14 May 2013 │ 9 pages

Wireless Telecommunication Services (GICS) │ Telecommunications Services - Wireless (Citi)
CEEMEA │ South Africa

Vodacom Group Limited (VODJ.J)

Alert: FY 13 Preview – Familiar Focus Points

- **Company Update**

- **Results next week** – Vodacom reports FY to Mar-13, on Monday 20May. The company's HEPS guidance, up 20-25%, was ahead of our (R8.42, +18.8%) and consensus' (R8.44) numbers. This potentially means a better than expected DPS as well, which could provide some short-term cheer for the share price. Citi-E DPS is R7.58/sh, implying a final divi of R4.03. Favourable movements in tax provide a below-the-line boost to the overall result. Our preview summary is in Figure 1.
- **Déjà vu** – We expect the operational focus points to be the same as previous results of the 12 months, namely: (i) evolution of trends in SA, and (ii) strength of the International performance.
  - **SA: Proof in the pudding** – The feedback regarding trends in SA has been mixed. MTN has had the upper hand for much of the past 12 months but suffered a disappointing Mar-13 quarter. Vodacom believes that it has clawed back some share in the Mar-13 quarter, challenging MTN's assertion that it managed to defend its gains in the period. Vodacom's numbers should provide some clarity on this but either way; we believe that MTN's Mar-13 showing and Vodacom's poor Dec-12 quarter, present broader signs of continued deterioration in SA which underpins our caution on the market.
  - **International surprise? Possibly** – We would not bet against another upside surprise in Vodacom's International operations, as has been the case over the course of the company's FY 13. The market has come to grips with the positive trends, however, so the extent of any surprise should be less than in previous results. In the bigger picture, International contributes 10.5% to group EBITDA, and we maintain that this segment's positive momentum (which we expect to slow) only benefits Vodacom so long as the other c90% (SA) holds up – which we have our doubts about, as mentioned.
- **Sell, R95 TP** – Vodacom's share has *under*performed MTN's by 24% over the past 12 months, and by 8% YTD; rightly so, in our opinion, from a fundamental viewpoint in light of Vodacom's premium valuation and larger exposure to SA (on which we are remain negative). We retain our preference for MTN (Buy) over Vodacom (Sell) going forward, but caution that recent developments (eg Nigeria challenges for MTN, potential positive divi surprise for Vodacom) could present some nearer-term risks to this outlook.

Sell	**3**
Price (14 May 13)	R112.73
Target price	R95.00
Expected share price return	-15.7%
Expected dividend yield	6.8%
Expected total return	**-9.0%**
Market Cap	R167,737M
	US$18,313M

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

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

FY 13 Results Preview

Figure 1. Vodacom FY 13 Preview Summary

	FY 13E	y-y	Comment
GROUP			
Subscribers	51.7mln	8.0%	Implies net additions of +3.8mln for the FY, and +0.7mln q-q for Q4 (in line with Q3 to Dec12). International should be the main driver of overall subscriber additions.
Service Revenue	R59.7bn	2.5%	Features a flat SA and mid-teen International growth on our estimates. We forecast total group revenue of R70.2bn, +4.9% y-y.
EBITDA	R25.4bn	11.4%	Reflects an improvement in margin to 36.1%, from 34%, on our forecasts. Improvements in both SA and International.
HEPS	R8.42/sh	18.8%	Vodacom's guidance, growth of 20-25%, is ahead of our number and consensus of R8.44/sh. This includes a boost from tax movements (change to withholding tax, from STC, and deferred tax asset in Mozambique) which we think could be key in the beat. The growth guidance implies a range of R8.50-8.85/sh.
DPS	R7.58/sh	6.8%	Assumes a 90% payout as per current policy ("at least 90%"). Higher HEPS guidance and the possibility of higher payout (this was 100% in FY 12) would suggest a beat on the dividend front as well.
SOUTH AFRICA			
Subscribers	30.5mln	5.5%	We look for net adds of +1.6mln for the FY, but net disconnections of -0.1mln q-q implied for Q4. It is possible that 'adds' turn out negative for the FY as a whole on the back of calling SIMs being cleared off the base; so subs could be worse than our forecast. This dynamic should be counter-balanced by better underlying ARPU.
SA ARPU	R 128	-18.2%	Our FY forecast implies a drop in Q4 to cR123, compared to an average of cR130 during the first three quarters of the FY. A cut in interconnect rates during Q4 plays a roll, but also due to deteriorating Voice ARPU on our expectations. As per the preceding point, a lower than expected subs number should result in a higher than expected ARPU due to the elimination of very low ARPU calling SIMs.
MOU	104	-8.8%	Elasticity has been poor throughout the year so far despite headline and promotional tariff reductions over the course. This reflects consumers under pressure and increased competition (splitting spend?) - part of our cautious thesis on the SA market. Elasticity was/is a key risk to our thesis but does not appear to be coming to the fore. Our FY forecast implies MOU of 108 in Q4, higher than the average of c103 over the preceding quarters - this tries to factor in the positive effect of eliminating low-MOU calling SIMs.
Service Revenue	R48.4bn	0.0%	We have not veered too far from Vodacom's previous indication that Service Revenue is likely to be flat in SA overall, after a disappointing Q3 showing. Interconnect revenue is likely to be a key factor, but we also expect Voice revenue to be down slightly (-0.3%) for the year. Data should once again be the positive in Service revenue (+16% for the FY on our forecast), and would be main source of any upside surprises in our view. We have total revenue of R58.7bn (+3.1% y-y) for SA, with strong Equipment sales growth (+23%) as a support.
EBITDA	R22.3bn	4.8%	Margin improving on cost containment and efficiencies - we see Marketing & Ad costs as a particular area this year. Vodacom does have some scope with cost savings (including on transmission) so is a lever the company is able to flex to try and support profitability; investment case around profitability, therefore, has more to do with might happen with the topline for now. We forecast an FY 13 EBITDA margin of 38%, up from 37.3%.
INTERNATIONAL			
Subscribers	21.1mln	11.9%	Implies net adds of +2.2mln in the year, +0.8mln in Q4. DRC the main driver on our expectations.
ARPU*	$4.7	1.3%	Supported by increased usage in Tanzania and Mozambique in particular.
Service Revenue	R11.6bn	14.3%	Performance blunted by disposal of Gateway Carrier. Stripping out all of Gateway (ie including Business) we estimates underlying MNO growth of +41% y-y; Data revenue should be continuing its strong growth from a low base. International has continually surprised on the upside during FY 13, so may possibly do so again in terms of the FY performance. We have total International Revenue at R11.9bn (+14.4% y-y)
EBITDA	R3bn	107.8%	Implies margin of 25.5%, up from 14%, reflects rebound in most International op's and disposal of loss-making Gateway Carrier. On underlying MNOs we estimate an improvement in margin to 31.2%, from 23.7%.

Source: Citi Research. *Citi calculated

Figure 2. Valuation Comps, CY

	PE		EV/EBITDA	
	2013	2014	2013	2014
CEEMEA AVERAGE	10.3	10.4	4.5	4.7
EM AVERAGE*	15.3	14.1	6.4	6.3
DVPD EUROPE AVERAGE	11.0	10.3	5.5	5.4
MTN	12.7	11.8	5.9	5.5
Vodacom	13.3	12.9	6.9	6.7

Source: dataCentral, Citi Research. Includes LatAm and Asia

Vodacom Group Limited

Valuation

Our DCF valuation is R95 per share. Our valuation incorporates WACC of 10.6% and a terminal growth rate of 2% for South African operators and 11.3%/3.1% for its other operations.

90% of our DCF is driven by South African operations. At our target price, Vodacom would trade at an implied 2014e EV/EBITDA of 6.4x, 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 exceeding 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 has 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.

MTN Group Limited

(MTNJ.J; R175.60; 1)

Valuation

Mobile telecommunication companies are generally strong operational cash generators. In our valuation approach, we use discounted cash flow analysis to arrive at the valuation of MTN. In the forecast of cash flows, provision is made for ongoing or maintenance capital expenditure, which we believe is a necessary cost of ongoing operations. While in its growth phase, depreciation is seldom as high as the maintenance capex charge when the network is fully rolled out. This is true in MTN's case, as South African operations will require significant maintenance capex even when the network reaches its capacity. Our target price of R195 is based on the sum-of-the-parts valuation of each of MTN's geographic operations on a DCF basis.

Risks

We would highlight the market risk associated with extensive investment in operations outside of South Africa, and the high forecast risk of operations in markets with little third-party knowledge on which to base our assumptions. If the impact of these risks is greater than we anticipate, then the share price might not reach our target price. On the other hand, we believe that MTN might continue to post strong earnings growth and that the market continues to value the stock as a momentum play, rather than on its free cash flow and risk fundamentals. This could cause the share price to rise above our target price. Furthermore, the high risk that we anticipate may manifest itself in a one-off event, either positive or negative. In particular, MTN faces litigation risk in some of its markets including Iran and Nigeria, which may or may not result in cash outflows.

Appendix A-1

Analyst Certification

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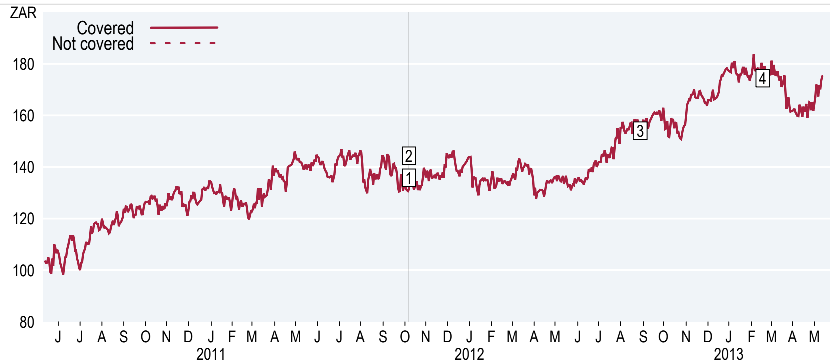
MTN Group Limited (MTNJ.J)

Ratings and Target Price History
Fundamental Research

Analyst: Thato Motlanthe
Covered since August 19 2011



	Date	Rating	Target Price	Closing Price
1	7-Oct-11	Stock rating system changed		
2	7-Oct-11	*1	150.00	131.40
3	29-Aug-12	1	*170.00	157.00
4	18-Feb-13	1	*195.00	177.50

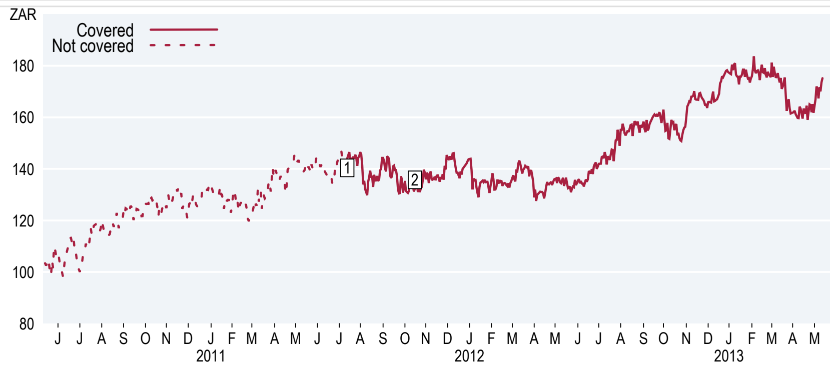
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

MTN Group Limited (MTNJ.J)

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

Analyst: Thato Motlanthe
Covered since August 19 2011



	Date	Rating	Target Price	Closing Price
1	13-Jul-11	*ADD LP	-	144.11
2	17-Oct-11	*REM LP	-	132.35

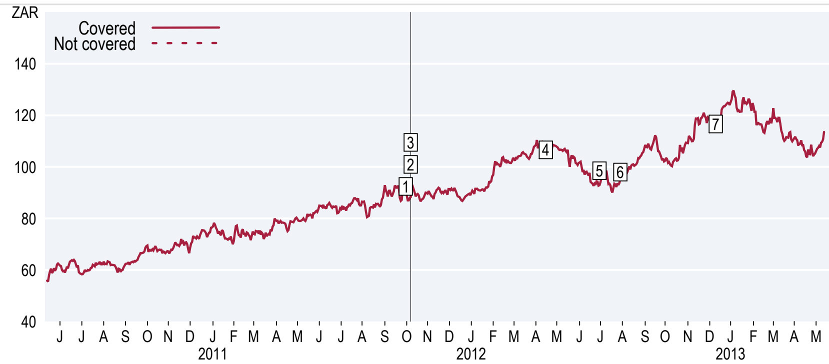
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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	30-Sep-11	*2M	*90.00	90.36
2	7-Oct-11	Stock rating system changed		
3	7-Oct-11	*2	90.00	88.25
4	16-Apr-12	*3	*85.00	107.00
5	29-Jun-12	3	*80.00	92.90
6	30-Jul-12	3	*83.00	95.41
7	11-Dec-12	3	*95.00	117.99

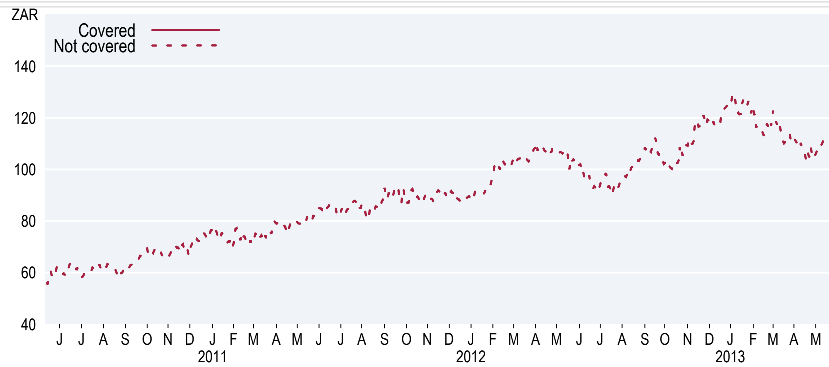
* Indicates change

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



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% of companies in each rating category that are investment banking clients	53%	49%	43%	65%	49%	51%

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