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THE SKY IS BLUE

Navigating regulatory risk: Why we see value in Blue Label Telecoms

At Tantalum Capital, we like investing in businesses with leading and defendable market positions. Concentrated industries with few competitors tend to earn good returns, and, given a fair entry price, often make for superior long-term investments. The investment cliché of looking for the widest possible "moat" around the business, defending itself against competitive attack, is obvious. As is the desire to pay a low price, the so-called "margin of safety". However, opportunities to invest like this are generally only possible opportunistically, when the market has misunderstood (or forgotten) these industries' strengths and long-term prospects.

Intuitively, the telecommunications ("telco") industry exhibits attractive moat characteristics: a limited number of competitors, technical barriers to entry, high fixed costs and high capital investment. In this newsletter we explore the telco investment proposition in more detail, and explain the thinking behind our underweight telco stance for most of the last two years, together with our reasons for recently investing in Blue Label Telecoms (BLU).

An industry that lends itself to concentration

An industry requiring very high initial capital investment naturally lends itself to a monopolistic market structure, at its purest with only one provider of a good or service. Why just one? Well, a second entrant would have a similar investment burden as the first, but with fewer customers. Assuming efficient management, there is thus a sound economic rationale for utility providers (eg. electricity and water) to be monopolies. However, due to a lack of competition and oversight, monopolies often become very inefficient, and market regulators are needed to prevent waste and protect consumer interests.

Telephony used to be one such utility. Telcos globally were powerful monopolies. Many (or most) of these, however, have since been broken up or privatised, as the technology and the industry evolved, and as the need for significant new investment presented itself. As an example close to home, Telkom, South Africa's initial fixed line provider, remains majority owned by the state, while Vodacom was spun out of Telkom.

Although no longer a monopoly, the telco industry of today remains highly concentrated. It is now oligopolistic in nature, still offering considerable scope to engage in exploitative behaviour. The responsibility for ensuring that consumers are not overcharged and that a good standard of service is delivered falls on the regulator. In South Africa's case this duty is performed by ICASA. ICASA also regulates broadcasting and postal services. It develops regulations, issues licences, plans and manages radio frequencies, and monitors licensee compliance with rules and regulations under its remit. As with all companies in South Africa, the Competition Commission also has the right and ability to investigate, evaluate and sanction any egregiously anti-competitive conduct which comes to its attention.

Tough choices: A well invested telco sector or low costs? Or both?

Government (represented by the regulator) and the telco industry have been involved in an intricate dance, where a misstep can have far reaching consequences. On the one hand, consumers (and an elected government!) want reliable telecom services at high speed and at the very lowest price, and at every point in the country. Conversely, telco companies target maximum profits. They would ideally like to minimise new investment in equipment, limit the need for providing outlying networks, charge high prices, and focus only on delivering dividends to shareholders. They would test the boundaries of the price elasticity of consumer demand at every point, and charge as high a price as possible.

Between these two objectives a middle ground has to be found, without which new investment would be impossible. Telco operators need to believe that the regulator will allow them to earn an economic return on their investments. Believing this, they will invest large amounts of capital into high capacity networks with ever lower marginal unit costs. The regulator can then in due course pass some of the benefits of added scale onto consumers by mandating lower price caps, as was indeed done through lowering Mobile Termination Rates during 2014-2016 in South Africa. Should the regulator cut price caps to consumers too aggressively, new capital investments (capex) by telcos would be unprofitable and would not happen. Network growth would be constrained, usage would be 'throttled' as the network gets overwhelmed by growing volumes, and consumer experience would rapidly deteriorate.

The difficulty in capturing value

The need for modern telecommunications services is indisputable. Daily life with limited or no access to the internet or connection to friends and family seems impossible! For such a crucial service one would expect major pricing power for the suppliers. Although the most aggressive pricing is curtailed by the regulator, consumers also have an expectation of reducing unitary costs, because this has been the norm. In a country with well entrenched inflation expectations such as South Africa, consumers would expect to pay more for food, water and electricity but they expect to pay less each year for a megabyte of data! Without the benefit of improving economies of scale, the consumer's expectation of lower future prices is very much misplaced.

An added challenge for telcos has been (and remains) so-called Over The Top (OTT) operators. Technology companies such as Whatsapp, Facebook, Amazon, Google, Uber and Netflix attract capital easily as they promise the capture of vast global user bases without much physical investment. Potentially, they offer very high returns to shareholders. Most of these tech companies are also famed for their ability to avoid local taxes. These OTT players will have no business without the networks' investment (no internet!) but they are often subject to less regulation and regulatory interference than the telcos.

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Spectrum

Spectrum is the range of radio-frequencies specifically reserved for and allocated to the media and telecommunications industry for transmission over the airwaves. The more spectrum a cellular provider has, the more efficient its network becomes. Spectrum is however limited, and if it is divided into too many 'slices' its usefulness diminishes. Ownership of spectrum vests in the state, with government allocating telco operators right of use for certain lease periods.

Long lease periods allow operators time to earn a return on their considerable investments and often there is an automatic right to renew the lease or an auction process to re-allocate spectrum at the end of the lease. Telco's build their businesses on the expectation that they will have a perpetual right to use spectrum and any legislation threatening this assumption would naturally cause much angst for telco operators and investors.

Regulatory roller-coaster

Halfway through November 2017, the SA cabinet approved the Electronic Communications Amendment (ECA) Bill keeping contentious clauses, which the industry believed would be watered down from the 2016 White Paper. For brevity's sake the ECA Bill envisages renationalisation of spectrum and a national, shared telco network, the WOAN (Wholesale Open Access Network).

Critically, this move would alter the key point of competition away from network quality (where Vodacom has traditionally excelled), and focus it on retail distribution and customer service. Taken to the extreme, the ECA bill would render MTN and Vodacom's (and Cell C's smaller) existing networks near worthless. SA would again (as with Telkom in the 'old days') become reliant on a consortium or state-directed entity investing network capex on behalf of the entire industry, while the larger incumbents would be vulnerable to new competition at the sharp end of the business. This monopoly WOAN approach has not been attempted anywhere else in the world. Consensus expectations are that the ECA Bill, if implemented as proposed, will be appealed all the way to the Constitutional Court. While our base case (echoing the view of most players in the telco industry) is that the legislation will not happen in its current form, at the very least the process will delay the potential release of new spectrum freed up by moving television signals away from terrestrial analogue frequencies, and defer much needed network investment.

Of course, it is worth remembering that regulators can and do cause real pain for everyone. Nothing captures the power that governments and regulators exercise over the fate of telco companies quite as starkly as the Nigerian regulator's fine for MTN. In late 2015, MTN received a fine of $5.2bn from the Nigerian regulator for disregarding sim-card registration regulations. The fine was eventually settled during June 2016 for around $1bn. Together with a weakening oil price, MTN's share price retreated from the highs of R260 during September 2014 to R107 during October 2016. Whilst many felt that the imposition of the fine was both excessive and unfair, MTN paid up, as the alternative was to walk away from its investment in Nigeria or engage in lengthy litigation with uncertain, and possibly ruinous outcomes. No one really came out a winner, as MTN's willingness to invest further in Nigeria has been severely tested and the Nigerian government has potentially damaged the country's reputation as an investment destination for large multinational companies.

BLUE LABEL: A CALL OPTION ON CELL C?

The discussion above gives a fairly clear idea of why we have not been significantly invested in either Vodacom or MTN for awhile. However, it begs the question of why we are investing in any telcos at the moment, and why in Blue Label? Let us explore the background to this company and its investment proposition in more detail, as there is much more to it than meets the eye.

Blue Label Telecoms ("BLU") is the leading distributor of prepaid airtime in South Africa. It has in excess of 150 000 points of sale. It also sells prepaid electricity, bus and event tickets using this infrastructure. It has also recently acquired 3G Telecom, which sources, finances and sells mobile phones. Over and above these interests, BLU also has international operations in India and Mexico. Most importantly, BLU recently acquired a 45% stake in Cell C. We have been following BLU closely since its listing in 2007. In essence, the core business has been as a 'wholesaler of airtime'; buying airtime in bulk from the mobile networks at a discount, and reselling this to spaza shops, retailers and banks. Over time, as the telco networks have decreased their discount to wholesalers and retailers, BLU has used its strong initial market presence to absorb further market share and hence grow earnings and cashflows. It handles more than half of SA's prepaid mobile revenues.

We believe that whilst no longer being a fast-growing business, BLU's distribution business represents a defendable, attractive annuity stream of profits. As a point of comparison and reference, ticketing sales and money transfers have become highly lucrative for Shoprite Checkers through their Money Market counters and Computicket. Additionally, Pep's main focus apart from apparel is now the sale of handsets and cellular equipment. The stock market values these revenue streams within retailers at between 16-20 times taxed earnings. Valuing BLU's earnings from the legacy distribution of airtime and the recent acquisition of 3G on just 12 times earnings equates to a fair value for BLU (excluding Cell C) of roughly R14.50, above the current share price. We do not ascribe any value to BLU's operations in India and view its operations in Mexico as free albeit interesting optionality.

CELL C: A PROFITABLE DISRUPTOR?

Cell C has been a very poor business in the past. It racked up huge losses, and large debts. Given this large debt burden, Cell C couldn't invest adequately in its network and operations. The company foolishly entered into a 'price war' with the bigger network operators, and tried to turn itself into the "price champion". The period since 2014 has been much better. Subscriber growth, good cost control and revenue growth ahead of the broader South African market contributed to an improvement in EBITDA from R424mln (3.6% margin) in 2014, to R3.7bln (23.5% margin) in 2017.

BLU acquired 45% in a recapitalised Cell C for R5.5bn. The previous shareholders and debtholders all took quite big "haircuts", and at the close of the transaction, Cell C was left with R6bn in interest-bearing debt, a vast improvement on the R20bn of debt before the recapitalisation. This transaction was ratified from a regulatory perspective by ICASA towards the end of November 2017. The investment case for Cell C now hinges on it being able to profitably grow revenue. Recent management interaction has provided some feasible plans to improve the business:

Geographic expansion

Due to its high levels of leverage, Cell C has had to be very judicious in its network investments and commercial strategy. In essence, this meant that Cell C's network was focused on Gauteng and the metropoles of Cape Town and Durban. For the rest of the country, Cell C relied on roaming on Vodacom's network (and paying Vodacom a fee for this). No marketing campaigns were run to acquire clients outside limited target areas. The 'new' Cell C is now focusing on Mpumalanga, Limpopo and Umtata to address large, previously untapped revenue pools.

A novel approach to contracts and handsets

Cell C has a brand and reputation that is seen as innovative. They were first to launch Whatsapp/Facebook bundles allowing users to have large allocations of social media data at very reasonable prices. Building on this market reputation, Cell C wants to focus on the 15-34 age group believing that they are value conscious and open to experimentation. Cell C and BLU are piloting a scheme whereby phones are leased rather than owned outright in the post-paid market. This allows the consumer to change phones more often to fit their aspirational lifestyles, whilst allowing Cell C to inject more "airtime value" into the contract. This is an interesting point of differentiation as high value post-paid subscribers have historically shunned Cell C due to poor perceptions related to their network quality.

Cost control and regulatory assistance

From its precarious financial position, Cell C entered into sub-optimal contracts and commercial arrangements (eg. tower leases) which can now be reviewed and renegotiated. Whilst limited immediate relief is expected, material long term contracts are up for renewal during 2019-2021. Given its new ability to invest in own infrastructure, Cell C can save costs in the short term by investing in network infrastructure in dense areas where it has relied on Vodacom in the past. Cell C is also likely to lobby hard for the regulator to allow for more entrenched network sharing (lowering industry costs whilst addressing their weakness of a second-rate network). It will also challenge industry practices which make it hard to win over postpaid clients. These practices inhibit the uptake of better value offerings in the market at large.

Modest assumptions, attractive upside

We do not expect miracles from Cell C. However, assuming high single digit revenue growth (thus assuming slight market share gains for Cell C) and some cost savings from network sharing, capital investment in leased sites and renegotiation of onerous contracts, we envisage R5.3bn (28.2% margin) of EBITDA in 2019. The resultant margin level is still far below Vodacom (40%) and MTN (35%) who benefit from greater scale than Cell C. However, this level of EBITDA, combined with the benefit of very low tax payments and reduced gearing adds approximately R6 per share in value to BLU's shares.

IN CLOSING

Telcos are oligopolistic, predictable, cash-generative businesses. However, the potential for regulatory interference has created significant variability in the perception and reality of investing in the sector. With an unfavourable regulatory backdrop not adequately discounted in equity prices for telcos in the recent past, we have (rightly) largely avoided the sector. Being nimble, we have stood ready to add to our telco exposure should the market underestimate the long-term earnings power of any of these businesses. Corporate action at Cell C, and improved competitive dynamics have seen a shift and provided us with an opportunity.

We have bought into Blue Label Telecoms, believing that it has significant upside optionality and has less to fear in terms of regulatory interference in comparison with its larger peers. With improving disclosure of Cell C's financial statements, and with further evidence of operational traction, we believe that BLU will rerate handsomely in time. In the interim, we take comfort from the fact that our assessment of the value of BLU, excluding Cell C, is already above the current market price.