

24 May 2010

Telecom Egypt

May buy out Vodafone in Egypt

Buy

Target price
££20.05

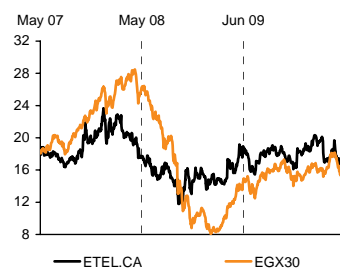
Price
££16.95

Short term (0-60 days)
n/a

Sector view
No Weighting

Price performance

	(1M)	(3M)	(12M)
Price (E£)	18.62	19.00	17.91
Absolute (%)	-9.0	-10.8	-5.4
Rel market (%)	6.8	-4.7	-12.5
Rel sector (%)	17.9	6.3	n/a



Market capitalisation
££28.93bn (€4.08bn)

Average (12M) daily turnover
££30.06m (€4.23m)

Sector: EGX30 Telecoms
RIC: ETEL.CA, ETEL.EY
Priced ££16.95 at close 23 May 2010.
Source: Bloomberg

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Vodafone and Telecom Egypt have held informal talks about the possible sale of Vodafone's 55% stake, although proceedings are at an early stage and no deal is imminent, according to Reuters. According to Bloomberg, the total deal value is estimated to be around £3bn (E£24bn).

Key forecasts

	FY08A	FY09A	FY10F	FY11F	FY12F
Revenue (E£m)	10,117	9,960	10,028	9,722	9,937
EBITDA (E£m)	5,048	4,526	4,404	4,365	4,507
Reported net profit (E£m)	2,448	2,912	3,086	3,081	3,186
Normalised net profit (E£m)	2,448	2,912	3,086	3,081	3,186
Normalised EPS (E£)	1.43	1.71	1.81	1.8	1.87
Dividend per share (E£)	1.3	0.75	1.45	1.53	1.68
Dividend yield (%)	7.67	4.42	8.53	9.05	9.91
Normalised PE (x)	11.8	9.94	9.38	9.39	9.08
EV/EBITDA (x)	5.83	6.09	6.04	5.87	5.51
EV/invested capital (x)	1.12	1.1	1.07	1.05	1.03
ROIC - WACC (%)	0	0	0	0	0

Accounting standard: IFRS
Source: Company data, Rasmala forecasts

year to Dec, fully diluted

Telecom Egypt's interest in Egyptian mobile market lingers

Telecom Egypt's management had stated its interest in adopting a more active role in the Egyptian mobile market by acquiring a fourth licence in the country if it is offered by the NTRA. We contacted Telecom Egypt in the light of the news, but management declined to comment on the validity of the news or the estimated deal value of £3bn, only saying that it is exploring several alternatives that include: 1) increasing its stake and role in Vodafone Egypt, or 2) applying for a fourth mobile licence if the Egyptian government was to make one available.

Need for external financing for Telecom Egypt

Telecom Egypt's balance sheet gives it considerable flexibility with net cash of E£1.7bn as at end-March 2010 (post dividends payable), and we believe this will allow it to raise E£24bn comfortably. We estimate the combined company can achieve nearly E£10bn in EBITDA in 2010 (E£4.5bn for TE and E£5.4bn for VE). We estimate that at current prices the combined company will trade at around 5x 2010F EBITDA. While these estimates assume no cost or revenue synergies, we see room for considerable cost synergies. We note that the speculated price (E£44.1bn for 100% of VE) would value Vodafone Egypt at around 8x EBITDA.

An increase in Vodafone stake is more positive than acquiring a fourth licence

In our MENA Telecommunications Initiation report (*Broadband explosion*, 12 May 2010), we were not positive on Telecom Egypt's intention to acquire a fourth mobile licence, given the country's penetration rates and aggressive competition levels. In our opinion, Telecom Egypt can derive more synergies by increasing its stake in Vodafone Egypt and building on its existing subscriber base. We note that if the transaction happens at the speculated levels, there is likely to be upside to our target price.

Important disclosures can be found in the Disclosures Appendix.

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TE's ticket to the Egyptian mobile market

Vodafone and Telecom Egypt have held informal talks about the possible sale of Vodafone's 55% stake for a total estimated value of £3bn.

According to a number of news sources on 21 May 2010, Telecom Egypt has informally approached Vodafone Global for its 55% stake in Vodafone Egypt, where the total investment value is around £3bn, according to Bloomberg.

Telecom Egypt is the country's fixed line monopoly and has a current 45% stake in Vodafone Egypt. Previously, the company's management expressed interest in a fourth mobile licence if it were to become available. At the time, Telecom Egypt's management cut the 2009 dividend to E£0.75 per share, from E£1.30 for 2008, to retain funds for potential investment opportunities, citing a fourth mobile licence as an example. Telecom Egypt reiterated this position on Friday, 21 May, stating to Reuters, "the company is exploring several alternatives including increasing its stake and role in Vodafone Egypt or potentially to apply for the fourth mobile licence if the Egyptian government were to make one available."

In our MENA Telecommunications Initiation report dated 12 May 2010 (*Broadband explosion*), we were not positive on Telecom Egypt's intention to acquire a fourth mobile licence, given the country's penetration rates and its holding in Vodafone Egypt. We believe an acquisition of the remaining 55% of Vodafone Egypt makes sense for the company. Vodafone Egypt ended March 2010 with a subscriber base of 24.6m, ranking it second behind Mobinil in terms of subscribers in Egypt. Competition within the Egyptian market has been quite fierce for some time, with the three operators aggressively marketing to capture share. All three players in the market – Mobinil, a subsidiary of Orascom Telecom Holding and France Telecom; Vodafone Egypt, a subsidiary of Vodafone Global and Telecom Egypt; and Etisalat Egypt, a subsidiary of UAE-based Etisalat – have rolled out several marketing campaigns to attract new customers and to defend their existing market shares.

Benefits for Telecom Egypt from this investment seem clear

Despite the fixed-to-mobile substitution trend in Egypt, Telecom Egypt has been able to salvage its declining top-line growth through its 45% stake investment on Vodafone Egypt. That noted, we see clear benefits for Telecom Egypt from fully acquiring Vodafone Egypt, given that the mobile market in Egypt is growing at a much a more rapid pace than the fixed line market. Furthermore, with full ownership of Vodafone Egypt, Telecom Egypt will be able to provide triple-play services, thereby offering unique bundled services, given the absence of another fixed-line operator in the market.

Need for external financing for Telecom Egypt

Telecom Egypt's balance sheet gives it considerable flexibility with a net cash position of E£1.7bn as at end-March 2010 (post dividends payable), which we believe will allow the company to raise E£24bn through debt without extending the balance sheet beyond manageable levels. We estimate the combined company can achieve close to E£10bn in EBITDA in 2010 (E£4.5bn for TE and E£5.4bn for VE). While we have assumed no cost or revenue synergies in these estimates, we believe there could be considerable cost synergies. Assuming the deal is financed exclusively through debt, the combined company would have an estimated net debt/EBITDA of 2.4x and would trade at 5x 2010F EBITDA post deal at the current price of E£16.95.

It is worth mentioning that at a £3bn investment, the estimated EV/EBITDA for this deal would be 8x. This is slightly lower than the average for recent M&A transactions in the telecom industry, which we estimate to be around 9.0x.

What could make this work?

Telecom Egypt's operating experience has been centred on operating a fixed-line virtual monopoly. The competitive landscape of the Egyptian mobile market is completely different, with three well-capitalised companies aggressively campaigning to capture market share.

In order for this deal to make sense, we believe Telecom Egypt will need to retain Vodafone Egypt's management team. The combined company should be able to achieve cost synergies and possible revenue synergies as the fixed to mobile substitution trend in Egypt continues. While revenue synergies are more difficult to quantify, we believe the company's government culture

could benefit from Vodafone's Egypt's private enterprise culture. If done properly, the combined company would have the best of both worlds stemming from a fixed-line monopoly with an entrepreneurial edge. Accordingly, we believe the success of this acquisition will depend on the company's ability to adapt to such an environment and to retain Vodafone Egypt's management team.

Reasons behind Vodafone Group's Egypt stake-sale

According to Reuters, Vodafone appears to be suffering from saturated and highly competitive European markets, and high costs and slowing growth in some of its emerging markets such as India. The situation has prompted some analysts to suggest it should look at non-core disposals. Vodafone is looking to pull out of Egypt to free up for other investments, especially in India and Europe. Unlike Vodafone's more mature markets of western Europe, where everyone already has a phone, penetration in Egypt is running at about three-quarters of the population. Prices and margins, however, are already coming under fierce pressure, so an early exit might suit Vodafone, according to the Guardian.

Any cash injection would also be welcome, as Vodafone faces a hefty bill for mobile phone spectrum in Europe and India at a time when it has promised shareholders that it will raise dividends by at least 7% annually over the next three years. While it expects to generate an annual £7bn in cash, the need to buy more spectrum means those dividend payments will not always be covered by earnings.

This week the Indian auction for licences to operate 3G services ended, having raised upwards of US\$15bn for the government – twice what it was expecting. Vodafone was left with a bill of Rs116.18bn (US\$2.5bn) but no bidder won spectrum across the sub-continent. The Indian government has also suggested that it might levy further charges on the spectrum that the country's mobile phone operators already own: something which Vodafone has made clear it will fight very hard to prevent, according to the Guardian.

Appendix

Company overview

Telecom Egypt provides retail telecommunication services including access, local, long-distance and international voice, Internet and data, and other services. The company also provides wholesale services, including broadband capacity leasing to ISPs, and national and international interconnection services. The fixed-line telephony market in Egypt remains 100% dominated by the 80% government-owned Telecom Egypt. Telecom Egypt's Internet and data services include the provision of Internet broadband access through its wholly owned subsidiary, TE Data. Telecom Egypt also participates in the growing mobile segment in Egypt by providing mobile interconnectivity through its 45% holding in Vodafone Egypt, one of the three Egyptian mobile operators and ranked second in terms of market share.

In December 2005, the IPO of Telecom Egypt took place at an unprecedented transaction value at the time – E£4,531m (US\$824m). Telecom Egypt listed 20% of its shares on the market.

Telecom Egypt is listed on both the Egyptian Stock Exchange and the London Stock Exchange.

Recommendation structure

Absolute performance, long term (fundamental) recommendation: The recommendation is based on implied upside/downside for the stock from the target price and only reflects capital appreciation. A Buy/Sell implies upside/downside of 10% or more and a Hold less than 10%.

Performance parameters and horizon: Given the volatility of share prices and our pre-disposition not to change recommendations frequently, these performance parameters should be interpreted flexibly. Performance in this context only reflects capital appreciation and the horizon is 12 months.

Market or sector view: This view is the responsibility of the strategy team and a relative call on the performance of the market/sector relative to the region. Overweight/Underweight implies upside/downside of 10% or more and Neutral implies less than 10% upside/downside.

Target price: The target price is the level the stock should currently trade at if the market were to accept the analyst's view of the stock and if the necessary catalysts were in place to effect this change in perception within the performance horizon. In this way, therefore, the target price abstracts from the need to take a view on the market or sector. If it is felt that the catalysts are not fully in place to effect a re-rating of the stock to its warranted value, the target price will differ from 'fair' value.

Valuation and risks to target price

Telecom Egypt (RIC: ETEL.CA, Rec: Buy, CP: E£16.95, TP: E£20.05): Our target price is based on an equal weighting of our DCF-based and multiples-based valuations. The main downside risk is the addition of a second fixed-line operator in Egypt, and the prevalent fixed-to-mobile substitution trend, arising from the aggressive competition of mobile operators.

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