Equities Valuation Update:

Company Specific Research

SAFCOM KN

5th March, 2018

AIB Capital Ltd.

SELL

Target Price: **KES 26.30**

Price on 1st March 2018:
KES 29.50

Potential Upside/Downside:
12.16%

52-week Trading Range:
KES 15.90 to KES 30.50

Dividend Yield:
3.29%

Market cap:
KES 1,181.93 Bn

Estimated Free float:
25.1%

Shares Outstanding:
40.065.4 Million

Latest Full Year Results:
FY 2017

Analyst

Victor Cheruiyot Koech

+254711047133

koechv@aibcapital.com

Safaricom Limited

Strong and Steady in Choppy waters

We update our **HOLD** recommendation to a **SELL** in congruence with our updated **target price of KES 26.30.** Our new target price means that at the current price of **KES 29.50**, our valuation reveals a potential **12.16%** downside**.** The downgrade of our previous **HOLD** recommendation is mainly due to the large upswing in Safaricom's price over the last one year that has driven the market price above fundamentals. Based on Enterprise Value, Net Asset value and earnings for the FY17, Safaricom is currently trading at what we consider demanding **multiples** (**EV/EBITDA of 11.01x** and **P/B of 12.36x)** compared to the **industry median (EV/EBITDA of 7.78x and P/B of 3.94x)** despite its trailing P/E of **23.18** is the industry median. We, however, note that the market might be pricing in a premium for Safaricom's recent innovative management initiatives.

FY17 in Review: -"Fortune favours the bold"

On the 10th of May Safaricom released their Full Year 2017 results for the period ended 31st March 2017. The results were much better than our previous expectations for FY17, spurred on by Safaricom's bold and aggressive investment in its non-legacy business. The market responded to the results by going on a bull run that eventually pushed the market price above values justifiable by fundamentals.

The actual FY17 **Net Income growth of 18.2% (y/y)** was 600 basis points above our forecast. The growth was mainly driven by the **32.7% growth of M-PESA** revenues and **38.5% growth of mobile data** revenues. We were particularly impressed by the **KES 55.0 bn M-PESA revenue** and **KES 29.3 bn Mobile Data revenue** recorded in FY17. We still see a strong case for earnings growth and estimate an **EPS (y/y) growth of 14%** in FY18 to EPS of **KES 1.38** from the FY17 EPS of **KES 1.21**.

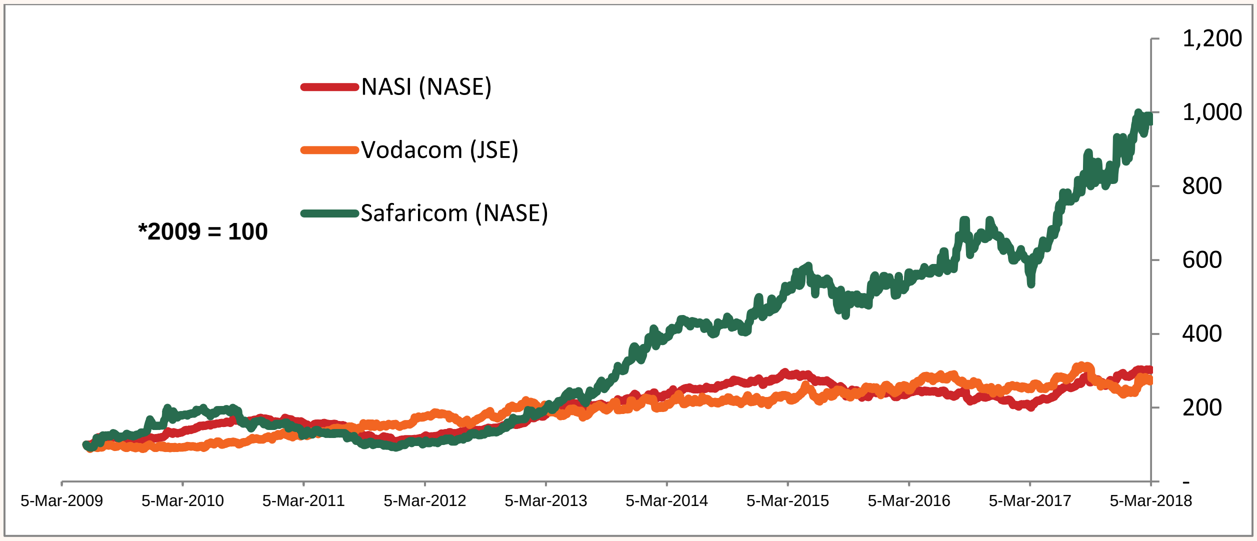
Table 1: Snapshot summary

Key Statistics	2016	2017	2018E	2019F	2020F
Revenue (KES m)	**195,685**	**212,885**	**244,309**	**283,920**	**328,713**
YoY % Change	*19.8%*	*8.8%*	*14.8%*	*16.2%*	*15.8%*
EBITDA (KES m)	**83,066**	**103,610**	**114,581**	**133,158**	**154,166**
YoY % Change	*16.7*	*24.7%*	*10.6%*	*16.2%*	*15.8%*
Net Income (KES m)	**38,104**	**48,444**	**55,581**	**66,917**	**80,119**
YoY % Change	*19.6%*	*27.1%*	*14.7%*	*20.4%*	*19.7%*
EPS (KES)	**0.95**	**1.21**	**1.39**	**1.67**	**2.00**
DPS (KES)	**0.76**	**0.97**	**1.11**	**1.34**	**1.60**
EBITDA Margin	*42%*	*49%*	*47%*	*47%*	*47%*
Net Profit Margin	*19.5%*	*22.8%*	*22.8%*	*23.6%*	*24.4%*
Trailing P/E ratio (x)	**20.14**	**22.12**	**17.69**	**14.69**	**12.27**
P/B ratio* (x)	**6.57**	**9.97**	**7.92**	**6.70**	**5.68**

Source: AIB Capital, Safaricom

CERTIFICATIONS AND REQUIRED DISCLOSURES BEGIN ON PAGE 8

Figure 1: Safaricom's stock price Performance:



Source: Bloomberg, AIB Capital

Investment Merits

- Safaricom's market dominance will translate to healthy service revenue growth going forward.
- The management's Innovative and bold differentiation strategy will deepen M-PESA and Mobile Data powering growth in segments it holds competitive advantages.
- The growth of household income in Kenya will boost demand for Safaricom's traditional and non-traditional offerings.
- Safaricom's future prospects are well supported by a strong and growing subscriber base.
- Transfer of **35%** of Vodafone shares to Vodacom will open the door to the regional expansion of Safaricom.
- The relaunch of the updated Big Box will create a distinct value proposition to its customers.
- Safaricom offers a good return to equity investors, producing a normalised ROE of **40.2%** in the latest Safaricom financial results.
- Safaricom's status as the largest taxpayer aligns the long-term interest of Safaricom with that of the government and by extension, the regulator.
- Launch of an E-Commerce platform, named Masoko, will help diversify and grow earnings.

Risks

- Communication Authority controversial award of the 700mhz 4G spectrum to JTL could bring on intensified competition to the market.
- The implementation of interoperability threatens M-PESAs growth trajectory.
- The regulatory environment remains a key impediment to Safaricom's continued dominance.
- Commercialization of 4G licenses by Airtel, Orange and JTL will put pressure on Safaricom's Mobile data revenues.
- Regional expansion strategy has the potential of exposing Safaricom to a cornucopia of risks.

Merits

Safaricom's strong market share will translate to healthy service revenue growth going forward. According to the latest data from the regulator, Safaricom grew its market share from **69.0%** of mobile subscribers in Q1 FY 16/17 to **71.9%** of mobile subscribers in Q1 FY17/18. The control of the market presents Safaricom with a great opportunity to sell more minutes of use and sell more SMS volumes to offset the decline of prices in both the SMS and voice segments. We see voice revenues continuing to baulk international trends at least in the medium term and grow albeit at a slower pace. We project that voice will grow at a **CAGR of 3.8%** in the next five years, slower than the previous five year's **CAGR of 5.4 %**.

The Innovative and bold differentiation strategy of deepening M-PESA and Mobile Data will help power growth in segments it holds competitive advantages. Safaricom is currently undertaking to differentiate their service offerings with the help of consumer analytics provider Flytxt. This strategy will be the most rewarding in M-PESA and the mobile data segment because Safaricom still holds great competitive advantages in those areas. One such innovative differentiation strategy that Safaricom has implemented is the NFC powered 1Tap that was launched in May of 2017. 1tap is aimed at reducing the number of steps in an M-PESA transaction to eight. We opine that this differentiating strategy will help keep mobile data and M-PESA growing in a competitive environment. We project that mobile data will grow at a slower CAGR of **25%** in the next five years compared to the actual historic five-year CAGR of **45%.** We also expect that M-PESA will continue to grow despite the operationalization of interoperability. We project that M-PESA's will grow at a slower five-year CAGR of **23%** compared to the **26%** CAGR witnessed in the last five years.

Income growth will boost the demand for Safaricom's traditional and non-traditional offerings. According to World Bank data, Kenya's household income grew at a **CAGR of 14.3%** in the period between 2013 and 2016. We expect that growth in income will propel the demand for more volumes of minutes of use, data, SMS and mobile transfer services. We especially see the income growth as a key driver of M-PESA revenue because higher income will lead to bigger volumes of chargeable transactions.

Safaricom fundamentals are supported by a foundation of strong and growing subscriber numbers. The growth of Safaricom's service revenue is well supported by underlying growth in subscribers. In the latest sector statistics released by Communication Authority, subscribers grew **10.5**% on a **year on year** basis to about **29.4 million** subscribers. We expect the growth of subscribers to continue driven by affordable handsets and Kenya's growing youthful population. We project that subscriber growth will grow at a **7%** CAGR for the next five years, slower than the **9%** CAGR recorded in the last five years.

Transfer of 35% of Vodafone shares to Vodacom will open the door to the expansion of M-PESA regionally. Vodafone International sold **35%** of its stake in Safaricom to Vodacom this year in return for **226.8 million** shares of Vodacom. This corporate action in our opinion is to allow for deeper collaboration between Safaricom and Vodacom that could see M-PESA introduced to some of Vodacom's **66.8 million** subscribers spread all over Africa. The ability to send mobile money across borders will definitely broaden the capability of M-PESA and hopefully, increase the volume of the chargeable transaction for M-PESA.

The relaunch of the updated big box help creates a good value proposition for its customers. This month Safaricom relaunched the android powered Big Box as Safaricom Digital TV just in time for the Christmas shopping. We see the Big Box as a very crucial piece of Safaricom's network convergence puzzle. If the Big Box recovers from its inglorious 2015 false start, it could help sell Safaricom's mobile data and promulgate its video on demand service.

Safaricom's status as the largest taxpayer aligns the long-term interest of Safaricom with the government and by extension, the regulator. Safaricom will avoid any value destroying regulation in the long run because it is in the interest of the government to keep Safaricom on its path to profitability. That is why we project that there is little probability of the regulator's proposed price controls will be implemented by the current revenue strapped government or that any other long term value destroying regulation will ever become law.

Safaricom's entry into the vibrant E-Commerce market will drive the diversification and growth of Safaricom's earnings. Safaricom's new venture, Masoko has great potential to grow Safaricom's revenue riding on the tailwinds of a young demographic and increased internet penetration in the region. Successful adoption and roll out of the platform Eastern Africa wide will mean more revenue and a more diversified business for Safaricom's long-term investors.

Risks

Communication Authority controversial award of the 700MHz 4G spectrum to JTL could bring on intensified competition to the market. This year CAK awarded JTL, a tier 2 company, a 4G license at a cost of **KES 100,000** without allowing other market players a chance to bid for the spectrum at auction. The unilateral decision also means that JTL is currently the sole owner of a spectrum that is the cheapest to operate and offers mobile data at faster speeds than the competition. If such controversial decisions were to become the norm, it could force Safaricom to compete in an unlevel playing field.

The proposed implementation of interoperability threatens M-PESAs trajectory of double-digit growth. Interoperability will reduce switching costs for users of Safaricom's M-PESA. This has the potential to scuttle the impressive momentum of M-PESA revenues that management has come to rely on to deliver positive results. We especially see M-PESA revenues from withdrawals and transfers as the most susceptible to competition from other mobile money players such as Airtel Money and Equitel.

The regulatory environment remains a key impediment to Safaricom's continued dominance. Safaricom business is constantly under pressure from a regulator who seeks to foster more competition in the industry. The June 2017 high court judgement that handed back independence to Communications Authority of Kenya will only embolden and harden its resolve of delivering its mandate. Safaricom's management and Investors should brace themselves for more far-reaching regulations deftly aimed at slashing Safaricom's market share.

Commercialization of 4G licenses by Airtel, Orange and JTL will put definitely put pressure on Safaricom's Mobile data revenues. This year 2018 has seen competition in the Mobile data space migrate to 4G, a previous bastion of Safaricom. Two operators have already launched their 4G services this year and we expect them to competitively price their mobile data to capture more market share from Safaricom. Competition in the data space will not only help democratise mobile data in Kenya but also bring down the price of data to the consumer. The new competitive focus on data in the industry will pressure Safaricom to further bring down the price of their data offerings to maintain their market share.

Regional M-PESA expansion strategy has the potential of exposing Safaricom to a cornucopia of country risks. M-PESA has become a success story since its launch ten years ago, mainly driven by demand for financial services from people who were largely ignored by the formal banking sector. There are good opportunities for M-PESA to thrive exist in the region, but that it may come with some risks. Country risks such as exchange rate risks, regulatory risks, political risks and economic risks exist in the region. We have seen Kenyan companies in the recent past grapple with the populist regime in Tanzania and come face to face with instability in South Sudan. These risks may a negative effect of Safaricom's bottom-line. Cross money transfer among the different countries could also subject Safaricom to a complex regulatory environment that will increase their cost of compliance.

HY1FY18 in Review: -

Safaricom released their H1FY18 results for the period ended 30th September 2017 on the 3rd of November, recording a **12% increase in service revenue** to KES 109.7 billion from KES 98.0 billion reported in 1HY17. Safaricom also reported an increase in earnings with an **EPS growth of 8.3% (y/y)** to KES 0.65 in H1FY18 from the EPS of KES 0.60 recorded in H1FY17. The results were laudable given the tough political and economic headwinds it faced during the period. The growth in EPS was mainly inspired by the **10.83% (y/y)** increase in total subscribers (to **29.4 million** from **26.61 million** in H1FY17) and **31%** increase in M-PESA revenues (to **KES 30.05bn** from **KES 25.87 bn** in H1FY17).

Table 2: Half Year Income Statement Highlights & KPIs

Income Statement (KES Billion)	1HY18	2HY17	1HY17	YoY % ch	HoH % ch
Voice revenue	47.35	47.76	45.70	*3.6%*	*-0.9%*
M-PESA revenue	30.05	29.21	25.87	*16.2%*	*2.9%*
SMS revenue	8.92	8.05	8.63	*3.4%*	*10.8%*
Mobile data revenue	17.55	15.89	13.40	*31.0%*	*10.5%*
Fixed service revenue	3.23	2.84	2.40	*34.6%*	*13.7%*
Other service revenue	2.63	2.35	2.01	*30.8%*	*12.1%*
Service Revenue	**109.73**	**106.10**	**98.01**	***12.0%***	***3.4%***
Total Revenue	**114.43**	**110.79**	**102.10**	***12.1%***	***3.3%***
Gross Profit	**79.12**	**76.77**	**71.80**	***10.2%***	***3.1%***
EBITDA	**54.27**	**52.80**	**50.81**	***6.8%***	***2.8%***
Depreciation & amortization	(16.74)	(16.88)	(16.35)	*2.4%*	*-0.9%*
EBIT	**37.53**	**35.92**	**34.46**	***8.9%***	***4.5%***
Earnings Before taxation	**37.82**	**34.49**	**34.49**	***9.7%***	***9.7%***
Taxation	(11.61)	(11.63)	(10.56)	*9.9%*	*-0.2%*
Net Income	**26.20**	**22.86**	**23.93**	***9.5%***	***14.6%***
Earnings per share (KES)	0.65	0.61	0.60	*8.3%*	*6.6%*

Key Performance Indicators	HY18	HY17	YoY % ch
Total customers (m)	29.49	26.61	*10.8%*
Total customer ARPU* (KES)	628.45	629.02	*-0.1%*
Churn (%)	24.58	20.62	*3.96%*
Voice ARPU(KES)	271.19	293.99	*-7.8%*
M-PESA ARPU (KES)	257.88	247.69	*4.1%*
Mobile Data ARPU (KES)	169.77	143.77	*18.1%*
SMS ARPU (KES)	51.11	55.12	*-7.3%*
Fixed Service ARPU (KES)	35,122	35,264	*-0.4%*

Growth in churn rates is of concern: In 1HFY18 Safaricom recorded **3.96%** attrition in market share to increase its churn rate to **24.58%** from **20.62%** reported during the same period last year. We should, however, point out that this loss in market share was offset by the **10.83%** growth of its subscribers.

Financial Statements

Income Statement (KES Thousands)	FY16	FY17	FY18E	FY19F	FY20F
Total revenue	195,685,224	212,885,194	244,308,978	283,920,034	328,713,061
EBITDA	83,066,273	103,609,797	114,580,910	133,158,496	154,166,426
Operating profit	55,123,727	70,375,388	79,687,479	95,834,894	114,401,843
Finance income	2,301,055	1,722,788	2,443,090	2,839,200	3,287,131
Finance costs	(1,399,507)	(1,484,860)	(2,748,974)	(3,099,254)	(3,255,864)
Share of profit of associate	104,089	18,757	19,882	21,075	22,340
Profit before income tax	55,762,505	70,632,073	79,401,477	95,595,916	114,455,449
Income tax expense	(17,658,215)	(22,187,655)	(23,820,443)	(28,678,775)	(34,336,635)
Net Income	**38,104,290**	**48,444,418**	**55,581,034**	**66,917,141**	**80,118,815**
EBITDA Margin	42%	49%	47%	47%	47%
EBIT Margin	28%	33%	33%	34%	35%
Net Profit Margin	19.5%	22.8%	22.8%	23.6%	24.4%
Diluted and Basic EPS	0.95	1.21	1.39	1.67	2.00
Weighted Average Ordinary Shares	40,065,428	40,065,428	40,065,428	40,065,428	40,065,428
Dividends	30,483,432	38,863,465	44,464,827	53,533,713	64,095,052
Ordinary dividend per share	0.76	0.97	1.11	1.34	1.60

Balance Sheet (KES Thousands)	FY16	FY17	FY18E	FY19F	FY20F
Equity attributable to owners					
Share capital	2,003,271	2,003,271	2,003,271	2,003,271	2,003,271
Share premium	2,200,040	2,200,040	2,200,040	2,200,040	2,200,040
Retained earnings	82,052,298	64,422,467	75,538,674	88,922,102	104,945,865
Proposed dividend	30,483,432	38,863,465	44,464,827	53,533,713	64,095,052
Total equity	**116,739,041**	**107,489,243**	**124,206,812**	**146,659,126**	**173,244,228**
Non-current liabilities					
Borrowings	-	-	-	-	-
Current liabilities	**42,443,538**	**54,197,753**	**58,284,352**	**66,379,977**	**75,027,025**
Total equity and liabilities	**159,182,579**	**161,686,996**	**182,491,164**	**213,039,103**	**248,271,253**
Net Plant Property and Equipment	113,419,398	117,199,063	120,160,662	122,958,749	125,913,956
Other Non-Current Assets	18,103,791	19,328,110	19,045,640	20,332,088	18,967,257
Non-current assets	**131,523,189**	**136,527,173**	**139,206,302**	**143,290,836**	**144,881,213**
Current assets	**27,659,390**	**25,159,823**	**43,284,862**	**69,748,267**	**103,390,040**
Total Assets	**159,182,579**	**161,686,996**	**182,491,164**	**213,039,103**	**248,271,253**

Statement of Cashflows (KES Thousands)	FY16	FY17	FY18E	FY19F	FY20F
Net cash generated from operating activities	64,603,473	79,527,138	102,702,514	110,970,567	127,927,305
Net cash used in investing activities	(33,299,475)	(37,726,573)	(37,552,680)	(41,387,586)	(41,332,145)
Net cash used in financing activities	(37,120,011)	(42,065,057)	(44,500,429)	(45,823,981)	(56,011,584)
Movement in cash and cash equivalents					
At start of year	12,036,018	6,220,005	5,955,513	26,604,918	50,363,918
Increase (Decrease) in cash	(5,816,013)	(264,492)	20,649,405	23,759,000	30,583,575
At end of year	6,220,005	5,955,513	26,604,918	50,363,918	80,947,493

Peer comparison:

Date: **6th March 2018**

Name	Country	EPS T12M (KES)	BVPS	Price:	P/B	P/E	EV/EBITDA
AIRTEL NETWORKS ZAMBIA PLC	Zambia	21.73	47.90	363.41	7.59	16.72	5.88
MAROC TELECOM	Morocco	69.22	199.16	1,662.87	8.35	24.02	8.97
MTN GROUP LTD	South Africa	34.19	445.90	1,076.43	2.41	31.48	7.78
SAFARICOM LTD	Kenya	1.26	2.37	29.25	12.36	23.18	11.01
TELECOM EGYPT	Egypt	8.47	103.97	71.72	0.69	8.47	6.18
TELKOM SA SOC LTD	South Africa	54.41	409.61	453.53	1.11	8.34	3.34
VODACOM GROUP LTD	South Africa	54.72	351.91	1,387.20	3.94	25.35	10.55
Median			**199.16**		**3.94**	**23.18**	**7.78**

P/E method:

FY18 EPS	1.39
X Industry Median P/E	23.18
Price	**32.16**

EV/EBITDA method:

FY18 EBITDA	114,580,910,472
X Industry Median EV/EBITDA	7.78
Entreprise Value	890,907,489,324

EV	890,907,489,324
Less Debt	(16,544,151,000)
Add back Cash	5,955,513,000
Equity Value	880,318,851,324
Number of Shares	40,065,428,000
Equity Value Per share	**21.97**

Summary:

Method	Target Value	Weighting	Weighted Value
DCF	25.47	50%	12.74
EV/EBITDA	21.97	25%	5.49
P/E	32.16	25%	8.04
Target Price			**26.27**

AIB Capital Research

Research Analysts,
AIB Capital Research

Willis Nalwenge
nalwengew@aibcapital.com
(+254) 711047105

Victor Koech
koechv@aibcapital.com
(+254) 711047133

Equity Dealing Desk

Chief Dealer,
AIB Capital Equities

Bernard Kung'u
kungub@aibcapital.com
(+254) 711047108

Head of Institutional Trading,
AIB Capital Equities

Bernard Gichuru
gichurub@aibcapital.com
(+254) 711047111

Equities and Derivatives trader,
AIB Capital Equities

Brian Tanui
tanuib@aibcapital.com
(+254) 711047124

Research Disclosure

NOTICE TO US INVESTORS

This report was prepared, approved, published and distributed by AIB Capital Limited Company located outside of the United States (a non-US Group Company"). This report is distributed in the U.S. by LXM LLP USA, a U.S. registered broker-dealer, on behalf of AIB Capital Limited only to major U.S. institutional investors (as defined in Rule 15a-6 under the
U.S. Securities Exchange Act of 1934 (the "Exchange Act")) pursuant to the exemption in Rule 15a-6 and any transaction effected by a U.S. customer in the securities described in this report must be effected through LXM LLP USA.
Neither the report nor any analyst who prepared or approved the report is subject to U.S. legal requirements or the Financial Industry Regulatory Authority, Inc. ("FINRA") or other regulatory requirements pertaining to research reports or research analysts. No non-US Group Company is registered as a broker-dealer under the Exchange Act or is a member of the Financial Industry Regulatory Authority, Inc. or any other U.S. self-regulatory organization.
Analyst Certification. Each of the analysts identified in this report certifies, with respect to the companies or securities that the individual analyses, that (1) the views expressed in this report reflect his or her personal views about all of the subject companies and securities and (2) no part of his or her compensation was, is or will be directly or indirectly dependent on the specific recommendations or views expressed in this report. Please bear in mind that (i) AIB Capital Limited is the employer of the research analysts responsible for the content of this report and (ii) research analysts preparing this report are resident outside the United States and are not associated persons of any US regulated broker-dealer and that therefore the analysts are not subject to supervision by a US broker-dealer, and are not required to satisfy the regulatory licensing requirements of FINRA or required to otherwise comply with US rules or regulations regarding, among other things, communications with a subject company, public appearances and trading securities held by a research analyst account.
Important US Regulatory Disclosures on Subject Companies. This material was produced by Analysis AIB Capital Limited solely for information purposes and for the use of the recipient. It is not to be reproduced under any circumstances and is not to be copied or made available to any person other than the recipient. It is distributed in the United States of America by LXM LLP USA and elsewhere in the world by AIB Capital Limited or an authorized affiliate of AIB Capital Limited. This document does not constitute an offer of, or an invitation by or on behalf of AIB Capital or its affiliates or any other company to any person, to buy or sell any security. The information contained herein has been obtained from published information and other sources, which AIB Capital Limited or its Affiliates consider to be reliable. None of AIB Capital Limited accepts any liability or responsibility whatsoever for the accuracy or completeness of any such information.
All estimates, expressions of opinion and other subjective judgments contained herein are made as of the date of this document. Emerging securities markets may be subject to risks significantly higher than more established markets. In particular, the political and economic environment, company practices and market prices and volumes may be subject to significant variations. The ability to assess such risks may also be limited due to significantly lower information quantity and quality. By accepting this document, you agree to be bound by all the foregoing provisions.
LXM LLP USA assumes responsibility for the research reports content in regards to research distributed in the U.S. LXM LLP USA or its affiliates has not managed or co-managed a public offering of securities for the subject company in the past 12 months, has not received compensation for investment banking services from the subject company in the past 12 months, does not expect to receive and does not intend to seek compensation for investment banking services from the subject company in the next 3 months. LXM LLP USA has never owned any class of equity securities of the subject company. There are not any other actual, material conflicts of interest of LXM LLP USA at the time of the publication of this research report. As of the publication of this report LXM LLP USA, does not make a market in the subject securities.