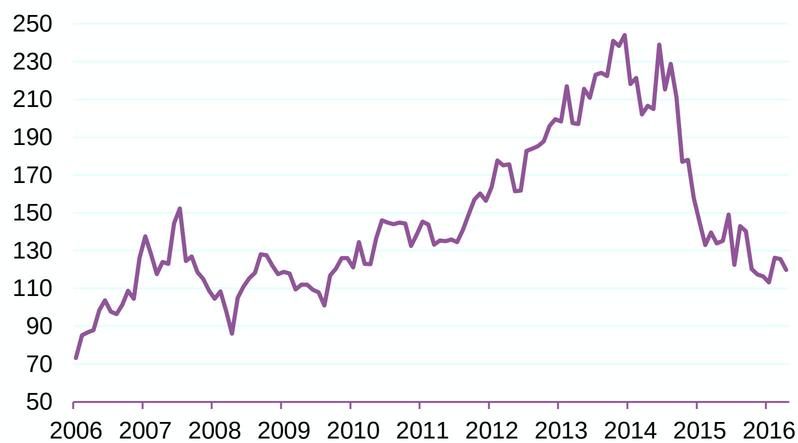
MTN: LOOKING BEYOND THE NEAR TERM

Mahomed Ibrahim, B Bus Sci (Act Sci), CFA, Analyst

MTN is facing challenges on many fronts resulting in a murky near term outlook. This has been weighing on its share price which has fallen by almost 60% since peaking in 2014. The share was last at these levels more than 6 years ago.

Figure 1: MTN Share price



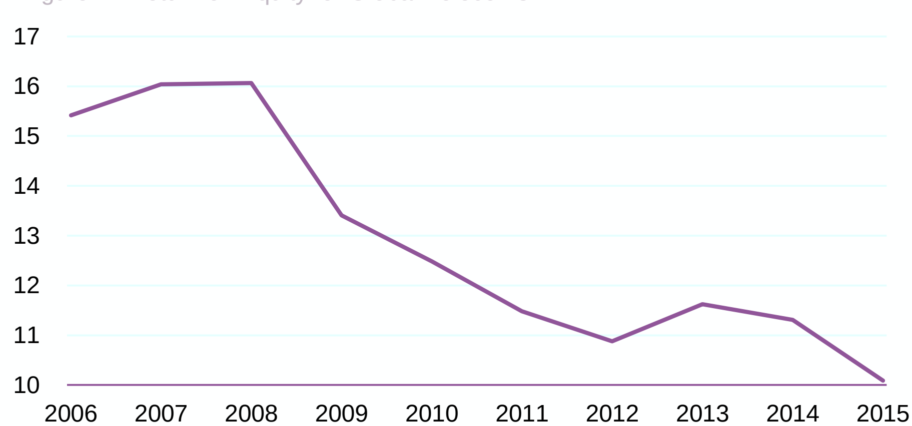
Source: Bloomberg

Looking out beyond the next few years, we expect some of these challenges recede, which gives us now an opportunity to invest in MTN at a level below our determination of its intrinsic value.

STRUCTURAL CHANGE

The Mobile Telecommunications industry is structurally changing. Voice traffic, which is highly profitable because of a strong licence advantage, is giving way to data traffic which is more commoditised. While strong data traffic growth has been more than offsetting price declines in the recent past, this has required high capital investment. The result has been declining margins and returns on capital for the industry.

Figure 2: Return on Equity for Global Telecoms$^{\alpha}$



Source: Company reports, Perpetua research

$^{\alpha}$Median of the 5-year rolling average of 8 of the world's largest telecommunication companies

INVESTMENT COMMENTARY (continued)

MTN is less affected by this change. Its exposure to Emerging Markets with low levels of smartphone penetration and young populations bode well for network traffic growth.

The company also identified this structural shift early on. To protect its competitive advantages, it has adopted a strategy to leverage off its brand and network advantages and move up the value chain into entertainment, e-commerce and financial services.

"it is clear that the industry has entered a new phase, with slower growth and heightened competition. The reduced growth of voice revenue and the abundance of internet-centric applications and connectivity from a wide range of service providers have put traditional mobile operators under severe pressure to develop new sources of revenue.
This challenge is further compounded by acute regulatory pressures to reduce tariffs in many markets. In light of this… a great deal of effort is being invested on innovation..."

- Phuthuma Nhleko, 2013 Financial Report

To show how serious MTN is about this change, it has:

- Begun selling cellphone towers - a key infrastructural advantage to voice traffic.
- Invested in internet businesses with e-commerce, taxi hailing and food delivery offerings.
- Invested in data-hungry music distribution, gaming development and entertainment content.
- Focused its management hiring on people with financial services and M&A experience.
- Prioritised the success of this strategy in management's KPIs (key performance indicators).

While it is still early stages on what will be a long road to replace its weakening competitive advantages, we think that these are all positive steps. Additionally, along the way this will feed data traffic growth with these services already accounting for a third of all data traffic on MTN's network.

CYCLICAL CHALLENGES

The economies of two of MTN's key markets, Nigeria and Iran, are largely oil-dependent. The 2014 collapse in the oil price has therefore resulted in poor economic growth, weakening local currencies and foreign currency shortages in these countries. For MTN, this has meant weak customer spend, lower revenue when translated back to South African Rand, weaker profit margins and diminished capital investment.

In addition, a second level effect has been increased regulatory risk. This has been most apparent in Nigeria where, in 2015, the regulator imposed what was then the largest ever fine on a telecommunications company globally. This pressure has continued with MTN currently under investigation for tax avoidance.

We believe that these are all cyclical challenges and will normalise over time. More importantly, we believe that the worst is over in these economies and it is unlikely that they will deteriorate further from here.

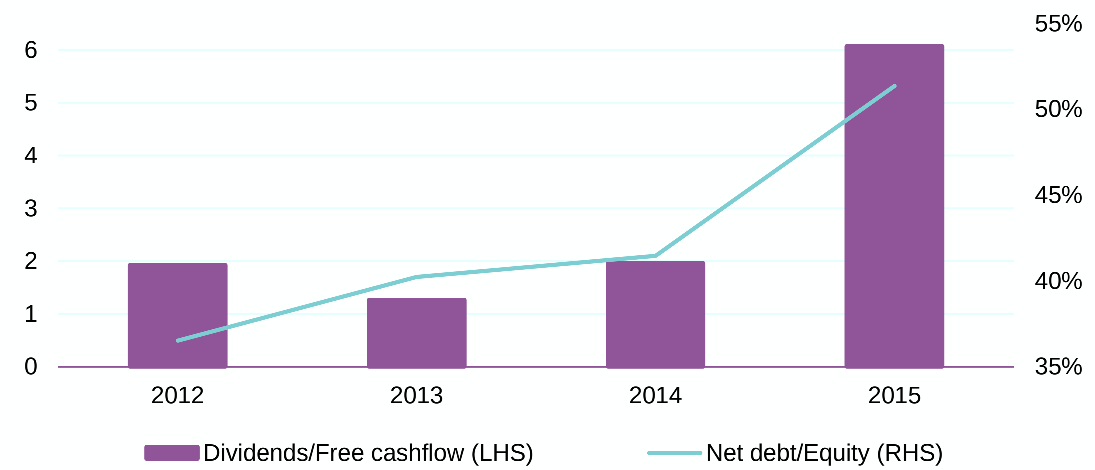
SELF-IMPOSED CHALLENGES

Over the past four years, MTN appears to have underinvested in its network in Nigeria over the past 4 years – spending significantly less than its competitors were spending and what was being spent in South Africa. The company was also late in rolling out the highly profitable 4G services in South Africa.
Instead the company appeared to have prioritised paying dividends, gearing up the balance sheet to do so. (refer to Figure 3).

Notably less than satisfactory internal controls within MTN Nigeria was also a notable feature in the business resulting in a fine of a significant amount of US$1.3bn levied on the company due to not disconnecting unregistered SIM cards within legislated periods. This latter point highlighted a potential culture of poor governance and controls within the company.

INVESTMENT COMMENTARY (continued)

Figure 3: Dividends have been higher than cashflow



Source: Company reports, Perpetua research

Catalysed by this material Nigerian fine, MTN has begun to address these issues and taken the following steps:

- Significantly overhauled its management team at the Group level and in Nigeria by bringing in highly rated and well-experienced executives.
- Rebased it dividends to a more sustainable level.
- Prioritised capital investment in key areas.
- Changed risk management procedures.
- Vastly improved corporate governance.

We believe that these actions will prove to be a turning point for the operations and strengthen the business going forward.

SUMMARY

MTN is indeed facing some notable near term challenges - its competitive advantages are weakening and it is operating in a very tough environment. Its current share price reflects the markets expectations for these headwinds to continue well into the future. We believe that this is unlikely as management are taking positive steps to address the issues within their control, while many of those outside of their control are cyclical and will normalise over time.

The share price of the company does not appear to be discounting this potential operational improvement into the medium term with the market focusing more on the near term factors such the headwinds of continued weakness in the Nigerian currency and short term earnings pressures (affected by one-off factors).

We have used the depressed share price to increase our exposure and invest in a business which is still highly cash generative, pays an attractive dividend and currently discounts very low expectations for a turnaround. In our examination of the detail, the actual business case for the investment is progressing steadily and once the market starts to see evidence of this operational recovery, so too will this be reflected in a meaningful share price recovery.