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MTN expected to weather the gathering regulatory storm clouds - Kagiso Asset Management Equity Analyst and Portfolio Manager Aslam Dalvi

Regulatory risks have recently been at the centre stage in the mobile telecommunications sector with a specific focus on major developments in interconnected rates and subscriber registration.

The weak performance by MTN over the last six months can partially be explained by increasing concerns around regulation in the sector and the potential impact on the business.

It is worth highlighting that, over time, one should expect further regulatory intervention as markets mature and as African governments increasingly adopt telecommunication policies of the developed world.

This has important consequences for mobile operators in developing markets. In particular, it is worth highlighting that in the absence of explicitly modelling the impact of regulation on each market, one will tend to over-estimate sustainable profits.

Effects of regulatory interventions on MTN

Since the announcement of these regulatory interventions, the market has been unsure of the exact impact on MTN.

While most participants approach this problem from a more theoretical point of view, Kagiso Asset Management has taken another approach: We have focused on more empirical research and drawn our conclusions from there. We believe this is an appropriate reference point from which to start and hopefully provide a better understanding of the likely impact on MTN.

Subscriber registration/RICA (Regulation of Interception of Communication Act and Provision of Communication-Related Information Act)

In South Africa this legislation was implemented on 1 July 2009 and the government has set a deadline whereby all subscribers will have to be registered before 1 December 2010. The Nigerian regulator followed shortly thereafter with the Nigerian Communication Commission (NCC) announcing that subscriber registration will be implemented from 1 March 2010, which was subsequently extended to May 1 2010. The NCC has indicated that operators will have 6 months to register subscribers.

While we acknowledge that not all mobile markets are directly comparable, we believe the exercise of comparing experience from subscriber registration in other markets does

provide some useful insights into the likely impact in South Africa and Nigeria. Based on experience in other markets such as Kenya, Pakistan, Algeria and Indonesia, subscriber registration will:

- Likely lead to a slowdown in net subscriber additions

This occurs as it takes time to alter distribution channels and equip them to handle the additional administrative burden. While data is not available, anecdotal evidence suggests that subscribers generally have multiple sim cards to take advantage of on-net calling plans and special deals, where for example airtime is bundled with the purchase of a new sim card. With subscriber registration, we would expect this behavior to decline as registration is generally viewed as cumbersome.

- Likely result in once-off declines in subscribers as operators terminate subscribers that cannot be registered
- Likely result in a reduction in churn with subscribers moving less between networks

In fast growing markets with low penetration (such as Nigeria) we believe subscriber registration does not alter the long-term demand characteristics of a market and we see subscriber growth normalizing once the registration process is complete. Subscriber registration therefore only shifts out our penetration expectations by 12 to 18 months with a small negative impact on valuation.

Decline in Mobile Termination Rates (MTRs)

In November 2009, government pressures in South Africa led mobile operators to agree to a 40% reduction in MTRs (from R1.25 to R0.80). The first decline will be implemented in March 2010 with rates falling from R1.25 to R0.89.

In December 2009, the NCC also announced a reduction in interconnect rates - the second time that rates were lowered in Nigeria after a first announcement in 2006.

While we believe these developments are negative for operators, we think the market is far too bearish on the likely impact of these developments on revenue.

From a theoretical point of view, the regulation of MTRs is not the same as tariff regulation. While we acknowledge that overall tariffs will likely decline, we see operators compensating by increasing overall subscription charges, reducing incentives to their distribution channel and through lower subsidies to customers.

Empirical research tends to support this view with several studies clearly documenting the presence of what is often referred to as the 'waterbed' effect – pressure in one area of the pricing equation being offset by increasing charges in other areas.

Work done by Christos Genakos and Tommaso Valletti^[1] provides strong evidence of the existence of this effect. The study tracks the overall bills of mobile customers in over 20 countries pre and post a forced reduction in termination rates. Findings provide a better understanding of the likely impact on operators in South Africa and a much better reference point for modelling. Key conclusions are summarized below:

- There is statistically significant evidence of the 'waterbed' effect. There is strong evidence highlighting that in the long run overall prices paid by customers increase once termination rates are cut. This often reflects operators compensating for lost interconnect profits, which in some cases were used to subsidise low end customers.
- Interestingly, the paper also looks at the profitability of operators pre and post the introduction of MTR cuts. While the evidence is statistically weaker, the findings show that short-term profitability of operators is positively correlated to movement in termination rates. The paper finds that for every 10% reduction in MTRs, Average Revenue Per User (ARPU) declines by between 2% and 3%.

It is clear from the above analysis that the impact of these regulatory changes, while negative, is not as material as initially feared. In addition, Kagiso Asset Management believes that MTN's share price has been unduly punished on the back of these changes and we expect the group's operations to comfortably weather the regulatory storm.

^[1] "Testing the 'Waterbed' Effect in Mobile Telephony," October 2007

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