; 1)
TEF 02 CZ (SPTTsp.PR; Kc375.00; 1)
MTN (MTNJ.J; R130.46; 1)
Cellcom (CEL.TA; NIS43.06; 3)
Magyar (MTEL.BU; Ft550; 1)
Vimpelcom (VIP.N; US$10.50; 1H)
TPSA (TPSA.WA; ZL16.87; 1)

Vodacom Group Limited

Company description

Vodacom is the leading cellular operator in South Africa, with 54% of the market and over 28m subscribers in South Africa. Vodacom is also a leading operator in Tanzania, DRC, Lesotho and quickly gaining share in Mozambique. It's subscriber base stood at 41.3m at the end of June 09. Vodacom operations also include Gateway, African satellite network operator, acquired in Dec 08.

Vodacom is 65% owned and controlled by Vodafone, which acquired control in May 2009. Telkom simultaneous agreed to unbundled its shares to its shareholders, thus bring about a listing of Vodacom on the JSE on the 19th of May 2009.

Investment strategy

We rate the stock Sell with an R85 price target. The South African market has started to mature and offers fewer growth opportunities. The medium-term consumer landscape has also gotten tougher, which we believe could impact on telecom spending. Importantly, against this backdrop, we expect a rise in competition to put further pressure on Vodacom's prospective ARPU and growth. Although growth could hold up for now, we believe the risks have increased and expect earnings to go backwards in FY 14.

Vodacom's strong outperformance over the past 18 months makes the stock look expensive and we believe that the share should de-rate to reflect its increased risk profile.

Valuation

Our DCF valuation R85 per share. Our valuation incorporates WACC of 12.8% and a terminal growth rate of 2% for South African operators and 14%/3.5% for its other operations.

94% of our DCF is driven by South African operations. At our target price, Vodacom would trade at an implied 2013e EV/EBITDA of 6x, which is towards the upper ranges of our valuation benchmarks for Vodacom's emerging market peers.

Risks

We see the following as the main risks to the share price falling to our target price:

An improvement in the economic and consumer landscape, improved dividends and potential special dividends, strong cost and margin management and a continued benign competitive environment.

More generally, we highlight the following risks:

Not being able to recover the loss of revenue from interconnection. As seen in markets like Egypt, it can take a one or two quarters to make up for loss in revenue from tariffs as prices are cut.

Cell-C may become more aggressive. Cell-C has not been able to make inroads into the South African market, and has seen its market share remain low since 2007. Cell-C is in a strong position to cut tariffs, which may put pressure on Vodacom as it targets an increase in market share to 25% from c13-14% currently.

Expansion may reduce returns. Vodacom has a patchy record in pursuing acquisitions and expanding outside of South Africa. It has had to impair Mozambique in the past, as well as the recent Gateway acquisition. We see a risk to dividends and cashflow if further acquisitions are made and believe Vodacom would benefit more from increasing its dividend and returning cash to shareholders.

Increasing regulatory noise - ICASA has had a limited impact on the South African market so far. But it has become more vocal (along with the government) in wanting to reduce pricing on mobile. A more hostile regulator may change the favourable dynamic operators have enjoyed since mobile started in 1993/4.

Appendix A-1

Analyst Certification

The research analyst(s) primarily responsible for the preparation and content of this research report are named in bold text in the author block at the front of the product except for those sections where an analyst's name appears in bold alongside content which is attributable to that analyst. Each of these analyst(s) certify, with respect to the section(s) of the report for which they are responsible, that the views expressed therein accurately reflect their personal views about each issuer and security referenced and were prepared in an independent manner, including with respect to Citigroup Global Markets Inc and its affiliates. No part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this report.

IMPORTANT DISCLOSURES

Vodacom Group Limited (VODJ.J)

Ratings and Target Price History
Fundamental Research

Analyst: Thato Motlanthe
Covered since October 9 2011

	Date	Rating	Target Price	Closing Price
1	4-Nov-09	*1M	*75.00	51.56
2	30-Sep-11	*2M	*90.00	90.36

	Date	Rating	Target Price	Closing Price
3	7-Oct-11	Stock rating system changed		
4	7-Oct-11	*2	90.00	88.25

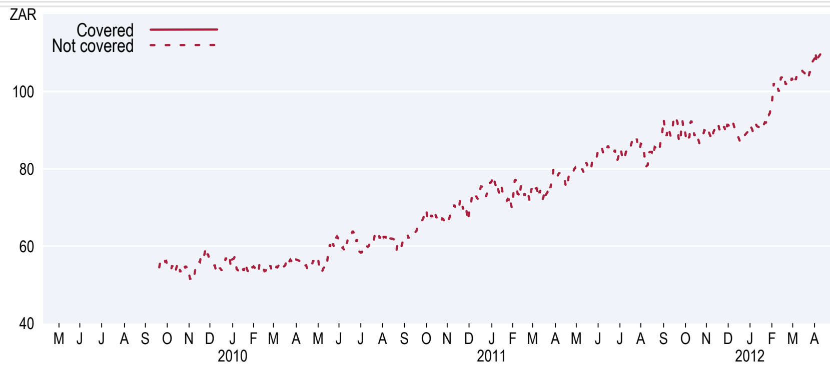
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Vodacom Group Limited (VODJ.J)

Ratings and Target Price History
Best Ideas Research
Relative Call (3 Month)

Analyst: Thato Motlanthe
Covered since October 9 2011



* Indicates change

Rating/target price changes above reflect Eastern Standard Time

DMBH is a market maker in the publicly traded equity securities of Telekomunikacja Polska SA. DMBH rating distribution versus Investment Banking service provision in the past 12 months as at 30th March 2012 is as follows: Buy (1) representing 54% of the DMBH coverage 0% of which are IB clients,Hold (2) representing 33% of the DMBH coverage 0% of which are IB clients,Sell (3) representing 13% of the DMBH coverage 0% of which are IB clients.

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Citi Investment Research & Analysis Ratings Distribution

	12 Month Rating			***Relative Rating***		
Data current as of 31 Mar 2012	**Buy**	**Hold**	**Sell**	**Buy**	**Hold**	**Sell**
Citi Investment Research & Analysis Global Fundamental Coverage	52%	37%	11%	10%	79%	10%
% of companies in each rating category that are investment banking clients	44%	42%	40%	47%	42%	43%

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Risk rating takes into account both price volatility and fundamental criteria. Stocks will either have no risk rating or a High risk rating assigned.
Investment Ratings: CIRA's investment ratings are Buy, Neutral and Sell. Our ratings are a function of analyst expectations of expected total return ("ETR") and risk. ETR is the sum of the forecast price appreciation (or depreciation) plus the dividend yield for a stock within the next 12 months. The Investment rating definitions are: Buy (1) ETR of 15% or more or 25% or more for High risk stocks; and Sell (3) for negative ETR. Any covered stock not assigned a Buy or a Sell is a Neutral (2). For stocks rated Neutral (2), if an analyst believes that there are insufficient valuation drivers and/or investment catalysts to derive a positive or negative investment view, they may elect with the approval of CIRA management not to assign a target price and, thus, not derive an ETR. Analysts may place covered stocks "Under Review" in response to exceptional circumstances (e.g. lack of information critical to the analyst's thesis) affecting the company and / or trading in the company's securities (e.g. trading suspension). As soon as practically possible, the analyst will publish a note re-establishing a rating and investment thesis. To satisfy regulatory requirements, we correspond Under Review and Neutral to Hold in our ratings distribution table for our 12-month fundamental rating system. However, we reiterate that we do not consider Under Review to be a recommendation.
Relative three-month ratings: CIRA may also assign a three-month relative call (or rating) to a stock to highlight expected out-performance (most preferred) or under-performance (least preferred) versus the geographic and industry sector over a 3 month period. The relative call may highlight a specific near-term catalyst or event impacting the company or the market that is anticipated to have a short-term price impact on the equity securities of the company. Absent any specific catalyst the analyst(s) will indicate the most and least preferred stocks in the universe of stocks under consideration, explaining the basis for this short-term view. This three-month view may be different from and does not affect a stock's fundamental equity rating, which reflects a longer-term total absolute return expectation. For purposes of NASD/NYSE ratings-distribution-disclosure rules, most preferred calls correspond to a buy recommendation and least preferred calls correspond to a sell recommendation. Any stock not assigned to a most preferred or least preferred call is considered non-relative-rated (NRR). For purposes of NASD/NYSE ratings-distribution-disclosure rules we correspond NRR to Hold in our ratings distribution table for our 3-month relative rating system. However, we reiterate that we do not consider NRR to be a recommendation.

Prior to October 8, 2011, the firm's stock recommendation system included a risk rating and an investment rating. **Risk ratings,** which took into account both price volatility and fundamental criteria, were: Low (L), Medium (M), High (H), and Speculative (S). **Investment Ratings** of Buy, Hold and Sell were a function of CIRA's expectation of total return (forecast price appreciation and dividend yield within the next 12 months) and risk rating. Additionally, analysts could have placed covered stocks "Under Review" in response to exceptional circumstances (e.g. lack of information critical to the analyst's thesis) affecting the company and/or trading in the company's securities (e.g. trading suspension). Stocks placed "Under Review" were monitored daily by management and as practically possible, the analyst published a note re-establishing a rating and investment thesis. For securities in developed markets (US, UK, Europe,

Japan, and Australia/New Zealand), investment ratings were:Buy (1) (expected total return of 10% or more for Low-Risk stocks, 15% or more for Medium-Risk stocks, 20% or more for High-Risk stocks, and 35% or more for Speculative stocks); Hold (2) (0%-10% for Low-Risk stocks, 0%-15% for Medium-Risk stocks, 0%-20% for High-Risk stocks, and 0%-35% for Speculative stocks); and Sell (3) (negative total return). For securities in emerging markets (Asia Pacific, Emerging Europe/Middle East/Africa, and Latin America), investment ratings were:Buy (1) (expected total return of 15% or more for Low-Risk stocks, 20% or more for Medium-Risk stocks, 30% or more for High-Risk stocks, and 40% or more for Speculative stocks); Hold (2) (5%-15% for Low-Risk stocks, 10%-20% for Medium-Risk stocks, 15%-30% for High-Risk stocks, and 20%-40% for Speculative stocks); and Sell (3) (5% or less for Low-Risk stocks, 10% or less for Medium-Risk stocks, 15% or less for High-Risk stocks, and 20% or less for Speculative stocks).

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