THE STRAIGHT TALKING
CURVED THINKING
QUARTERLY

TANTALUM CAPITAL

QUARTERLY REPORT
ISSUE 04
31 DECEMBER 2013

IS TALK BECOMING CHEAP?

The South African Telecommunications industry has been the subject of considerable news flow over the past quarter. During October 2013, the Independent Communications Authority of South Africa (ICASA) announced a new glide path to reduce the Mobile Termination Rate (MTR) from 40 cents presently to 10 cents in 2016. A final decision is expected in this regard at the end of January 2014. ICASA's objective is to reduce the cost of mobile telecommunication services by reducing the amount mobile operators charge each other for connecting and terminating a call onto a competitor's network. Through the MTR cut, the price floor for calls is reduced as it would be economic suicide for a telecommunications company (Telco) to offer a subscriber minutes at a lower cost than the MTR (to other networks).

Telco's have very high barriers to entry as the regulator allocates scarce spectrum and large capital outlays are required. This is the ideal breeding ground for oligopolistic market structures to become entrenched. To promote competitiveness, ICASA proposed a significant increase in the percentage of asymmetry relating to smaller operators. This means that the smaller operators will pay significantly less to terminate their calls on the larger networks and vice versa. South Africa's third network operator, Cell C, is known to be loss making at present.

> Without regulatory assistance, South Africa may well be left with a mobile duopoly, a situation the regulator would like to avoid.

In the week following the announcement by ICASA, Vodacom and MTN lost R40bn in combined market capitalisation. Vodacom, being the dominant player in South Africa, bore the brunt of investors' displeasure. We used price weakness to selectively add to our positions in Telco's believing that these businesses are attractively valued, pay generous dividends and have significant opportunities for future growth which are underappreciated.

RUNNING UP A DOWN ESCALATOR?

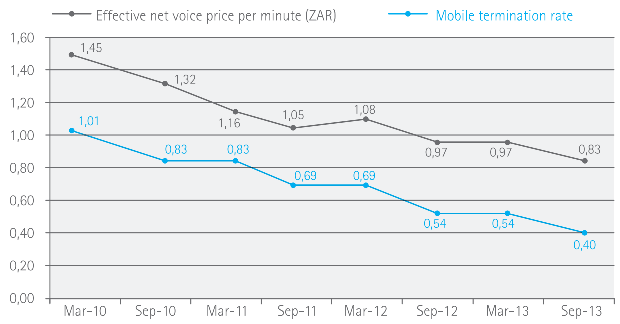
There are few industries where price disinflation is as prevalent as in technology and telecommunications.

Constant innovation forces unit costs down whilst continuous investment is required to increase capacity. Consumers demand ever cheaper minutes and data, reducing the marginal return on investment for Telco's. Following ICASA's announcement, the financial markets feared that the South African telecommunications market's revenue would be vastly reduced, and with relatively fixed cost bases, profitability would be impacted.

The proposed MTR cut is a further 75% reduction in tariffs and would bring South Africa's MTR in line with global averages. In light of the historical performance of the South African market in the face of MTR cuts, we expect South African revenues to be more robust than what the markets are pricing. This is due to several factors, the most important, in the short term, being the increased uptake in mobile data. To give a sense of the pace of growth, consider that mobile data volumes doubled globally between the first quarters of 2013 and 2012.

In South Africa, the MTR has fallen by 60% since March 2010, whilst Vodacom's headline call rates have reduced by 43%.

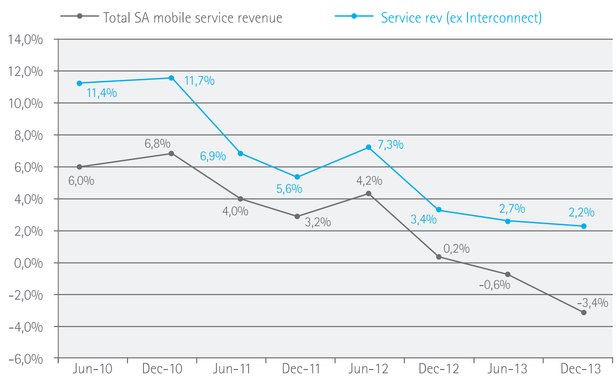
Vodacom effective retail rates vs mobile termination rates (ZAR)



> Globally, regional mobile data traffic will increase anywhere between 7 and 11 times in the period between 2013 and 2019.

However, in the same period, total South African service revenue excluding mobile termination has remained positive. This was achieved due to positive elasticity on voice revenue (as the price reduced the demand for minutes increased) and the meteoric rise of data revenues.

SA (Vod+MTN) service revenue momentum

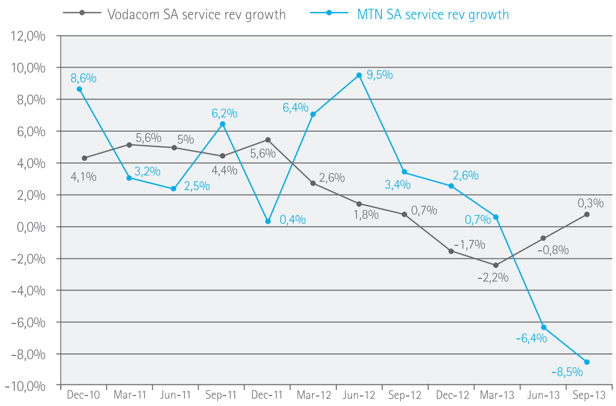


VODACOM: POWER TO YOU

Vodacom has outperformed MTN in South Africa by applying Vodafone best practice in the face of a price war, as is evidenced by the companies' respective growth rates in service revenues.

Whereas MTN was slow to reduce pricing following price decreases from Cell C, Vodacom re-priced sooner and marketed more keenly, leaving them in a better relative position in the period under review. Vodacom grew revenues despite falling MTR's and call rates. We expect this trend to continue. Between March 2010 and the latest reporting period Vodacom grew revenue by 25% despite falling call rates. Mobile voice revenue as a percentage of total revenue fell by 7% to 47% of total revenue (increasing by 6% in absolute terms), interconnect revenue fell by 10% to 6% of total revenue. Making up a greater share of revenue, data has moved from 9% of total revenue to 17% (a 104% increase in absolute terms) and equipment revenue from 11% to 20%.

From an operating perspective, costs have been contained at below inflation for the past three years. A significant contributor to this achievement was the build out of an own fibre backbone, routing 67% of Vodacom's traffic on its own network and reducing Vodacom's exposure to Telkom's predatory pricing. In addition to the likelihood of full self-provisioning, Vodacom's proposed deal with Neotel will give it access to an extensive fibre network which could be used to challenge Telkom in the corporate segment and eventually allow Vodacom to provide a full suite of services to a client whether it be at work, at home or on the run.



In our opinion, Vodacom is excellently managed from a strategic and operational perspective.

THE CELL C EFFECT: DO YOU BELIEVE?

Telkom Mobile has the most price competitive offers in the market.

However due to a reputation for poor service quality it has not managed to gain a substantive mass of profitable subscribers to challenge the three larger operators. With MTN and Vodacom the profitable incumbents in a saturated South African market, Cell C needs to attack them to gain market share and ultimately become profitable through scale benefits.

Much has been made of the threat of Cell C destroying profitability for the entire market. The bear case for the South African market revolves around the owners of Cell C having an infinite capacity to bear financial pain and thus acting irrationally to gain market share even if huge losses are incurred.

We believe these fears are overblown:

- Cell C is being dressed up for sale; an astute buyer is unlikely to want to buy an unprofitable third operator in a market in which value has been destroyed
- Cell C's management incentives are linked to profitability in the medium term
- Cell C's network is already straining under current volumes and if they reduce prices further and gain new clients network quality and client satisfaction will deteriorate further
- Cell C is unprofitable and some of the benefits of asymmetry would need to be reinvested in its network as well as in dividends to owners. Thus some of the benefits of asymmetry will not be passed on to the consumer through lower pricing
- Cell C is unlikely to be a first choice network partner for Telkom Mobile, meaning that it may have to foot its future capex bill off its already stretched balance sheet
- It is impossible for Cell C to reduce prices below 45c a minute as a roaming agreement with Vodacom (which is valid until 2018) requires Cell C to pay this amount to Vodacom to utilise Vodacom's network in areas where Cell C does not have coverage

SIZE MATTERS!

Vodacom is the largest network provider in South Africa with a 44% subscriber market share, whilst MTN has a 47% subscriber market share in Nigeria; its main profit generator. Both companies have estimated revenue market share in and around 60% in their respective markets.

The larger players have significant competitive benefits when compared to smaller operators:

- The largest (oldest) network has the widest geographic coverage
- The largest network tends to have the most cash available and thus the best quality network
- Early adopters are prone to be wealthier and generate significantly higher Average Revenue Per User (ARPU) than users who join networks later
- Network effects - the largest network terminates the majority of calls on itself (costing nothing)-whereas smaller players have to pay for their customers to reach the larger client pools
- Established distribution channels and mechanisms
- Scale benefits with regards to back office and procurement of handsets and technology

MTN's market dominance in the rest of Africa allows us to be constructive on the company as a whole despite its poor relative performance in South Africa of late. Africa is a fantastic market for mobile telecommunications companies. Favourable demographics, geographic vastness and lack of fixed line infrastructure, low mobile penetration by global standards, low levels of existing technology, underdeveloped banking and payment systems and robust expected economic growth makes this a space an investor can ill afford to ignore. Whilst MTN has a much larger footprint on the African continent, Vodacom has also reiterated its intent to grow in the rest of Africa recently by buying out 17.2% of minorities in Tanzania, and opening a representative office in Ethiopia.

In Africa, Vodacom and MTN seldom compete in a market with each other and in a vast majority of jurisdictions they are either the #1 or #2 players. This dominance and concomitant scale benefits draws us to both companies as investment opportunities.

Tantalum MNC Fund

Strategy	Multi-strategy, hedge					
Fund Objective	The fund is targeting above average real returns (8% to 12%) over the medium term at lower volatility than the market. Returns come from equity alpha on the long and short side, with yield enhancement from fixed interest, preference shares, hybrid instruments and listed property.					
Launch date	Jun-05					
AUM	R854m					
Return data:	3-mth	YTD	12-mnth	3-yr (p.a.)	Incept (p.a)	Total Return
	4.91%	12.54%	12.54%	9.58%	12.59%	176.71%
Risk data:	12-mth Std Dev	3-yr Std Dev	Std Dev since incep			
	4.14%	3.24%	7.24%			

Tantalum Focus Fund

Strategy	Multi-strategy, hedge					
Fund Objective	The fund is targeting above average real returns (10% to 15%) over the medium term at lower volatility than the market. Returns come from equity alpha on the long and short side, with yield enhancement from fixed interest, preference shares, hybrid instruments and listed property.					
Launch date	Nov-10					
AUM	R260m					
Return data:	3-mth	YTD	12-mnth	3-yr (p.a.)	Incept (p.a)	Total Return
	7.26%	14.84%	14.84%	N/A	13.51%	49.36%
Risk data:	12-mth Std Dev	3-yr Std Dev	Std Dev since incep			
	4.18%	N/A	5.27%			

Tantalum Fusion Fund

Strategy	Fixed Income, hedge					
Fund Objective	The fund is targeting cash + 2% returns over the medium term at lower volatility than the market. Returns come from fixed income alpha on the long and short side, with yield enhancement from preference shares, hybrid instruments and listed property.					
Launch date	Mar-06					
AUM	R58m					
Return data:	3-mth	YTD	12-mnth	3-yr (p.a.)	Incept (p.a)	Total Return
	1.83%	6.63%	6.63%	7.31%	8.75%	92.87%
Risk data:	12-mth Std Dev	3-yr Std Dev	Std Dev since incep			
	1.15%	1.48%	3.23%			

Tantalum Resources Fund (ZAR)

Strategy	Resources, hedge					
Fund Objective	The fund is targeting 15%-25% over the medium term at lower volatility than the resources and commodity markets. The fund invests in a global portfolio of mining and energy equities, commodities and associated derivatives trading on the LSE, JSE, ASX, TSX and NYSE.					
Launch date	Mar-13					
AUM	R49m					
Return data:	3-mth	YTD	12-mnth	3-yr (p.a.)	Incept (p.a)	Total Return
	3.73%	7.64%	N/A	N/A	9.23%	7.64%
Risk data:	12-mth Std Dev	3-yr Std Dev	Std Dev since incep			
	17.45%	N/A	17.45%			

Tantalum Global Resources Fund (USD)

Strategy	Resources, hedge					
Fund Objective	The fund is targeting 10%-20% over the medium term at lower volatility than the resources and commodity markets. The fund invests in a global portfolio of mining and energy equities, commodities and associated derivatives trading on the LSE, JSE, ASX, TSX and NYSE.					
Launch date	May-12					
AUM	$5.2m					
Return data:	3-mth	YTD	12-mnth	3-yr (p.a.)	Incept (p.a)	Total Return
	0.19%	-1.93%	-1.93%	N/A	-0.26%	-0.43%
Risk data:	12-mth Std Dev	3-yr Std Dev	Std Dev since incep			
	12.54%	N/A	10.63%			

Tantalum Enhanced Cash Fund

Strategy	Fixed Income, long only					
Fund Objective	The fund is targeting cash plus return over the medium term. Returns come from fixed income alpha, with yield enhancement from preference shares, hybrid instruments and listed property.					
Launch date	Aug-10					
AUM	R826m					
Return data:	3-mth	YTD	12-mnth	3-yr (p.a.)	Incept (p.a)	Total Return
	2.08%	7.02%	7.02%	7.62%	8.84%	33.56%
Risk data:	12-mth Std Dev	3-yr Std Dev	Std Dev since incep			
	1.14%	1.17%	1.48%			

Tantalum Balanced Fund

Strategy	Multi-Asset, long only					
Fund Objective	A Reg 28 compliant fund which invests in a mix of domestic equities, bonds, property, commodities and cash where the asset allocation is tactically managed. Maximum net equity exposure is 75% and index derivatives may be used to reduce net equity exposure.					
Launch date	May-13					
AUM	R314m					
Return data:	3-mth	YTD	12-mnth	3-yr (p.a.)	Incept (p.a)	Total Return
	3.58%	12.00%	N/A	N/A	18.53%	12.00%
Risk data:	12-mth Std Dev	3-yr Std Dev	Std Dev since incep			
	5.40%	N/A	5.40%			