

Kestrel Capital (East Africa) Ltd

Member of the Nairobi Stock Exchange

Safaricom Ltd

Company Update

Bytes into Bucks

Recommendation: LONG TERM BUY

Investment Summary

- We recommend an **LONG TERM BUY** on Safaricom and encourage investors to take advantage of pricing weakness. The stock is trading at a slight premium to other emerging market mobile players. In our view, a relatively underpenetrated market and higher growth prospects, accelerating free cash flow generation and higher profitability margins justify the premium. Short term concerns about economic performance, declining disposable income and thus mobile spend, coupled with intense competition and declining voice ARPU's as well as margin compression are likely to be offset by long term ARPU convergence as minutes of usage accelerate and strong growth potential from the lucrative and underpenetrated data segment is realized.
- We have concerns about medium term performance for Safaricom in light of the numerous challenges facing the mobile telephony sector including; an ongoing price war in voice, declining voice ARPU's, rising opex and capex, more expensive debt and sliding margins. 1H09 results already displayed a 15.6% fall in profitability and with the launch of two new mobile players in 2H09 and a steep decline in tariffs (by 40%), the profitability outlook does not look any better. We expect a 3 year CAGR of 3.6% in earnings till FY11F. Nevertheless, during the same period, EBITDA is expected to grow faster at 6.2%.
- Market dynamics favor long term performance for the sector with a low mobile penetration rate (46%), low minutes of usage (35 minutes on a monthly subscriber basis) and a low internet penetration rate (< 10%). Long term economic growth and increased capacity in the near term horizon will drive these metrics up. Notwithstanding the increased level of competition in the industry (with the entry of Telkom Kenya and Econet Wireless in 4Q08), we believe Safaricom is best placed to take advantage of sectoral subscriber growth with a 50.8% market share of net adds over a 3 year period to FY11F. Furthermore, we estimate that the other players are currently experiencing operating losses.
- Data is the "big opportunity" for Safaricom as it seeks to diversify from the competitive voice landscape. Key drivers bode well for growth potential due to low internet penetration (<10%), economies of scale and ready market positioning in this segment. Safaricom is currently the only mobile telephony player with a 3G license and established network. It has positioned itself in the internet segment via the acquisition of a 51% stake in a Wi-max player OneCom (whose main advantage is additional frequencies) and already has an established distributor network. Furthermore, the landing of various undersea fiber optic cables in Kenya in late 2009 will increase bandwidth capacity significantly and drive down costs, resulting in a steep increase in data uptake. We expect data to contribute 20% to revenue by FY11F.

Key Statistics

Kshs m	FY07	FY08E	FY09F	FY10F	FY11F
Sales	47,447	61,369	63,181	70,636	81,428
EBITDA	24,491	28,148	27,203	29,554	33,673
Net Profits	12,010	13,853	11,205	12,794	15,302
Adjusted Net Profits	12,010	13,120	11,205	12,794	15,302
FCF	4,737	4,883	1,136	11,928	16,894
Dividends	4,000	2,000	3,407	9,542	13,515
PER x	16.7	7.4	9.1	8.0	6.7
Adjusted PER x	16.7	7.8	9.1	8.0	6.7
EV/EBITDA x	8.3	3.8	4.0	3.5	2.9
P/NAV x	6.1	2.4	2.0	1.8	1.7
Div yield %	2.0	2.0	3.3	9.4	13.3

27 February 2009

EQUITY RESEARCH

Telecoms Sector

Share Statistics

Price (Kshs)	2.55
Issued shares (m)	40,000
Year end	31 Mar
Mkt cap (USD m)	1,275
Mkt cap (Kshs b)	102
Free Float	25%
Av. daily trd vol (USD)	182,298

Price Performance

	Absolute %
3 m	-30.1%
6 m	-53.6%

Bloomberg code: SAFCOM KN

EPS growth	%
1 yr EPS ch	-19.0
1 yr adj. EPS ch	-14.5
3 yr EPS CAGR	5.5
3 yr adj EPS CAGR	5.5

Ratio's	USD
Market cap/subscriber 08	143
Market cap/subscriber 09	102
Market cap/subscriber 10	91
Market cap/subscriber 11	91
EV/subscriber 08	148
EV/subscriber 09	109
EV/subscriber 10	92
EV/subscriber 11	87

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Safaricom Ltd

Company Update

Ongoing price war

Orange likely to succeed in aggressive subscriber acquisition strategy

Sector Update

New Players and Price War

2008 marked the entry of two new players in the mobile telephony sector; Telkom Kenya ("Orange") and Econet Wireless ("Yu") and a price war initiated by one of the incumbents, Zain Kenya. Aggressive price cutting by incumbent and new players has resulted in up to a 40% decline in average tariffs as displayed in the table below. ARPU's have fallen at similar levels. At present, Orange is the cheapest provider followed by Yu.

Competitive Dynamics

Player	Tariff (Kshs per minute)			Subs	Network cov.
	On-net	Pref	Off-net		
Safaricom	8.00	-	15.00	13 million	85% of Land mass
Zain kenya	8.00	3.00*	8.00	3 million	80% of Land mass
Orange	3.50	1.00*	7.00	500,000	Major urban centers
Yu	7.50	0.50**	7.50	60,000	Nairobi, Mombasa

*Source: Industry, * applies to 10 "nominated friends" **applies after two minutes*

Telkom Kenya, which was previously the state owned national fixed line operator, was privatized in 2007 with a France Telecom led consortium acquiring a 51% stake in the company at a cost of USD 26m. Following this, Telkom Kenya applied for and was granted a GSM license. It has since launched wireless operations in October 2008 using the Orange brand and currently has approximately 450,000 active subscribers. Due to the extensive national coverage of the fixed line network, "deeper pockets", experience in other African markets and its earlier launch compared to the other new entrant, Telkom Kenya is expected to succeed in its aggressive subscriber acquisition strategy. Orange currently offers connectivity in the major towns in Kenya. It also engages in site sharing with Safaricom. Due to its ability to leverage off its national fixed line network, we expect coverage to expand to other parts of Kenya reasonably quickly.

Econet Wireless has a longer history in the mobile telephony sector in Kenya. The company was initially granted a license to operate in 2002 but litigation with various parties and lack of funding hindered its ability to launch operations till 2007. Consequently, Essar Communications acquired a controlling stake in the parent company and after settling its legal action, the company launched mobile operations in Kenya in December 2008 under the "Yu" brand.

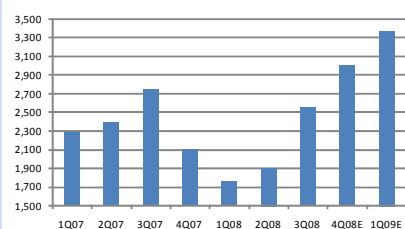
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Safaricom Ltd

Company Update

Zain Quarterly Subscriber Trend



Source: Company, Year end Dec

Zain Kenya once again acquiring subscribers but making an EBITDA loss at current tariffs

However, poor network coverage and its status as the “fourth operator” are limiting factors for steep acceleration in subscriber acquisition. Econet is believed to have entered into a site sharing agreement with Zain Kenya. Econet has allegedly raised USD 450m to fund its operations. We suspect that at current tariffs, Econet and the other two players, Telkom Kenya and Zain Kenya are incurring operating losses and thus believe the price war is not sustainable in the medium term.

Zain Kenya, which was actually the first operator to launch mobile telephony services in Kenya in 2000 has over the years suffered from various ownership, management and strategy changes, such that in early 1Q08, its subscriber base had declined 23.1% y-o-y and market share fallen to 14% from 29%. However, the company initiated a price war in 1Q08 slashing its tariffs by more than 40%. It has also enhanced its marketing and distributor channels since then. As at December 2008, its subscriber base stood at approximately 3 million following its aggressive and innovative subscriber acquisition strategy. Zain also relaunched its mobile money transfer service “Zap” to compete with Safaricom’s highly effective M-Pesa product.

It is unlikely that the ongoing low tariff regime is sustainable in the medium term, especially in the current negative global macro economic environment. Furthermore, as indicated in the table below, we estimate that both the new players and one of the incumbents (Zain Kenya) are currently operating at below breakeven levels at current tariffs and incurring extensive debt to fund operations at a time when credit is both expensive and difficult to obtain.

Zain Kenya	1Q08	2Q08	3Q08
ARPU (USD)	6	7	5
Revenue (USD m)	39.2	40.2	41.8
EBITDA (USD m)	3.2	-3.0	-9.7
EBITDA margin	8%	-7.5	-23.2
Subscribers ('000)	1,713	1,909	2,558
Market Share %	14	14	17

Source: Company

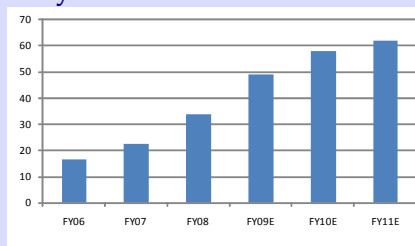
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Safaricom Ltd

Company Update

Kenya Subscriber Penetration %



Source: Company, Kestrel Capital Estimates

Strong Subscriber Growth

Sector subscriber growth accelerated in 2008 with the reported subscriber penetration climbing to 46% as at Dec 2008 from 34% in March 2008. The total number of active subscribers stands at approximately 16 million, however it is difficult to interpret this data due to the existence of dual/triple SIM card holders. Safaricom management yield that approximately 25% of its 13 million subscriber base also hold Zain SIM's. We estimate that 80% of Orange SIM card holders hold either Safaricom or Zain SIM cards, thus an approximate "real" subscriber number is closer to 13 million, implying a 36% penetration rate.

The table below displays the subscriber numbers and our expectations for the various operators within the sector.

Subscribers	FY07	FY08F	FY09E	FY10E	FY11E	FY12E
Safaricom	6,083	10,200	14,220	15,959	16,085	16,205
Market Share %	72.7	83.8	77.2	72.5	67.7	64.4
ch %	54.3	67.7	39.4	12.2	0.8	0.7
Celtel Kenya	2,284	1,757	3,374	3,805	4,107	4,178
Market Share %	27.3	14.4	18.3	17.3	17.3	16.6
ch %	13.5	-23.1	92.0	12.8	7.9	1.7
Telkom Kenya	-	220	723	1,769	2,985	4,068
Market share %	0.0	1.8	3.9	8.0	12.6	16.2
ch %			228.5	144.8	68.7	36.3
Econet	-	-	93	477	586	712
Market share %	0.0	0.0	0.5	2.2	2.5	2.8
ch %				410.3	22.8	21.4
Total Subscribers	8,367	12,177	18,410	22,010	23,763	25,162
ch %	40.5	45.5	51.2	19.6	8.0	5.9

Source: Various players, Kestrel Capital

Mobile number portability unlikely in the near future

Regulatory Issues and Unified Licensing Regime

One of the long term challenges facing mobile telephony players is mobile number portability. In late 2008, the Communications Commission of Kenya (the regulatory body "CCK") had announced its intention to implement MNP as early as April 2009, but after discussions with various stakeholders, the implementation of MNP has been delayed due to inadequate systems. Increased customer churn will become a significant risk, in the current tariff environment, where Safaricom is the most expensive mobile operator.

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Safaricom Ltd

Company Update

Licensing fees have reduced significantly under the Unified Licensing Regime

In 2008, the CCK introduced a unified licensing regime, splitting licenses into four major categories. Prior to this, the operators had to obtain individualized licenses to operate a GSM network. In the Unified Licensing regime, the cellular mobile operator's license encompasses a fixed line, GSM and 3G license. Ultimately, the unified licensing regime will reduce the barriers to entry within the sector due to lower fees. However, the cost of setting up infrastructure is still prohibitive, even with option of site sharing.

License	Cost	
	Initial charge	Annual fee
Prior Licensing Regime		
Initial GSM license (ML-99-0001)	USD 55m	0.5% of gross turnover
International Gateway license	Kshs 15m	higher of 0.5% of gross revenues and Kshs 5m
3G	USD 25m	
Unified license fees		
Cellular Mobile Operators*	Kshs 15m	0.5% of gross turnover
Data Network Operators	Kshs 15m	0.5% of gross turnover
International Gateway license	Kshs15m	0.5% of gross turnover
Internet service providers	Kshs 100,000	higher of 0.5% of gross turnover and Kshs 100,000
Sub Marine Landing License	USD 1M	0.5% of gross turnover

*Source: CCK, *includes national fixed line operator license and cellular mobile operator license*

Increasingly, another barrier to entry in the mobile telephony sector is the availability of spectrum. CCK is currently conducting an exercise to withdraw unused spectrum from licensed players in the telecommunications sector. Spectrum constraints are a challenge, especially for mobile players with heavy voice traffic such as Safaricom.

We hold the view that in the recent past, the regulatory body has been balanced and takes into consideration, views of all stakeholders in the decision making process. The advent of the unified licensing regime points to a general decline in bureaucracy within the sector.

Regulatory body generally consults all stakeholders in key decision making

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Safaricom Ltd

Company Update

1H09 Earnings Analysis

Metric (Kshs m)	1H07	2H07	1H08	2H08	1H09	h-o-h ch%	y-o-y ch%
Subscribers ('000)	-	-	7,956	10,200	11,956	17.2	50.3
Blended ARPU (KES monthly)	-	-	665	616	503	-18.3	-24.4
Revenue from voice	18,547	22,961	25,384	28,819	29,716	3.1	17.1
Revenue from SMS and other data	1,843	2,200	2,112	2,390	3,720	55.6	76.1
Revenue from acquisition	758	582	873	942	934	-0.8	7.0
Total revenue	21,410	26,037	28,650	32,614	34,508	5.8	20.4
Interconnection costs	1,426	1,065	1,340	1,387	-	-	-
Airtime	2,500	3,305	3,458	4,389	-	-	-
Network	2,045	2,294	2,541	3,242	-	-	-
Acquisition	1,514	1,771	2,909	2,814	-	-	-
Retention	88	301	576	450	-	-	-
Total Variable costs	8,397	9,758	12,128	13,938	15,309	9.8	26.2
Payroll and personnel	1,032	1,299	1,481	1,674	-	-	-
Marketing and publicity	561	646	1,254	1,037	-	-	-
General and administrative	546	717	806	903	-	-	-
Total fixed costs	2,139	2,662	3,541	3,614	4,194	16.0	18.4
EBITDA	10,874	13,617	12,981	15,062	15,005	-0.4	15.6
Depreciation	3,034	3,360	3,861	4,473	5,432	21.4	40.7
Amortisation	163	163	163	267	-	-	-
Operating costs	5,336	6,185	7,565	8,354	9,626	15.2	27.2
Operating Profit	7,677	10,094	8,957	10,322	9,573	-7.3	6.9
Net financing cost	(391)	(205)	(180)	(311)	(597)	92.3	231.7
Profit before tax and extraordinary items	7,286	9,889	8,777	10,011	8,976	-10.3	2.3
Extraordinary items	-	-	1,755	(708)	-	-	-
Profit before tax	7,286	9,889	10,532	9,304	8,976	-3.5	-14.8
Taxation	(2,332)	(2,850)	(3,247)	(2,845)	(2,759)	-3.0	-15.0
Profit after tax	4,954	7,039	7,285	6,459	6,217	-3.7	-14.7
Dividends	-	4,000	-	2,000	-	-	-

Source: Company reports

Safaricom 1H09 net profits were down 14.7% to Kshs 6.2 billion, driven by a decline in ARPU's and accelerating costs. Adjusted net profits (after removing the impact of the one off gain in 1H08) were up 5.5% to Kshs 9.0 billion. The one off gain was as a result of a one-off payment of Kshs 1.75 billion resulting in a forex gain on a shareholder loan that was paid back.

Revenue was up 20.4% to Kshs 34.5 billion driven by aggressive subscriber acquisition (subscriber base was up 50.3% to 12 million) and growth in both voice and data revenue. However, ARPU declined 24.4% to Kshs 504 due to a steep decline in marginal ARPU as Safaricom increasingly captured the lower spending rural subscribers. Safaricom's cost of sales was up 26.2% to Kshs 15.3 billion. The bulk of the increase was driven by rising subscriber acquisition and retention costs. Network costs were also negatively impacted due to the rising cost of energy. SGA costs were up 18.4% to Kshs 4.6 billion. Consequently, EBITDA was up 15.6% to Kshs 15.0 billion. Depreciation and amortization was up 40.7% to Kshs 5.4 billion. Safaricom incurred capex to the tune of Kshs 10 billion relative to Kshs 12.8 billion in 1H08.

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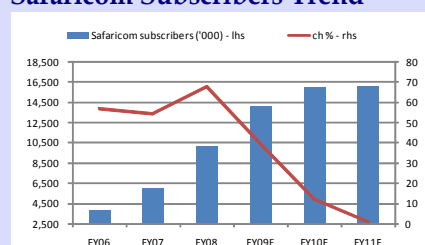
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Safaricom Ltd

Company Update

Mobile penetration rate reported at 46% in Dec 2008

Safaricom Subscribers Trend



Source: Company, Kestrel Capital Estimates

Steep ARPU decline expected due to declining tariffs and lower marginal spend

Key Earnings Drivers and Risks

Subscriber Growth

A relatively underpenetrated mobile market is likely to be the key driver for Safaricom subscriber growth. Mobile penetration was reported as 46% of the population in December 2008. Due to the existence of multiple SIM card holders, this rate is likely much lower and thus offers further room for upside.

We expect a 3 year CAGR of 16.4% in Safaricom subscribers to 16.1 million in FY11F. Despite the increased competition, Safaricom's competitive advantage (wide distribution network and national coverage), is expected to afford it the largest market share of net additions. Much of the subscriber growth will be realized from rural areas, which are still largely untapped. To this end, Safaricom is increasing its base station presence in rural Kenya. By the end of FY07, the company had approximately 1,400 base stations, half of which are located in Nairobi and Rift Valley province. With 20% of the geography of Kenya covered so far, we expect the company to boost its base station presence significantly.

Revenue Model	FY07	FY08	FY09E	FY10F	FY11F
Post paid subscribers	5,990	10,045	14,004	15,716	15,840
% of total	98.5%	98.5%	98.5%	98.5%	98.5%
Pre paid subscribers	93	155	216	243	245
% of total	1.5%	1.5%	1.5%	1.5%	1.5%
Churn %	25.0	25.0	25.0	18.0	18.0
Net additions	2,140	4,118	4,020	1,738	126
Total Subscribers	6,083	10,200	14,220	15,959	16,085
Market share %	72.7	83.8	77.2	72.5	67.7
Penetration rate	22.5	34.0	49.0	58.0	62.0
Blended ARPU (Kshs)	799	616	431	390	424

Source: Company, Kestrel Capital Estimates

Risks to our bullish outlook on subscriber growth include stronger than expected competitor action resulting in higher churn rates than present and a protracted economic slowdown which would impact both on subscriber growth and ARPU's for the sector. In any case, ARPU is expected to decline sharply in the next few years driven down by declining tariffs and an ongoing price war. The decline in ARPU is driven by a two fold mechanism; declining tariffs and lower marginal mobile spend by new subscribers.

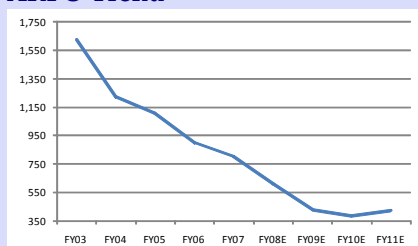
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Safaricom Ltd

Company Update

ARPU Trend



Source: Company, Kestrel Capital Estimates

Long term upside in minutes of usage likely to boost ARPU

M-Pesa money transfer service highly successful

Following tariff cuts by other players in 2008, Safaricom offered a “limited edition lower tariff” in October 2008 which has since expired as the company moved to conserve its margins. Management yield that demand elasticity stands at 0.9x, implying that tariff increases/reduction do not have a significant impact on minutes of usage.

We expect blended ARPU to decline 30% in FY09E and 9% in FY10F. A key driver for voice ARPU is the monthly minutes of usage (currently quite low at between 35 minutes). While we expect a long term spike in MOU driven by economic growth and growing disposal income, in the short term, the economic challenges being experienced in Kenya are likely to drive MOU down or keep it constant.

A positive contributor to blended ARPU and thus revenue in the medium and long term term is data.

	FY08E	FY09F	FY10F	FY11F	FY12F
Voice	54,203	53,704	56,509	61,885	54,203
% ch	30.6	-0.9	5.2	9.5	30.6
SMS & Data	4,502	6,950	11,302	16,286	4,502
% ch	11.4	54.4	62.6	44.1	11.4
Acquisition	1,815	1,769	1,978	2,280	1,815
% ch	35.4	-2.5	11.8	15.3	35.4
Other	744	758	848	977	744
% ch	33.8	1.9	11.8	15.3	33.8

Source: Company, Kestrel Capital Estimates

M-Pesa

Safaricom has started various initiatives to reduce customer churn including the “Bonga Loyalty Program”, and its mobile money transfer service M-Pesa. M-Pesa is essentially a mobile bank available only to Safaricom subscribers with functionality to offer a range of services, such as money transfer, bill payments, and a de facto limited interest free deposit account.

It has grown significantly since its inception (2007) and currently has 5 million users and transacts over Kshs 9.6 billion on a monthly basis. Various players within the commercial banking industry have accused the product as being an effective bank and it has faced intense scrutiny from the Central Bank of Kenya. Safaricom management, however, disagrees and further state that M-Pesa is unlikely to become a significant contributor to profitability.

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Safaricom Ltd

Company Update

After conducting investigations, CBK ultimately cleared Safaricom and M-Pesa. Currently, transaction costs on M-Pesa are relatively cheap (approximately Kshs 20 - 30 per transaction) but we believe that any upward momentum could result in significant revenue upside potential for Safaricom. At present, Vodafone PLC owns the rights to M-Pesa, thus limiting potential strong revenue upside (Vodafone takes away 32.5% of revenues in service fees) However, should Safaricom purchase this system and price itself, efficiently, it has the potential to contribute significantly to profitability.

Various M-Pesa Statistics

Approx cost - Sending money	Kshs 30-Kshs 400
Receiving Money	Kshs 25-Kshs 170
Cumulative Volume transacted (till 1H09)	Kshs 53.9 billion
Monthly Transaction volume (current)	<Kshs 9 billion
Subscribers (1H09)	4,100,000

Source: Company

*Safaricom to become dominant player
in data segment*

*Landing of fiber optic cable will
change the landscape of the industry*

Data

We hold the view that Safaricom is likely to become the dominant player in the data segment over the next two years. This hypothesis is supported by its ready market positioning as illustrated below:

- To date, Safaricom is the only licensed 3G player with an established network in key urban centers. Furthermore, all its planned new base stations are 3G enabled. Admittedly, for the most part currently, the 3G network is mostly being utilized to transfer voice traffic where possible from its heavily constrained GSM network. The 3G network allows it to provide data usage on mobile phones at much more efficient speeds than competitors, who are currently utilizing their GSM networks for the same purpose. 3G will also allow more sophisticated functions such as multimedia messaging which competitors cannot offer efficiently. At present, Safaricom uses satellite bandwidth, which is much slower and more expensive.
- Safaricom has purchased a 20% stake in the TEAMS undersea fiber optic cable at a cost of USD 20 million and is also purchasing bandwidth from Seacom. Ultimately, the company will have at its disposal approximately 0.5 Tbps of bandwidth at less than half the current unit cost. We estimate that Safaricom alone can fulfill demand for bandwidth in current market conditions and become a reseller of bandwidth.

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Member of the Nairobi Stock Exchange

Safaricom Ltd

Company Update

Low internet penetration will boost industry

- However internet penetration stands at below 10% and the data segment is likely to grow exponentially in the near term. By virtue of its economies of scale and distributor network, Safaricom is best placed to take advantage of growth in the data segment relative to all the market players.
- Safaricom purchased a 51% stake in WiMax network operator, OneCom in 2008, which has a small network of 5 base stations, all in Nairobi and more importantly, reserved spectrum. The acquisition was cash based and cost USD 2.6 million. Safaricom has rights to increase its stake at a future date. OneCom is deploying a WiMax network, which will be used to offer Safaricom Broadband Offering. Initially, Safaricom plans to tap into the corporate, high end user and small to medium enterprise (“SME”) market but we believe as with the direction of voice over the years, the retail (home broadband) segment will become increasingly lucrative and provide the impetus for long term growth in data provision.

It is difficult to quantify the size of the data market but we estimate that are 40,000 corporates and at least 500,000 SME’s that Safaricom can target. Further, a conservative size of the home broadband market stands at over 5 million. Current ARPU’s are estimated at KShs 2,000 but are likely to decline with the availability of relatively cheaper fiber optic bandwidth.

Margin Contraction

We expect profitability margins to contract in the near term driven by rising acquisition and retention costs as well as increased opex relating to ramping up of the Customer Service department. Marketing spend is also likely to accelerate due to the highly competitive environment. Thus, the EBITDA margin is expected to decline 281bp to 43.1% in FY09E and to 41.8% in FY10F. Safaricom has identified cost management strategies including initiatives to reduce dealer costs by increasing retail outlets (dealers are believed to charge as much as 6% of revenues) as well as ultimately move to a system of “paperless top-up’s”. In 2007/8, escalating fuel costs had impacted negatively on Safaricom’s network costs, but with the steep decline in global fuel prices, we expect a reversal in this trend.

EBITDA margin expected to decline 281bp to 43.1% in FY09E

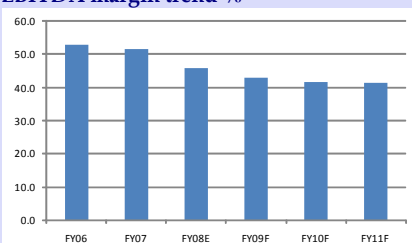
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Member of the Nairobi Stock Exchange

Safaricom Ltd

Company Update

EBITDA margin trend %



Source: Company, Kestrel Capital Estimates

Costs (Kshs m)	FY08	FY09E	FY10F	FY11F
Interconnection costs	2,727	2,780	2,472	2,850
% of revenue	4.4%	4.4%	3.5%	3.5%
Airtime	7,847	8,079	9,032	10,412
% of revenue	12.8%	12.8%	12.8%	12.8%
Network	5,783	5,954	6,656	7,673
% of revenue	9.4%	9.4%	9.4%	9.4%
Acquisition	5,723	6,318	7,770	8,957
% of revenue	9.3%	10.0%	11.0%	11.0%
Retention	1,026	1,056	1,554	2,443
% of revenue	1.7%	1.7%	2.2%	3.0%
Other	2,960	3,047	3,407	3,927
% of revenue	4.8%	4.8%	4.8%	4.8%
Total Variable costs	26,066	27,234	30,891	36,262
Fixed costs				
Payroll and personnel	3,155	3,944	4,733	5,442
Marketing and publicity	2,291	2,749	3,162	3,478
General and administrative	1,709	2,051	2,297	2,573
Total	7,155	8,744	10,191	11,493
ch %	49.0	22.2	16.6	12.8
EBITDA	28,148	27,203	29,554	33,673
Depreciation	8,334	10,091	10,610	10,921
Amortisation	430,452	441.67	441.67	441.67
Operating costs	15,919	19,276	21,242	22,855

Source: Company, Kestrel Capital Estimates

Gearing and Free Cash flow

In an effort to restructure its balance sheet and optimize its gearing ratio, Safaricom is likely to raise Kshs 20 billion in debt in FY10F in the form of local currency debt. This will allow the company to finance capex requirements from debt and result in a significant boost in free cashflows and dividend payouts.

Kshs m	FY07	FY08	FY09E	FY10F	FY11F
Capex	16,338	23,000	22,000	14,127	13,028
% of sales	34.4	37.5	34.8	20.0	16.0
Free cashflows	4,737	4,883	1,136	11,928	16,894
Dividends	4,000	2,000	3,407	9,542	13,515
Net debt/(cash)	4,547	3,665	6,232	779	(4,586)
Net debt/equity %	13.9	8.6	12.3	1.4	-7.5

Source: Company, Kestrel Capital Estimates

Key Risks

In our view, the one of the key risks that the company face and that could derail our projection of long term growth is stronger than expected competition that could have a significant impact on the subscriber market share and thus revenue and profitability. A protracted economic decline could also have a strong negative impact on mobile spend and profitability for the industry.

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Company Update

Peer Comparison

Metric	Safaricom	Maroc Telecom	Millicom	Vodafone	MTN	Telkom SA	Mobinil	Orascom	Egypt Mobile	Celtel Zam	France Telecom	Zain Kuw.	Mean	Median
Country	Kenya	Morocco	USA	Britain	SA	SA	Egypt	Egypt	Egypt	Zambia	France	Kuwait		
EBITDA mgn %														
FY08	45.9	59.6	40.6	37.5	43.0	36.8	44.9	43.6	53.9	47.5	35.9	39.4	44.1	43.3
FY09	43.1	59.7	41.9	35.9	41.7	34.4	43.4	42.4	53.8	48.1	35.5	39.5	43.3	42.1
FY10	41.8	59.8	42.3	35.8	41.3	34.3	43.6	41.5	50.6	47.5	35.3	39.5	42.8	41.7
FY11	41.4	60.0	42.9	35.0	38.1	34.2	43.7	39.2	50.5	48.1	34.9	38.9	42.2	40.3
ROE %														
FY08	36.7	56.8	37.4	9.1	29.6	24.5	103.8	30.0	11.3	43.7	17.3	14.3	34.6	29.8
FY09	24.0	70.5	30.3	9.5	28.3	20.2	86.8	32.8	12.9	33.3	16.2	14.7	31.6	26.1
FY10	23.7	72.4	26.3	10.3	26.9	19.6	73.6	30.0	13.9	43.7	16.1	15.9	31.0	25.0
FY11	25.9	n/a	21.0	10.3	24.2	18.3	60.5	29.0	13.3	33.3	14.7	15.9	24.2	21.0
PER (adj) x														
FY08	7.4	15.2	7.2	10.5	10.4	6.5	7.7	6.4	8.8	5.6	8.8	8.0	8.5	7.8
FY09	9.1	14.5	6.8	9.0	7.9	7.1	7.4	6.3	7.4	4.9	8.9	6.9	8.0	7.4
FY10	8.0	13.8	6.1	8.0	6.8	6.6	6.6	4.9	6.9	5.6	8.7	5.8	7.3	6.7
FY11	6.7	14.2	5.9	5.8	6.3	6.4	5.5	3.9	6.0	4.9	9.2	5.3	6.7	5.9
P/NAVx														
FY08	2.4	7.6	2.5	0.9	2.5	1.5	6.9	0.4	1.0	2.3	1.5	1.1	2.6	1.9
FY09	2.0	8.3	1.8	0.8	2.1	1.4	6.1	0.3	0.9	1.7	1.5	1.0	2.3	1.6
FY10	1.8	8.1	1.4	0.8	1.8	1.3	5.1	0.3	0.9	2.3	1.4	0.9	2.2	1.4
FY11	1.7	7.7	1.2	0.8	1.5	1.2	3.1	1.1	0.8	1.7	1.4	0.8	1.9	1.3
Div Yld %														
FY08	2.0	6.3	1.2	5.9	2.0	8.6	10.2	6.1	7.3	4.4	7.9	6.7	5.7	6.2
FY09	3.3	6.8	3.2	6.4	3.0	7.7	10.1	7.6	8.9	5.1	8.3	6.8	6.4	6.8
FY10	9.4	7.1	2.4	6.6	3.6	7.7	11.0	9.3	10.5	4.4	8.7	8.5	7.4	8.1
FY11	13.3	6.9	3.8	7.0	3.9	8.3	12.7	10.2	9.5	5.1	8.4	13.0	8.5	8.3
EV/EBITDA x														
FY08	3.8	8.3	4.0	7.0	5.0	3.5	n/a	3.6	4.9	2.9	4.6	6.3	4.9	4.6
FY09	4.0	8.0	3.4	6.4	4.3	3.5	n/a	3.4	4.6	2.4	4.7	5.1	4.5	4.3
FY10	3.5	7.7	3.1	6.0	4.0	3.3	n/a	3.2	4.8	2.9	4.7	4.5	4.3	4.0
FY11	2.9	7.7	2.8	5.9	4.0	3.1	n/a	2.8	4.8	2.4	4.8	4.1	4.1	4.0

Source: Bloomberg

Kestrel Capital (East Africa) Ltd

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Company Update

Financial Summary - Kshs m (Year ending March 31)

Income statement	FY07	FY08	FY09E	FY10F	FY11F	1yr ch %	3 yr CAGR %
Sales	47,447	61,369	63,181	70,636	81,428	3.0	9.9
Gross profit	29,292	35,303	35,947	39,745	45,165	1.8	8.6
EBITDA	24,508	28,152	27,203	29,554	33,673	-3.4	6.2
Less Dep and Amort.	(6,720)	(8,764)	(10,533)	(11,052)	(11,362)	20.2	9.0
Operating profit	17,789	19,388	16,670	18,502	22,310	-14.0	4.8
Finance cost/income	(596)	(491)	(663)	(976)	(1,348)	35.2	40.1
Profit before tax	17,193	18,898	16,007	17,526	20,962	-15.3	3.5
Extraordinary item	-	1,048	-	-	-	-	-
Taxation	(5,182)	(6,092)	(4,802)	(4,732)	(5,660)	-21.2	-2.4
Profit after tax	12,010	13,853	11,205	12,794	15,302	-19.1	3.4
Adjusted Profit after tax	12,010	13,120	11,205	12,794	15,302	-14.6	5.3
EPS	0.30	0.35	0.28	0.32	0.38	-19.1	3.4
ch %	42.5	15.3	(19.1)	14.2	19.6	-224.6	8.5
Adjusted EPS (Kshs)	0.30	0.33	0.28	0.32	0.38	-14.6	5.3
ch %	42.5	9.2	(14.6)	14.2	19.6	-258.0	28.5
DPS	0.10	0.05	0.09	0.24	0.34	70.4	89.1
ch %	33.7	(50.0)	70.4	180.1	41.6	-240.7	-194.1
Balance sheet	FY07	FY08	FY09E	FY10F	FY11F		
Fixed assets	42,732	56,480	68,390	71,907	74,015	21.1	9.4
Other non-current assets	3,527	4,998	4,557	4,115	3,673	-8.8	-9.8
Current assets	10,150	12,887	10,853	35,946	41,037	-15.8	47.1
Total Assets	56,408	74,366	83,799	111,968	118,725	12.7	16.9
Shareholders equity	32,789	42,643	50,790	57,110	60,883	19.1	12.6
Non current liabilities	10,435	6,480	8,184	26,547	21,238	26.3	48.5
Current liabilities	13,184	25,244	24,825	28,311	36,603	-1.7	13.2
Total equity and liabilities	56,408	74,366	83,799	111,968	118,725	12.7	16.9
Debt	10,435	9,199	9,480	28,184	26,547	3.1	42.4
Net debt/(cash)	4,547	3,665	6,232	779	(4,586)	70.1	-207.8
Cash flow statement	FY07	FY08	FY09E	FY10F	FY11F		
Cash generated by operations	24,652	29,516	27,526	29,554	33,673	-6.7	4.5
Working capital	2,233	7,000	752	2,209	3,257	-89.3	-22.5
Operating Cash Flow	26,925	35,618	28,278	31,763	36,930	-20.6	1.2
Net interest received/(paid)	(638)	898	(340)	(976)	(1,348)	-137.9	-214.5
Cash taxes	(5,002)	(6,962)	(4,802)	(4,732)	(5,660)	-31.0	-6.7
Net cashflow before investing	21,285	29,553	23,136	26,055	29,922	-21.7	0.4
Net cash invested	(16,548)	(24,670)	(22,000)	(14,127)	(13,028)	-10.8	-19.2
Free cash flow	4,737	4,883	1,136	11,928	16,894	-76.7	51.2
Net financing cash flow	(4,737)	(4,883)	(1,136)	(11,928)	(16,894)	-76.7	51.2
Net cash flow for the year	2,970	(353)	(2,287)	24,157	3,728	548.3	-319.5
Opening cash balance	2,917	5,888	5,535	3,248	27,405	-6.0	67.0
Forex adjustment							
Closing cash balance	5,888	5,535	3,248	27,405	31,133	-41.3	77.8
Operating Data							
Subscribers ('000)	6,083	10,200	14,220	15,959	16,085	39.4	16.4
Blended ARPU (Kshs)	799	616	431	390	424	-30.0	-11.7
Blended churn	32.0%	25.0%	25.0%	25.0%	18.0%	0.0	-10.4

Kestrel Capital (East Africa) Ltd

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Company Update

SWOT Analysis

Strengths	Weaknesses
<ul style="list-style-type: none">• Leading market share and economies of scale• Established network coverage with >85% of population covered as well as nationwide distribution network• Financial capacity to take advantage of opportunities<ul style="list-style-type: none">◦ Strong cashflow generation◦ Low leverage levels thus capacity to increase borrowing significantly• Skilled human resources and management capability with added expertise from Vodafone experience in emerging markets• Low mobile telephony penetration provides strong growth potential	<ul style="list-style-type: none">• ARPU and margin contraction a reality• Declining pricing power with increased competition• Regional expansion unlikely
Opportunities	Threats
<ul style="list-style-type: none">• Low mobile penetration rate and minutes of usage offers long term upside potential• Rapid increase in data revenue and profitability with ready market positioning• Cost management via increased own retail outlets and other measures• Unrealised potential from M-Pesa	<ul style="list-style-type: none">• Lack of suitable replacement with the exit of CEO in December 2008• Mobile number portability could increase customer churn significantly• Economic slowdown likely to have a negative impact on mobile spend

Source: Kestrel Capital

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Company Update

RECOMMENDATIONS

STRONG BUY:	Highly undervalued/ strong fundamentals
BUY:	Good value/ strong fundamentals
ACCUMULATE:	Buy on price dips
HOLD:	Correctly valued with little pricing upside or downside
LIGHTEN:	Overvalued by the market/ Reduce exposure/Declining fundamentals/ industry concerns
SELL:	Weak fundamentals and challenging operating environment/Highly overpriced

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