ETEL: Telecoms landscape, changes afoot – BUY

- **We believe that Egypt is moving towards the biggest shake-up in its telecoms market since the entry of the cellular operators in late 1990's**
- **While there has yet been no official statement by any operator, the regulator (NTRA) or the MCIT, we have pieced together from various press comments what we believe the new telecoms landscape could look like**
- **We believe it is increasingly likely that on a three-year view, Egypt will have a telco market in which all existing players will have the opportunity to become fully integrated players. This does not necessarily mean all operators will choose to become fully integrated. Whether players take up licences will depend on the economics of the proposition, i.e. the cost of the licences, access charges and pricing, as well as expected market share penetration**
- **We believe that further liberalisation of the telecoms market will occur in two phases**

Phase 1

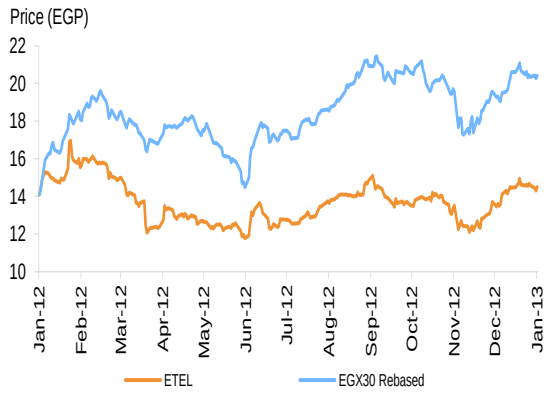
This phase is expected to last two years and comprises the following:

1. ETEL is granted a mobile virtual network operator (MVNO) licence, either for a small fee or gratis
2. The three existing mobile operators are granted the right to offer domestic fixed-line services to end-customers through ETEL's existing network
3. International gateway licences (IGW) are re-priced, making them more economically viable for Vodafone Egypt (VFE) and Mobinil. IGW licences are already on offer, but at a cost of EGP100/existing subscriber plus EGP25/future subscriber are prohibitively expensive. We believe NTRA may alter the pricing to a one-time payment that is independent of the subscriber base. In such a scenario, the government may have to compensate Etisalat Misr for changing the goal posts after it paid for its IGW in 2007

Phase 2

After two years, the government may offer full-scope integrated licences, including 4G mobile services and fixed-line services (i.e. give operators the right to install their own fiber infrastructure). At this stage, ETEL would move from being an MVNO to a fully-fledged mobile operator with its own spectrum and tower/cell-site infrastructure. By then, it should have built a critical mass of subscribers through its two-year old MVNO service.

ETEL vs. EGX 30 Rebased



Source: Bloomberg, NAEEM Research

Market Price (EGP)	14.5
Target Price (EGP)	17.5
Upside Potential (%)	20.7
Free Float (%)	20.0
Market Cap. (EGPm)	24,753
Market Cap. (USDm)	3,722
Reuters Code	ETEL.CA
Bloomberg Code	ETEL EY

Year to 31 December	2010a	2011a	2012e	2013f	2014f
Revenue (EGPm)	10,218	9,895	9,940	9,626	9,475
Revenue (% Δ)	2.6	(3.2)	(0.5)	(3.2)	(1.6)
EBITDA (EGPm)	4,663	4,551	4,185	4,043	3,961
EBITDA Margin (%)	45.6	46.0	42.1	42.0	41.8
EPS (EGP)	1.62	1.49	1.55	1.39	1.31
EPS (% Δ)	(3.0)	(8.0)	4.0	(10.4)	(6.1)
P/E (x)	9.0	9.7	9.4	10.4	11.1
EV/EBITDA (x)	3.7	3.6	3.7	3.8	3.7
P/CF (x)	7.8	7.7	7.9	7.4	7.5
DPS (EGP)	1.30	1.40	1.45	1.30	1.20
Yield (%)	9.0	9.7	10.0	9.0	8.3
ROE (%)	9.6	9.5	9.7	7.9	8.1

Source: Company data, NAEEM estimates
Closing price as of 22 January 2013

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Meanwhile, cellular operators would have had the opportunity to build their own fiber rings to handle their traffic (cellular and any domestic fixed-line) as well as backhaul links to their IGWs.

Implication for ETEL: Positive in the short-term, but competitive IGWs would be damaging

We have long been in sync with ETEL management's "if you can't beat 'em join 'em" thinking on mobile. While we are sanguine about the MVNO approach, we have concerns regarding the "price" ETEL is paying for direct access to the mobile market, i.e. the risk from additional competitive IGWs, and later on, the prospect of other players owning their fiber infrastructure. Both developments would be damaging to ETEL's wholesale revenues. International wholesale revenue, which would be most at risk, currently accounts for 40% of ETEL's total revenues (75.2% of its wholesale revenue). We note, however, that both Mobinil and VFE currently have live, three-year wholesale agreements with ETEL, giving it protection for at least that period.

We think an MVNO can work for ETEL

We believe that an MVNO licence fee would not be a burden on ETEL and could cost less than USD100m. ETEL currently holds EGP5bn in cash (c. USD751.8m). ETEL may even be awarded the licence at no cost, given that there is no spectrum allocation involved. Further, MVNO does not involve any capital investment, as network capacity is leased from other cellular operators.

We see the two years as a decent interim period for ETEL to gain critical mass in its MVNO before embarking on a capital-intensive green-field infrastructure licence. We believe that after two years as an MVNO, ETEL could build a subscriber base of around 3-5m (subjected to the type of strategy it adopts).

As things stand, we would expect ETEL to run its MVNO service over VFE's network; however, it is possible that this relationship will change (see below). Therefore, to get the best pricing, ETEL will likely play off all three mobile operators when buying capacity.

We expect ETEL's MVNO to focus on the enterprise segment (especially government entities and state-owned banks) and broadband (data is becoming key while voice is increasingly being commoditised). This differs from a usual MVNO market focus, which tends to be towards the lower end of the pre-paid market.

Once it has its MVNO licence, ETEL could begin offering its customers triple-play (fixed voice, ADSL broadband and mobile) bundles, assuming regulatory approval comes through.

Cellular at last, but at what cost?

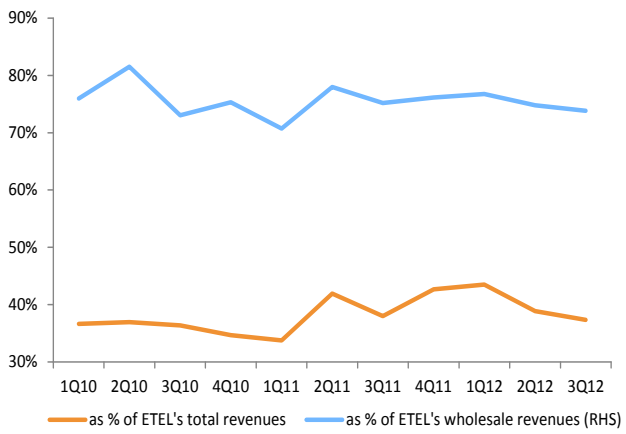
If ETEL is to be given an MVNO licence without an auction, the government may feel obliged, or even pressured, to provide a *quid pro quo* to mobile operators. Initially, we believe this will be the right to resell domestic fixed-line services using ETEL's network and a re-pricing of IGW licence fees to make them economically viable for Mobinil and VFE.

While mobile operators may be interested in offering domestic fixed line services to customers, history shows that in other markets, switching to alternative service providers is a slow process, and the incumbent usually continues to retain the dominant market share. Further, to the extent that cellular operators do sell this service, ETEL will still get paid for transmitting and terminating calls. Lastly, interconnect and access charge regime negotiations tend to be arduous and, in the end, often require intervention from the regulator to fix rates. As a result, we are not overly concerned about ETEL's loss to competitors reselling domestic fixed-line services over ETEL's network in the medium term.

A much greater risk to ETEL, in our view, is from Mobinil and VFE being given the right to install their own IGWs under much easier licence terms than are current being offered (EGP100/existing subscriber and EGP25/future subscriber, which would cost Mobinil EGP3.3bn and VFE EGP3.9bn).

We believe these new IGWs would be very damaging to ETEL's wholesale segment, as revenue from the expected nascent mobile business would be insufficient to offset the impact. We estimate that at least c. 20% of ETEL's revenue would be at risk.

Figure 1: Int'l revenues as % of wholesale and total revenues



Source: Company data, NAEEM Research

Basically, once the international switches are installed, the two cellular operators could immediately direct all outbound international calls through their own gateways. They may even be able to compete to land incoming international traffic from foreign operators (although this is a much more fickle business).

Thankfully for ETEL, there is some protection in the near term, as Mobinil and VFE have both signed three-year wholesale (I&I) agreements with ETEL. Even if the integrated licences are offered immediately, wholesale revenues should be protected for at least that period (it would also take mobile players at least 18 months to install their infrastructure). Further, the pricing of the licence and the termination rates operators can negotiate will still have to be assessed in a build-or-buy analysis.

Challenges in phase 2

Egypt's mobile market is maturing fast (penetration at the end of 2012 was c. 132% and marginal ARPU below USD3), and by the time ETEL is able to build and launch its own network in 2015 or 2016, penetration could be in excess of 150%. Further, recent history shows that the mobile market is already highly competitive, making it very difficult for a new entrant to build market share with decent profitability margins.

4G licences, including spectrum, could be costly. Etisalat paid EGP16.9bn (USD2.7bn) for the third (2G & 3G) licence in 2007, so it would be difficult for the NTRA to ignore this as a pricing guideline for new licences. While ETEL would have the cash (see below), the key factor is the return on investment.

ETEL would likely incur start-up losses for at least the first two years of its network being operational.

Mobile operators building their own IGW and fiber backbone:

- ETEL's management argues that in a build-or-buy analysis (assuming mobile operators have the right to install fiber backbones and/or IGW), mobile operators would still opt to buy capacity and gateway access from ETEL
- We are not banking on this and believe that Mobinil, VFE and Etisalat would be keen to install fiber rings in Egypt's main cities in the medium term

What of ETEL's VFE stake?

ETEL currently owns 45% of VFE. There has been much speculation over whether it would be required to sell this stake if it obtains a mobile license.

In our view, we do not think the authorities will force ETEL to sell its stake while it operates as just an MVNO. However, as we move into phase 2 under which ETEL would become an infrastructure-based operator with its own spectrum, it may then be forced to divest.

In theory therefore, ETEL could hold on to its VFE stake for now, and look for a buyer at a later stage. However, we think ETEL may not wait, preferring to find a buyer sooner rather than facing a forced sale at a later stage. We would not be surprised if ETEL has already been courting buyers. Possible buyers include regional heavyweight Qtel and Asian players such as SingTel, China Telecom or PCCW. Players of this size and reputation would have the necessary clout to buy not just ETEL's stake but the whole company from Vodafone Group (VG).

The sale would hit ETEL's P&L, as it would lose income from investments from VFE (35% of ETEL's 2011 net earnings and 37% of 9M12 net earnings), and revenue from the nascent mobile business would be insufficient to offset the impact in the short term.

Nevertheless, selling its stake in VFE could raise c. USD2bn for ETEL (we value VFE at USD4.4bn based on a 6x forward EV/EBITDA), which means that a generous special dividend might be on the cards (bearing in mind that a cash-hungry government owns 80% of ETEL); the cash would also provide ETEL the financial firepower to buy a 4G licence and roll out a network.

On current multiples of 11.6x 2013e P/E and 5.6x EV/EBITDA, ETEL trades at 14% and 20% discount to peers, respectively, while the underlying fixed line business trades at an implied EV/EBITDA of just 3.1x. We believe that as Egypt's political future become more settled after the parliamentary elections (expected in 2Q13), and if the USD4.8bn IMF loan is finally approved, then ETEL shares should rerate towards the peer average. Accordingly, we raise our target price to EGP17.5 (from EGP16.6 previously), indicating 21% upside potential from current levels and maintain our BUY recommendation.

While we have medium-term concerns over ETEL's business in a liberalized environment, particularly its international wholesale revenues, investors are advised to remain buyers in the near term, both on valuation and for the prospect of the 2012 dividend (a 94% payout is expected) being followed by a windfall payout if ETEL sells its VFE stake. Further, from a sentiment perspective, we believe ETEL's shares will respond favourably to the announcement of an MVNO and a possible sale of its VFE stake.

Disclosure Appendix

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REDUCE	<-10% to -20%	0%
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