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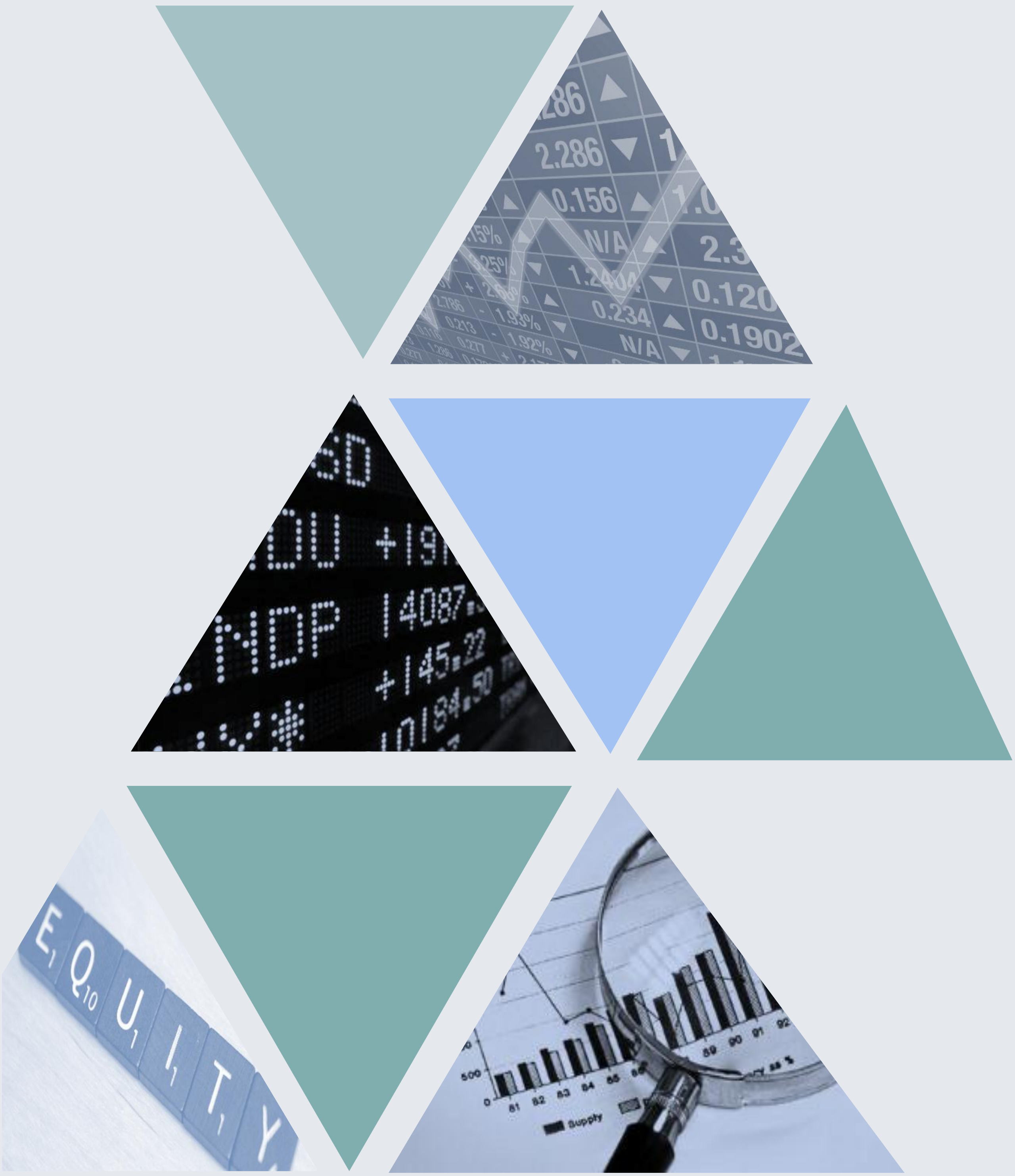

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Telkom Limited

Telkom is a leading communications service provider in South Africa, which listed on the JSE main board in March 2003 under the share code TKG at R28 per share. The share price climbed as high as R90 per share by 2007, but drastically fell to R55 per share when Vodacom was unbundled from Telkom. Telkom has various investors with the government of South Africa holding 39% of the shares, institutional investors holding 51% shares and the remaining 10% of shares being held by others (non-institutional investors, Telkom treasury shares and miscellaneous). Institutional shareholders are spread across the world with 45% of the institutional investors being in the United States of America, 41% of the institutional investors located in South Africa and the others are located in different parts of Europe.

Telkom offers fixed line, mobile, ICT and data services to business and consumer markets and other ICT products to meet the needs of its customers. Telkom has for many years been the only provider of fixed-line telecommunication in South Africa, until Neotel came to the fore and provided some competition to Telkom. Telkom's biggest competitors on mobile telecommunications are Vodacom and MTN (covered in Issue 2 & 5). Table 1 below shows each company's performance in the past financial year. Vodacom generated the most operating revenue of R62.28 billion and had the highest closing share price at its financial year end of R160.53. Telkom generated operating revenue of R37.33 billion and its share price closed at R57.57 at year end. Telkom's revenue also includes 7 months of revenue generated by Business Connexion, which was acquired by Telkom to boost Telkom's revenue.

Table 1: SA's Largest Mobile Network Companies

	Operating Revenue (R'million)	Market Capitalisation (R'million)	Share price at year end (Rands)	NAV per share (Rands)	Year end
Vodacom SA	62 278	238 028	160.53	1 647.16	Mar-16
MTN	40 038	239 726	138.67	7 931.16	Dec-15
Telkom	37 325	35 163	57.57	4 959.49	Mar-16

Source: Telkom Integrated Report 2016, Investec W&I and EAR

Telkom acquired the entire issued capital of Business Connexion (BCX). BCX provides innovative business solutions based on information and communication technology runs ICT systems and managed products, services and solutions for a wide range of customers in South Africa, the UK and Dubai. The merger will enable Telkom to expand its existing offerings, provide scale in IT and enhance Telkom's convergence strategy. BCX has 13 subsidiaries that have operations in South Africa, Mozambique, Zambia, Kenya, Botswana and other parts of Africa. The subsidiaries offer different services ranging from ICT solutions, integrated banking and payment software platforms, BankOne – the world's leading cloud infrastructure for banking and payment processing targeted at small and medium financial institutions. The subsidiaries also offer training solutions, provision of computer hardware, software licensing, IT outsourcing and resourcing. The subsidiaries are also involved in developing cryptographic technology, provision of point of sale and retail solution, maintenance of point of sale solutions and provision of people management solutions (e.g. biometric access control, human resource management and time and attendance solutions, etc.). BCX services various clients across different sectors including mining and resources, public sector, retail, petrochemical, financial services and automotive.

Telkom's Operating Environment

The Middle East and Africa regions, which are Telkom's operating regions, are expected to reflect the highest growth worldwide in mobile and fixed broadband subscriptions with growth expected to be 3.1% and 8.5% respectively according to Ovum. This means that Telkom has the potential to grow its customer base to substitute the declining use of fixed-line voice. The Middle East and Africa market for mobile data and fixed broadband is expected to grow by 8.5% and 13.3% respectively. Telkom, through BCX will be able to tap into the Middle Eastern market and the rest of Africa where BCX has subsidiaries.

The acquisition of BCX boosted Telkom's revenue by adding R 4.8 billion to operating revenue. The increase in revenue is also attributable to higher data revenue, higher fixed-line subscription and higher equipment sales; all these gains were partially offset by the decline in fixed-line voice revenue and lower connectivity revenue. BCX was only part of Telkom for 7 months and has the potential of contributing R 8.22 billion (estimated) towards revenue in a full year of operating. The acquisition of BCX will allow Telkom to grow its customer base, diversify its operations and improve and streamline some of its internal functions through using the services provided by BCX, which will help Telkom meet its objective of becoming a leading provider of converged ICT solutions. The newly formed partnership between Telkom and BCX has allowed Telkom to embark on being Africa's premium end-to-end digital solutions partner. The world and businesses alike are becoming digitized. Telkom and BCX will be the premium digital solutions partner through offering cloud computing services to businesses in all industries, deploying big data , providing highly customized solution to suit unique requirements of every business, machine to machine communication, interconnected network of physical devices with valuable business data and robotics. Telkom and BCX have done extensive research on how digitalization can be applied and deployed in the various sectors like education, health and mining. This research and partnership puts Telkom ahead of ICT companies as it has the potential to be the provider of choice for companies and industries that are about start and those that have started the digital migration. This new offering to customers has the potential to increase Telkom Business revenue and allow Telkom to dominate the so-called future business industry. Telkom is diversifying its product offering for businesses and using the advancement of technology to its advantage. The synergies that exist between Telkom and BCX will allow Telkom to penetrate other African countries, Dubai and the UK through its current Telkom business offering and the future business offering.

Telkom's New Disruptive Offering

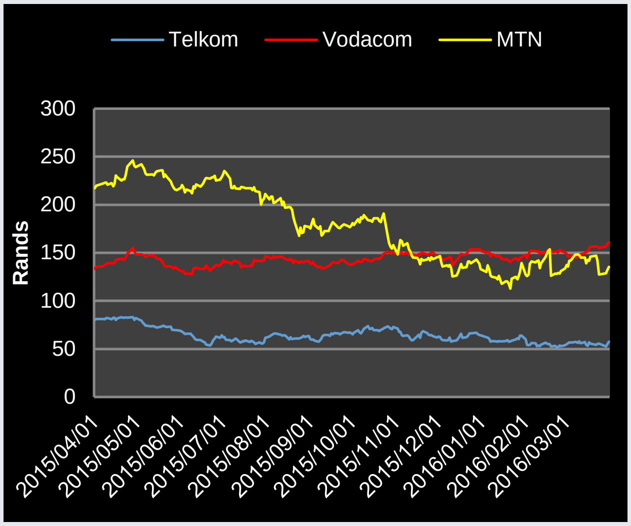
Telkom launched the "FreeMe" packages on 21 July 2016 which are sim only contracts and can also be linked to cell phone contracts (device inclusive). The "FreeMe" packages offer aggressive pricing and a simple product. Each "FreeMe" contract includes free calls and free messaging on WhatsApp, BBM and Viber, as well as free on-network calls (Telkom to Telkom) and free 50 messages per day. These new contracts offer stiff competition to Vodacom and MTN as we live in information driven society and data prices have been high for many years, because the "FreeME" contracts provide cheaper data bundles compared to packages offered by competitors. Telkom may gain new customers because of this offering and grow its market share in the mobile telecommunications sector. The offering of the "FreeMe" packages will also aid Telkom in its convergence objective.

Share Performance

Telkom's share price at the beginning of its financial year (1 April 2015) opened at R80.20 and by the end of its financial year; the share price had plummeted by 28% to R57.57. The average return was -0.10 % for the 1 April 2015

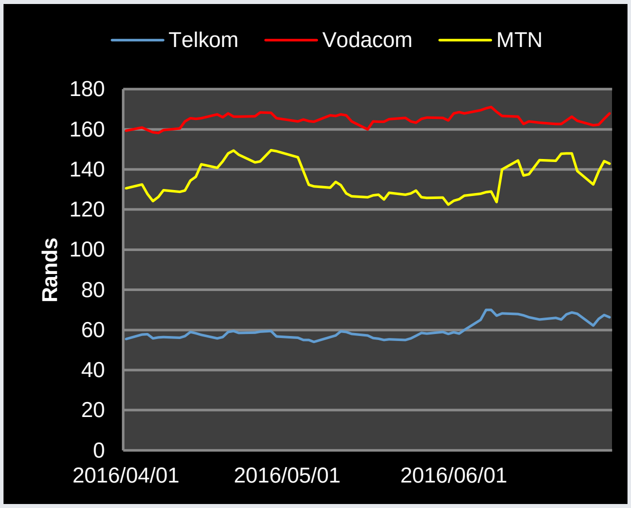
– 31 March 2016 period. Figure 1 and Figure 2 below respectively shows Telkom's share performance against its competitors for the 12 months ended 31 March 2016 and Quarter (Q1) ended 30 June 2016.

Figure 1: Share performance against competitors at year end



Source: I-Net and EAR

Figure 2: Share performance against competitors Q1



Source: I-Net and EAR

Telkom's share price started to improve in the first quarter of the 2016/17 financial year (1 April 2016 – 30 June 2016) with an average daily return of 0.33%. The daily returns were higher than that of its competitors, Vodacom and MTN, which had average daily returns of 0.09% and 0.19%, respectively. The share growth of the first quarter was 19% which is mainly attributable to Telkom releasing a good set of financial year end results on 6 June 2016 and declaring a dividend of R2.70 per share (26% increase from the previous year). The share price increased by 8% on 6 and 7 June 2016 respectively, reaching the R70 per share mark on 7 June 2016. It should also be noted that over these two days (6 and 7 June 2016) the volumes were the highest for the quarter with 3 784 738 shares being traded on the 6th of June and 5 393 741 shares being traded on the 7th of June.

Forecasted Share Price

A stressed random walk model was applied to forecast Telkom's share price. Table 2 below shows the actual share price from 1 July 2016 – 26 August 2016 as well as the forecasted share price until the end of the second quarter (Q2), ending on 30 September 2016.

Table 2: Actual share price for 1 July 2016 – 26 August 2016 and forecasted share price for the remainder of Q2 (up to 30 September 2016)

	Telkom - Actual (Rand per share) 1/7/16 - 26/8/16	Telkom - Forecasted (Rand per share) 29/8/16 - 30/9/16
Average	64.53	62.15

Source: I-Net and EAR's workings

For the observed period of 1 July 2016 to 26 August 2016 the average actual share price was R64.53 per share. For the remainder of Q2 (ending 30 September 2016), Telkom shares are expected average R62.15 for the forecasted period.

Telkom has the potential of becoming a significant player in the mobile telecommunications industry. This is informed by the expected synergies from the BCX acquisition coming into full swing in the current financial year. Becoming the provider of choice for end-to-end digital solutions provider and the growth in its mobile communication market may boost Telkom's business prospects. Revenue from the introduction of the "FreeMe" packages and the convergence strategy being fully implemented in all regions of its operations has the potential of making Telkom a market leader.

Telkom is on a growth trajectory thus there is potential of the share price growing. Caution should be exercised when trading (either buy/sell) Telkom shares because it is becoming a complex technological company (tech-company) therefore the readers need to understand the business and its advancements in technology. There is also a possibility of synergies between Telkom and BCX may not come to fruition in the expected time frame. There is also the risk of businesses and industries being slow to digitize, thus hampering on its digital solutions business. The policy uncertainty on moving terrestrial signals over to digital by the Department of Telecommunications and Postal Services has the potential of hampering Telkom's mobile communications growth as the spectrum that was expected to be freed up by this policy is delayed and thus will not allow Telkom to receive the much needed spectrum to connect more people to its network and improve its internet speed.

Contributor: Tlhologelo Dan Mphelo

For queries please email: earesearchj203@gmail.com or the contributor on tlholodan@gmail.com

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FirstRand Limited

FirstRand ranks among the top list of Africa's largest banking groups that has consistently created shareholder value over the past few years. FirstRand's latest integrated report for the year ended 31 December 2015 shows that the group's reported return on equity (ROE) stood at 24.7% as at year end in 2015 from 18.7% in 2011, representing a compounded annual growth rate of 7% in shareholder value creation. Over the same period the group's reported cost of equity declined from 14.3% to 13.5%, implying that the minimum return expected from FirstRand by the group's shareholders has been declining.

The table below shows how FirstRand compares to other local banking groups in terms of assets (risk weighted assets) and the capital the banking groups have on their books in order to manage the risk that the assets pose. Whilst Barclays Africa may have the largest risk weighted asset base, the group has a relatively lower base capital (CET1 in terms of Rands and percentage) to absorb the risks that its asset may pose to the bank, although Barclays's CET1 is well above the minimum required of 6.5%. FirstRand's asset base is the second largest in the SA banking industry; however, the bank has the highest equity to absorb any risk that may be posed by its assets, which allows FirstRand to have the highest CET1 ratio.

Table 3: Risk Weighted Assets and Core Capital of SA's Largest Banking Groups

	Barclays Africa	FirstRand	Standard Bank
Risk Weighted Assets (RWA) - R billions	703.00	634.00	620.00
Base regulatory capital (CET1) - R billions	83.66	88.13	79.98
CET1 (%)	11.9%	13.9%	12.9%
Information is based on results as at 31 December 2015			

Source: FirstRand's 2015 Annual Report and Standard Bank's 2016 Banking Report

Investors choosing to invest in banks often overlook or ignore the importance of regulation. Bank regulation has intensified over the past few years to reduce the probability of banks failing and to reduce excessive risk-taking by banks. However, these measures have had cost implications for banks and have limited banks' abilities to generate significant returns. This is something FirstRand's chairman has highlighted to shareholders more than once. The main regulatory consideration for FirstRand and other SA banking groups is Basel III. Basel III, through the capital adequacy ratio (CAR), net stable funding ratio (NSFR) and liquidity coverage ratio (LCR) requires banks to hold a percentage of capital (mainly equity) to absorb the risk they take, have stable capital in the form of liabilities and equity to fund relatively long-term loans they advance to customers as well as have sufficient and appropriate liquidity to meet short-term outflows.

Why is the analysis of the FirstRand's regulatory ratios important? Assuming FirstRand was failing to meet/keep to minimum capital requirements, any profits reported for the year would not be declared as dividends as the profits would be retained as equity to build the capital base of FirstRand to ensure the bank has sufficient equity relative to its assets (risk weighted assets). A low CAR is not ideal as it limits the bank's dividend policy, risk taking or its ability to increase assets (the likes of FNB, RMB and WesBank may be restricted in terms of issuing loans that bear higher risk weights in terms of Basel).

For EAR, any restrictions on FirstRand's dividend policy may be viewed as unattractive considering the unattractive returns/losses on FirstRand's share price over the last 6 months of the 2015 financial year. The share declined by 19.33% over the same period (assuming an investor bought shares on 1 July 2015 and was assessing the performance of the shares on 31 December 2015). The returns over the past 6 months of the new financial year have improved significantly as the share gained 8.66% (4 January 2016 up to 4 July 2016). Due to the negative returns generated by an investor over that period, the dividend policy becomes very crucial in assessing shareholder returns. Assuming FirstRand was struggling to meet the minimum capital requirements or was close to the minimum requirements, management of the group would most likely impose dividend restrictions or change FirstRand's current dividend policy of a dividend cover ratio of 1.8 times to 2.2 time (45% to 56% of profits for the year will be declared as dividends). The importance of FirstRand meeting/keeping to its capital requirements mean that the banking group will be in a position to transfer shareholder value created through the declaration of dividends as opposed to retaining entire profits to comply with Basel. An investor who would have experienced a decline in the value of an investment in FirstRand (19% decline in the share price as mentioned above) would have been compensated through the dividends, hence it is important to assess Basel ratios and the buffers the bank has in terms of Basel compliance.

The Importance of Understanding Shareholder Value Creation Measures

FirstRand constantly refers to the ROE (return on equity) versus the COE (cost of equity). EAR is of the opinion that these two variables should be contextualized, assessed independently and should not be compared. The COE is an implied cost using capital asset pricing model (CAPM), which is out of FirstRand's control. If the market, in this case the JSE ALSI (All Share Index) or Banking Index, generates lower excess returns above the government benchmark bond yield, then the expected implied return (or COE) for FirstRand would be lower assuming a beta of 1 or less than 1. The ROE is something that is within FirstRand's control as it reflects the group's efficiency, prudent capital allocation as well as profitability, which has to link to the changes in its assets (mainly loans issued). Therefore, the ROE should be assessed in the context of returns generated to maintain the bank's regulatory capital (achieve previous year's ratio as a bare minimum) and returns over and above regulatory requirements. The COE or "implied cost" should be assessed against the returns generated from the share price.

ROE In Excess of the Base ROE or Compulsory ROE

The COE for FirstRand for the 2015 financial year was 13.5%, whilst FirstRand's internally calculated ROE was 24.7%, which is based on normalized headline earnings divided by average normalized shareholders' equity. EAR's calculation of FirstRand's ROE (profit for the year and ordinary equity after taking into account preference and ordinary dividends) was 10.4%. EAR believes the ROE should be assessed in the context of excess returns generated over and above compulsory returns. Compulsory returns or base ROE refers to the profit that FirstRand would need to generate to maintain/protect its capital base measured against its assets, which then reflects whether the changes in asset levels resulted in efficiencies. Any profits above the compulsory profits represent an excess ROE. FirstRand grew its risk weighted assets to R634 billion in 2015 from R572 billion, implying that FirstRand needed to generate an adjusted ROE of 8.7% in 2015 to maintain its CET1 of 13.9%. The group generated excess returns shown by an adjusted ROE of 10.4%, implying that FirstRand generated equity returns to protect and maintain its capital base from the previous financial year (8.7%) and a further 1.7%. In Rand terms, FirstRand generated a compulsory equity return of R1 (after paying all dividends) as well as an extra R0.23 indicating that the bank's risk management in terms of capital improved even after satisfying all dividend expectations.

Cost of Equity (COE)

EAR calculated the bank's expected COE using capital asset pricing model for the past 6 months of the 2016 financial year. The COE equated to 8.49% mainly due to the lower excess returns generated by the market and FirstRand having a beta coefficient of 0.89. Over the same period, FirstRand's shares gained 8.66% implying that FirstRand investors received a return that was marginally above the shareholders' expected minimum return (represented by alpha). Only Standard Bank shares generated better returns than FirstRand and a better alpha than FirstRand's shares in the banking index as shown below. One thing readers need to be aware of is that CAPM has its unique limitations. Over the first 6 months of the 2016 calendar year, which is identical to FirstRand's financial year, the JSE ALSI returns did not exceed the government benchmark bond yield, referred to as the risk-free rate. Because EAR wanted to assess the returns in the first 6 months of 2016 to compare to the cost of equity over the same period, the observation period could not be extended and therefore the only ideal option was to use sub-indices some of which FirstRand is part. The Banking Index was the only index of which FirstRand was part and generated returns in excess of the risk-free rate. The returns in this index were then used to calculate the beta (after checking the linear relationship between FirstRand's share returns and the Banking Index returns).

Table 4: Key Share Data of FirstRand and Standard Bank

	FirstRand	Standard Bank
Average share price (Rands)	44.17	141.24
Share gain since the start of the year (%)	8.66%	13.43%
Cost of equity (COE) - using CAPM	8.49%	8.47%
Beta (relative to banking index)	0.8897	0.6721
Excess returns for share investors (Alpha) (%)	0.17%	4.95%
All variables reflect observations from 4 January 2016 to 4 July 2016		

Source: I-Net and EAR

Descriptive Statistics

Table 5: Key Share Data of FirstRand and Other Banks

2016 (Jan - July)	Barclays Africa	FirstRand	Investec Limited	Nedbank	Standard Bank	Capitec	Banking Index
Average share price (Rands)	141.21	44.17	103.93	181.26	118.71	543.42	
Average daily returns (%)	3.86%	9.94%	-1.73%	0.07%	6.69%	3.74%	6.19%
Skewness of the returns	-0.211	-0.310	-0.894	-0.209	-0.544	-0.516	-0.570
Kurtosis of the returns	2.619	2.523	3.985	2.270	2.248	1.916	-0.339

Source: I-Net and EAR

The table above is important when assessing the performance of the banking groups. As mentioned above, the Banking Index was determined as an appropriate benchmark or market due to the "acceptable returns" as well as the strong linear relationships of the returns with the banks, including FirstRand, relative to the JSE All Share Index (ALSI) and Financials15 index. FirstRand's daily average returns were the highest in the banking industry (although the share gain was the second highest to Standard Bank). What may be interesting for FirstRand shareholders are the moderately negatively skewed daily returns.

Net Stable Funding Ratio (NSFR) for FirstRand

NSFR will likely force FirstRand to issue more long-term debt for funding as they move away from short-term debt in an attempt to maintain its high NSFR of 107% (compared the minimum requirement of 100% and the second best in the SA banking market of 104% - Nedbank). Whilst convention suggests that this may impact FirstRand's net income margins due to an expected high cost of funding, EAR thinks long-term debt issuances may possibly have an opposite effect, though marginal if it happens. This is because more long-term debt/bond issuances by FirstRand may enhance the liquidity and attractiveness of FirstRand's debt instruments. EAR's inaugural fixed income edition touches on some of FirstRand's debt instruments (link to the fixed income reports: http://earesearch.co.za/FIReports.html).

It would be interesting to see how FirstRand responds over time as the COE has been declining, implying it may be "cheaper" to issue equity due to the implied lower expected returns whilst Basel rules may indirectly enhance attractiveness of FirstRand's longer-term debt, due to issue sizes of long-term debt increasing, resulting in long-term debt liquidity. EAR believes equity may be a better option for the bank to maintain margins and profitability if debt adversely impacts margins due to the use of longer term debt and the need to keep a high NSFR. Assuming the cost of longer-term debt increases for FirstRand, the bank will likely cut back on normal long-term loans and allocate more capital to residential mortgages as they carry lower risk factor weightings in terms of Basel, if the intention is to fund more long-term assets. The other outcome could be FirstRand (through RMB, FNB and WesBank) not extending conventional loans to corporate clients and proposing corporates to issue bonds as they carry "good ratings" for NSFR purposes due to their liquidity as opposed to conventional loans that are not liquid.

EAR's View on FirstRand

Investing in FirstRand or any other listed bank goes beyond analyzing the net interest margin, cost to income as well as other conventional ratios. Regulatory compliance is an element most investors overlook and often under-price when buying shares in banking groups such as FirstRand. In terms of regulatory compliance and risk management; FirstRand appears to be ahead, which gives the banking group sufficient space to focus on generating returns and adding value as opposed to creating value to comply. EAR believes this as a significant component that will differentiate FirstRand from other banking groups in SA as to how they go about their operations going forward. However, we urge readers to be mindful and monitor the regulatory implications. The regulatory aspect is a significant "cost" that the banks need to bear.

Whilst EAR may believe that FirstRand has some breathing space to focus on generating shareholder value, it would be prudent to also assess the possible share price paths. FirstRand's share price between 1 July 2016 and 22 August 2016 averaged R47.73 with a minimum of R42.23 and a maximum of R50.40 during this period. The skewness of the prices, which reflects the frequency of the prices (with regards to trading in the red or green relative to the average price), indicates that most of the time FirstRand shares were trading in the green (i.e. trading close to the maximum of R50.40). By implication, relatively high share prices occurred more frequently within the stated historical range (R42.23 – R50.40).

EAR used a pricing technique that could capture extreme prices within the stated parameters. This was done in an attempt to capture extreme low share prices in spite of the low share prices occurring less frequently (within the stated average and standard deviation). According to the EAR's quantitative technique, FirstRand shares are not expected to trade above R51.46 over the next 35 trading days commencing on 22 August 2016 given a 95% confidence interval. Therefore, (the share price is not expected to trade above R51.46 – 95% of the time over the next 35 trading days. For those who intend on selling FirstRand shares need to be mindful of the price. In addition, the share price is expected to trade above R43.90 – 95% of the time, over the same period. This is important to note for readers who might want to buy FirstRand at lower levels. Assuming the moderate negative skewness observed in July and August continues over the next 35 trading days; EAR expects FirstRand shares to close at higher share prices (leaning towards the 95% percentile, with the median (50% percentile) being above the average). EAR urges readers to be mindful of these possibilities and carefully weigh the probabilities to suit their investment decisions.

Contributor: Letlhogonolo Modungwa CA (SA)

For queries please email: earesearchj203@gmail.com or the contributor on letlogonolomodunugwa@ymail.com

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Disclosures

Some EAR contributors hold shares in Telkom and FirstRand.

Terminology

The following terms used in the above analysis are defined as follows:

- *Biometric access control:* access controls using the human physic e.g. fingerprint access and retina scanners.
- *Convergence strategy:* a combination of two or more different technologies in a single device.
- *Cryptographic technology:* technology used to convert ordinary information into unaccessible information for security reasons (encryption).
- *Fixed broadband*: High-speed data transmission (internet) to homes and businesses using cables.
- *Fixed-line telecommunication:* A landline telephone.
- *Integrated banking:* wireless banking services integrated with conventional banking activities e.g. internet banking and cellphone banking.
- *Payment software platforms:* technologies/applications that allow for online payments e.g. PayPal.
- *Basel:* an international business standard that requires financial institutions to maintain enough cash reserves to cover risks incurred by operations.
- *Capital adequacy ratio (CAR):* the ratio of a bank's capital to its risk weighted assets.
- *Liquidity coverage ratio (LCR):* a Basel III ratio defining the amount of liquid assets that financial institutions are required to hold.
- *Net stable funding ratio (NSFR):* a Basel III ratio calculating the amount of available stable funding relative to the amount of required stable funding for a financial institution over the next year.
- *Risk weighted assets:* a bank's assets or off-balance-sheet exposures, weighted according to risk. This asset calculation is used in determining the CAR for a financial institution.

Disclaimers
