Vodacom Corporate Park
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South Africa
http://www.vodacom.co.za

RESEARCH REPORT:

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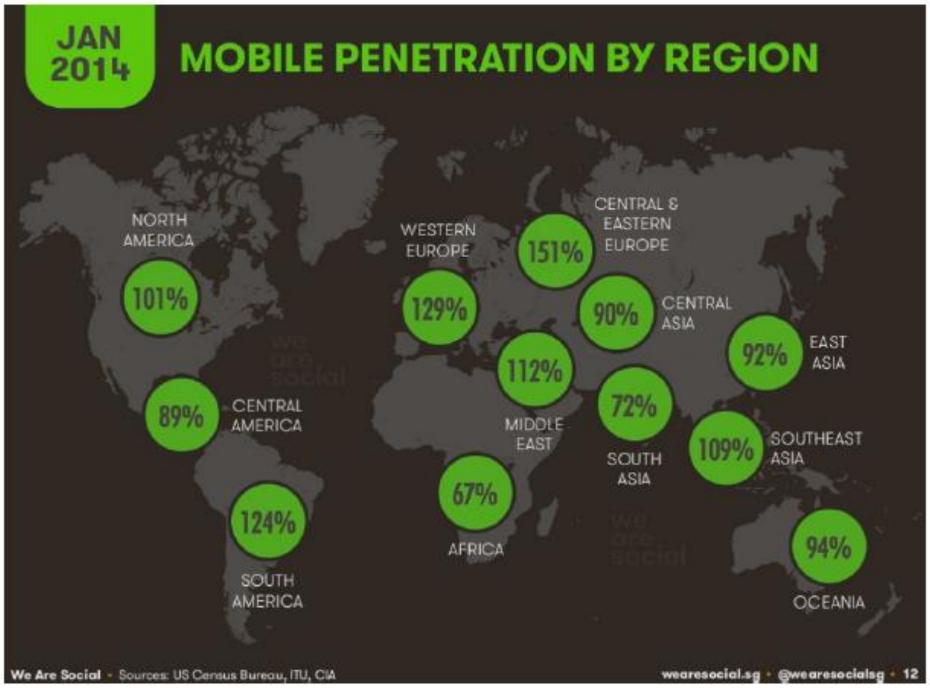
COMPANY OVERVIEW AND REPORTABLE SEGMENTS:

Vodacom Group Limited (VDMCY) is a leading mobile and communications company providing a wide range of services, including mobile voice, messaging, data and converged services to approximately 57.5 million customers in South Africa and internationally throughout the African continent. The company also offers internet and fixed line services, as well as M-Pesa – a proprietary mobile money transfer service. In addition to their chief presence in South Africa, Vodacom has grown their mobile operations to include networks in Tanzania, the Democratic Republic of Congo (DRC), Mozambique and Lesotho. The company also offers business managed services to enterprises in over 40 countries across Africa. Further, Vodacom is majority owned (65%) by Vodafone Group PLC (VOD).

The company has three reportable segments: Corporate, South Africa and International. Corporate comprises the holding companies of Vodacom which do not relate to specific operating segments. South Africa consists of the company's operations related to the South African-based cellular network, service provider and other business segments. Lastly, International includes all business related to the non-South African-based cellular networks in Tanzania, Mozambique, Lesotho and the Democratic Republic of Congo (DRC), as well as the operations of Vodacom International Limited, Vodacom Business Africa and for prior years, Gateway Carrier Services.

INDUSTRY AND COMPETITION:

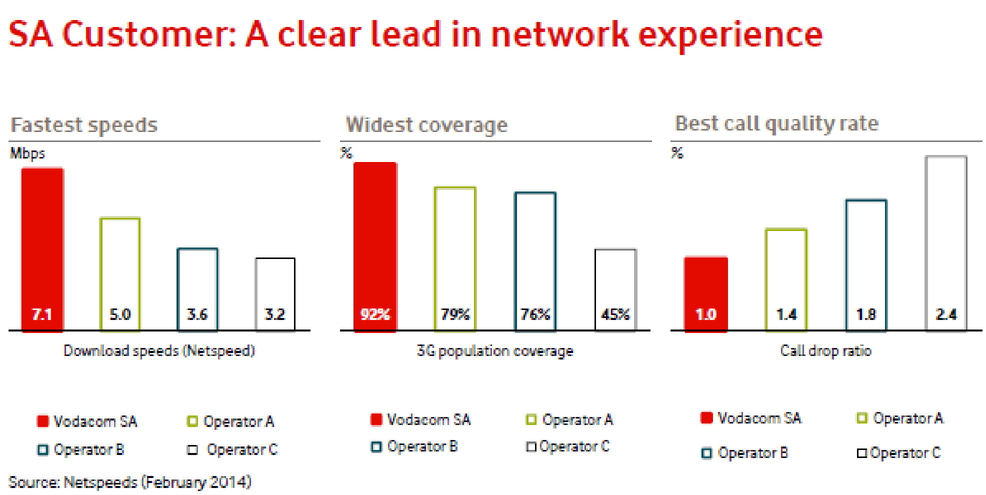
The mobile telecommunications market in Africa is rather bifurcated with some countries, such as South Africa, experiencing high levels of penetration and some countries, such as DRC, exhibiting fairly low levels of penetration. Overall, Africa has the lowest mobile penetration in the world despite having a population over one billion. As a result, the growth potential there in mobile is among the highest in the world.



Source: African Digital Statistics 2014, Lagos[1]

Across Africa, the telecom and cell phone markets are dominated by just a few major providers, with some smaller companies scattered throughout the continent. In South Africa, where cell phone use is high, the two biggest companies are Vodacom and MTN in the #1 and #2 spots, respectively. Other smaller companies who compete in the same market are Cell C, Virgin Mobile and Telkom Mobile.

However, as illustrated in their 2014 *Annual Results Presentation*, Vodacom appears to have the upper hand in South Africa on a variety of network-related metrics, including those concerning speed and coverage.



Source: VDMCY Annual Results Presentation, 31 March 2014

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While Vodacom's presence in South Africa is slightly larger than MTN's, the two companies do not really compete as much in other markets as Vodacom's diversification is more limited than MTN's. For example, Vodacom's international operations include only four other countries, while MTN's international operations stretch to about 20 with many in the Middle East.

Within the countries that Vodacom operates, their presence is not only large, but subject to favorable growth opportunities in the future – mostly due to low penetration rates in some of those markets.

Penetration Rates	**South Africa**	**DRC**	**Tanzania**	**Mozambique**	**Lesotho**
Population	53 million	69 million	51 million	27 million	2 million
Active Customers	31.5 million	10.0 million	10.3 million	4.3 million	1.3 million
Mobile Penetration	146%	35%	57%	39%	82%
% of VDMCY Total Customers	*55%*	*17%*	*18%*	*7%*	*2%*

Source: VDMCY Integrated Annual Report 2014, 31 March 2014

Going forward, Vodacom has identified two notable industry trends that will contribute to diversifying their revenues over the coming years – the rapid growth in demand for data and the increased potential for mobile financial services. With regard to the former, as higher speed networks (see: 3G and 4G) and more advanced devices become more commonplace in the market, the rate of growth in data traffic is likely to far outstrip the growth in mobile connections. Currently, the proportion of these higher speed networks is approximately 33%, but that is expected to double by 2020.[2] In order to deal with this increase in global data traffic, mobile operators have invested substantially in their networks by extending the quality, speed and coverage of data connectivity.

Meanwhile, the advent and growing acceptance of mobile financial services can help transform the daily lives of people and drive socioeconomic development in developing regions around the world. Through mobile technology, financial services can be brought to previously unbanked and under-banked populations of the world, helping drive economic growth and promoting financial inclusion. Further, mobile connectivity can also benefit some of the most disadvantaged communities through other emerging services such as e-Health and e-Education.[3]

FINANCIALS:

Suffice it to say that Vodacom not only has a dominant presence in one of the largest markets in Africa, but it also has excellent growth prospects in their international markets due to the lower rates of penetration in those markets. As such, it should not be surprising that the company's financials are favorable and have shown improvement over the past several years.

Since 2006, Vodacom has managed to grow their revenue and EBITDA by an average of nearly 11%, while improving gross margin more than 10% to 56.6% at the end of March 31, 2014. Additionally, the company has grown earnings per share (EPS) by an average of 8.9% over the same time frame.

As shown below, over the last three years the company's International Segment has grown revenue and EBITDA faster than their South Africa Segment. Further, over the same time period, Vodacom has derived more of their revenue and EBITDA from their International Segment (increasing from 15.6% to 19.0% and from 6.4% to 15.6%, respectively) while their South Africa Segment has accounted for less (decreasing from 85.1% to 81.6% and from 93.4% to 84.5%, respectively).

Revenue Breakdown by Segment (ZAR in millions)	**2014**	**2014**	**2013**	**2013**	**2012**	**2012**
Corporate	93	0.1%	578	0.8%	541	0.8%
South Africa	61,806	81.6%	58,607	83.8%	56,932	85.1%
YoY South Africa Growth	***5.5%***		***2.9%***			
International	14,356	19.0%	11,583	16.6%	10,426	15.6%
YoY International Growth	***23.9%***		***11.1%***			
Eliminations	*(544)*	*-0.7%*	*(851)*	*-1.2%*	*(970)*	*-1.4%*
Total	**75,711**	**100%**	**69,917**	**100%**	**66,929**	**100%**

EBITDA Breakdown by Segment (ZAR in millions)	**2014**	**2014**	**2013**	**2013**	**2012**	**2012**
Corporate	(56)	-0.2%	84	0.3%	(114)	-0.5%
South Africa	23,087	84.5%	22,408	88.7%	21,254	93.4%
YoY South Africa Growth	***3.0%***		***5.4%***			
International	4,256	15.6%	2,739	10.8%	1,461	6.4%
YoY International Growth	***55.4%***		***87.5%***			
Eliminations	*27*	*0.1%*	*22*	*0.1%*	*162*	*0.7%*
Total	**27,315**	**100%**	**25,254**	**100%**	**22,763**	**100%**

Source: VDMCY Integrated Annual Report 2014, 31 March 2014

In addition, it appears as though the company has been relatively consistent in their asset utilization while also improving efficiency over the years. For example, not only has Vodacom been experiencing a negative cash conversion cycle, but it has become increasingly negative over the years. A negative cash conversion cycle is favorable because it occurs when the company does not pay for their inventory or materials until after they have sold the final product associated with those materials. While some telecom competitors also exhibit negative cash conversion cycles, Vodacom is arguably among the more efficient companies. Moreover, while the trends in the company's turnover ratios are not as favorable as their cash conversion cycle and its components, these values have remained fairly consistent over the years with 2014's ratios hovering near their longer-term averages.

Efficiency Ratios	**2006-03**	**2007-03**	**2008-03**	**2009-03**	**2010-03**	**2011-03**	**2012-03**	**2013-03**	**2014-03**	**AVG**
Days Sales Outstanding	*48.11*	*45.22*	*47.38*	*52.60*	*59.64*	*62.02*	*60.40*	*58.34*	*54.30*	***54.22***
Days Inventory	*9.06*	*6.66*	*6.95*	*7.74*	*9.27*	*9.96*	*9.84*	*10.17*	*10.72*	***8.93***
Payables Period	*101.83*	*97.42*	*100.17*	*92.54*	*133.46*	*163.45*	*171.32*	*199.32*	*211.77*	***141.25***
Cash Conversion Cycle	*-44.66*	*-45.55*	*-45.84*	*-32.21*	*-64.55*	*-91.47*	*-101.08*	*-130.82*	*-146.75*	***-78.10***
Receivables Turnover	*7.59*	*8.07*	*7.70*	*6.94*	*6.12*	*5.89*	*6.04*	*6.26*	*6.72*	***6.81***
Inventory Turnover	*40.28*	*54.82*	*52.54*	*47.18*	*39.39*	*36.65*	*37.11*	*35.89*	*34.06*	***41.99***
Fixed Assets Turnover	*2.54*	*2.70*	*2.66*	*2.69*	*2.71*	*2.85*	*2.91*	*2.68*	*2.59*	***2.70***
Asset Turnover	*1.37*	*1.55*	*1.54*	*1.35*	*1.31*	*1.47*	*1.49*	*1.35*	*1.30*	***1.41***

Source: Morningstar

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Additionally, in looking at the company's return on assets (ROA) and return on equity (ROE) over the years, there exists further proof of management's effectiveness in using the firm's resources – both physically and monetarily. Given both the high percentages and the fact that both ratios are currently higher than their longer-term averages, it seems safe to say that management is able to earn a nice profit on both company assets and shareholders' money.

Profitability	**2006-03**	**2007-03**	**2008-03**	**2009-03**	**2010-03**	**2011-03**	**2012-03**	**2013-03**	**2014-03**	**AVG**
Return on Assets (ROA) %	*20.29*	*23.83*	*24.94*	*14.94*	*9.42*	*19.84*	*22.65*	*25.03*	*22.77*	***20.41***
Return on Equity (ROE) %	*57.96*	*69.24*	*72.83*	*45.27*	*28.22*	*53.51*	*57.85*	*64.72*	*58.91*	***56.50***

Source: Morningstar

Furthermore, as evidenced by the company's improving Sloan Accruals ratio over the years, Vodacom has shown that their earnings are more likely to be made up of cash rather than accruals, therefore suggesting an improvement in the *quality* of their earnings as well.

	2006-03	**2007-03**	**2008-03**	**2009-03**	**2010-03**	**2011-03**	**2012-03**	**2013-03**	**2014-03**	**AVG**
Sloan Accruals Ratio	21.9%	29.1%	30.2%	31.2%	-10.6%	-4.4%	-2.3%	0.3%	-1.6%	***10.4%***

Meanwhile, Vodacom's balance sheet has exhibited a similar and encouraging pattern over the past several years. Although the company has grown their debt load over the years, the amount is small relative to their overall market cap, while many of their associated liquidity and debt ratios have shown improvement since 2006.

Some of this evidence can be seen below via the company's increasing current ratio and improving working capital over the years, helped somewhat by Vodacom's growing cash position during that time. Further, Vodacom's financial leverage (see: debt to equity ratio) has decreased over the years and is currently below its longer-term average, while their interest coverage ratio has shown dramatic improvement since 2006 and is currently above its longer-term average. Additionally, Vodacom's current interest coverage ratio of 19.4 is further proof that the company can easily pay the interest on its outstanding debt and is therefore not hindered in any way by its debt burden.

Liquidity	**2006-03**	**2007-03**	**2008-03**	**2009-03**	**2010-03**	**2011-03**	**2012-03**	**2013-03**	**2014-03**	**AVG**
D/E Ratio	1.86	1.95	1.89	2.14	1.85	1.56	1.55	1.62	1.56	***1.77***
LT Debt/Equity Ratio	0.09	0.21	0.26	0.55	0.67	0.45	0.48	0.37	0.41	***0.39***
Current Ratio	0.63	0.51	0.55	0.56	0.81	0.81	0.96	0.85	0.91	***0.73***
Working Capital (CA-CL)	(5,170)	(7,385)	(7,875)	(9,696)	(2,905)	(3,059)	(816)	(3,598)	(2,201)	***(4,745)***
Interest Coverage Ratio	6.94	5.97	18.11	8.05	7.01	15.85	22.22	20.39	19.40	***13.77***

Moreover, in perhaps one of the more important points, Vodacom has been free cash flow (FCF) positive since 2010 and has grown their free cash flow by an average of 12.4% over the past four years. Considering the company's impressive operating cash flow (OCF) growth since 2006 (at approximately 37.7%), it is not that surprising that Vodacom has managed to significantly increase their free cash flow over the years.

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Lastly, despite the company's plan to increase their capital expenditures (capex) by almost 20% to around R13 billion, as a percentage of OCF this amount is not expected to increase too dramatically. In fact, over the last several years, as the company's capex spending has increased, it has been offset by their growing OCF. Plus, this increase in capex spending should be viewed as a positive for the company considering the majority of their investment will go toward reinforcing their network advantage while providing new revenue opportunities in the fixed line and enterprise markets.

REIT-LIKE CHARACTERISTICS:

While Vodacom operates in higher risk, developing countries compared to less volatile, developed countries such as the US, conservative investors will likely view shares of VDMCY in a favorable light given the company's position within the telecom industry and their high dividend yield. In fact, the company's policy of returning at least 90% of headline earnings per share to shareholders in the form of ordinary dividends is part of management's business strategy going forward, and has been in place for the last couple of years. For example, in 2013 and 2014, Vodacom's payout ratio has been approximately 92%. As such, shares of VDMCY act as sort of a pseudo-REIT considering REITs (real estate investment trusts) are required to distribute at least 90% of their income in order to claim tax exemption at the trust level. Although VDMCY does not qualify for any favorable tax treatment based upon their payout ratio like REITs, it does provide some margin of safety for their shareholders.

VALUATION AND RECOMMENDATION:

Using a blended valuation combining the dividend discount model (DDM) and a discounted cash flow (DCF) model, I recommend buying shares of VDMCY at current levels (approximately $12.79 per ADR share) and see a one-year price target of $13.37 for an approximate price return of about 4.5%. This, coupled with VDMCY's roughly 6% dividend yield, should provide an estimated total return of 10.5% for the year. Further details and assumptions are shown below:

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Assumptions:	**DDM**	
	Req. Return on Equity	11.21%
	Country Risk Premium	2.92%
	Foreign Currency Sensitivity	0.5
	2015 Dividend (ZAR)	8.6229
	Growth Rate (g)	4.52%
	ZAR/USD (as of 6/20/14)	0.09385
	Price VDMCY ADR	**$12.10**
	DCF	
	WACC	10.78%
	Growth Rate (g)	4.52%
	2015 FCF (ZAR)	14,345.37
	ZAR/USD (as of 6/20/14)	0.09385
	Value (ZAR)	229.14B
	Shares Outstanding	1.47B
	Price VDMCY ADR	**$14.63**

Blended Price Target:

Forecasted Price	Weighting	Factor
$12.10	0.5	$6.05
$14.63	0.5	$7.32
		$13.37

Additionally, although the company currently maintains a 90% or greater payout ratio, if this were to decrease in the future, the risk for the stock price would be to the upside as the company would keep more of their earnings to reinvest in future growth. However, this price increase would be mitigated to some degree by the decrease in yield and possible negative perception in the market as a result of this change in dividend policy.

CONCERNS:

Aside from the obvious concerns regarding Vodacom's operations in various emerging market countries within Africa and the associated geopolitical risks, the company is also subject to significant foreign currency risk related to the South African rand. For example, US-listed ADR shares of VDMCY will be impacted depending on the direction of the ZAR/USD rate in the future.

Meanwhile, another major risk associated with shares of VDMCY relates to the company's churn rates over the past three years in South Africa and internationally. The churn rate is essentially the percentage of subscribers that discontinue their service over a set time period. Given the amount of competitors in the telecom industry, for example, it is relatively easy for subscribers to switch between providers, and as a result, is a heavily monitored metric by companies such as Vodacom. Although the data provided by the company only shows the last three years, most of the countries below have exhibited an increasing churn rate over that time. Moreover, some countries such as DRC and Mozambique already exhibit fairly high churn rates, which could be worrisome going forward.

Churn Rate	**2014**	**2013**	**2012**
South Africa	53.8%	51.2%	37.8%
Tanzania	51.1%	69.0%	39.6%
DRC	85.1%	79.7%	69.5%
Mozambique	76.4%	63.9%	60.5%
Lesotho	42.2%	35.4%	22.7%

Source: VDMCY Integrated Annual Report 2014, 31 March 2014

BOTTOM LINE:

Shares of VDMCY appear to be undervalued at current prices, especially considering the company's hefty dividend yield. While churn rates have been on the rise recently, Vodacom's financials paint a favorable picture over the past several years, and are expected to continue going forward. Additionally, the company's position in its key market of South Africa, as well as its international markets, is encouraging and should be helped by both their reputation and increased capex spending. Moreover, Vodacom's management team has certainly proven to be capable over the years and will likely be aided going forward by the significant resources available to them through Vodafone's 65% ownership in VDMCY.

SOURCES:

[1] http://socialmediaweek.org/lagos/2014/02/03/african-digital-statistics-2014/
[2] VDMCY Integrated Annual Report 2014. Year End 31 March 2014. Page 12.
[3] Ibid.

Disclosure
I have no positions in any stocks mentioned, and no plans to initiate any positions within the next 72 hours. I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it, and I have no business relationship with any company whose stock is mentioned in the article.

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