EDISON

Kcell Joint Stock Company

Resilience and consolidation benefits expected

Initiation of coverage

Telecoms

A change in market structure and strategy has transformed Kcell's prospects. It delivered a c 80% rise in underlying profits and cash flow in FY19 and a 31% y-o-y rise in adjusted EBIT in Q1. We assume the pace of profit growth slows in the remainder of FY20 as COVID-19 measures and a slump in the oil price affect economic activity. However, beyond FY20 scope for further market consolidation should ensure that healthy profit and cash flow growth resumes.

Year end	Revenue (KZTbn)	Adj EBITDA* (KZTbn)	Adj EPS* (KZT)	EV/Adj* EBITDA (x)	P/E (x)	FCF yield (%)	Div yield (%)
12/19	156.7	63.5	104	8.7	24.2	3.1	1.2
12/20e	159.5	66.4	108	8.3	23.1	6.7	1.8
12/21e	169.7	69.9	124	7.9	20.1	6.6	5.0
12/22e	177.9	72.8	138	7.6	18.0	7.1	4.9

Note: *EBITDA and EPS are adjusted to exclude amortisation of acquired intangibles and exceptional items.

The consolidation catalyst

Kcell's prospects have been transformed following Kazakhtelecom (KT) taking a 75% stake in the business in December 2018. Consolidation helped sustain a recovery in the Kazakhstan mobile market, new management introduced a strategy targeting higher margin segments, and Kcell's major shareholder is now the dominant national telco. In 2019 the company delivered its first growth in service revenues in five years. Fuelled by 15.5 y-o-y% ARPU growth and cost savings, EBITDA margins rose 7pp while underlying profits and cash flow grew c 80%.

ARPU-driven growth and margin expansion

We see further consolidation benefits, even in the uncertain environment. Demand for unlimited access to social media is fuelling adoption of Kcell's premium bundle and raising ARPU. Our forecast for adjusted EBIT margins rising from 21% in FY19 to 26% in FY22 is predicated on this rising ARPU plus some synergies within the KT group and falling depreciation and amortisation. Our FY22 adjusted EPS estimate of KZT138 implies a 10% CAGR from FY19.

COVID-19 and the oil price slump

With a quasi-utility revenue base, telcos are relatively resilient to downturns and some operators are seeing traffic surge due to COVID-19. Nevertheless, we expect COVID measures and the oil price slump to affect the Kazakhstan economy. Our current estimates already assume a 6% and 20% y-o-y fall in business and handset revenues respectively. A downside scenario where these declines double to 12% and 40%, respectively, cuts FY20 adjusted EPS 14% to KZT93, a 10% y-o-y fall.

Valuation: Relative resilience

Year to date, telcos have outperformed broader markets and Kcell's share price is largely unchanged. At US$5.9, Kcell's current share price implies an FY22e EV/EBIT multiple of 11.9x, a premium to its historical rating and its nearest peers. However, we believe this rating partially reflects Kcell's better growth prospects, rising margins and scope to beat forecasts.

4 May 2020

Price (GDR)	**US$5.9**
Market cap	**US$1,180m**
	KZT426/US$
Net debt (KZTbn) at end FY19	53
Shares in issue	200m
Free float	25%
Code	KCEL
Exchanges	KASE, AIX, LSE

Share price performance

%	1m	3m	12m
Abs	1.0	11.4	30.8
Rel (local)	(1.8)	12.7	34.2
52-week high/low		US$5.9	US$4.4

Business description

Kcell Joint Stock Company (Kcell) is a mobile operator in Kazakhstan and a listed subsidiary of Kazakhtelecom (KT), a state-owned incumbent with a 70% share of the market. Consolidation is delivering dramatic improvements in the market and as a subsidiary of the dominant operator, Kcell is well positioned to benefit.

Next events

Interim results	30 July 2020

Analyst

Dan Gardiner +44 (0)20 3077 5700

telecoms@edisongroup.com

Edison profile page

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Investment summary

The consolidation catalyst

Kcell's prospects have been transformed following KT taking a 75% stake in the business. Consolidation is helping to sustain a recovery in the Kazakhstan mobile market, new management successfully introduced a strategy targeting higher margin segments and Kcell's major shareholder is now the dominant national telecom player. 2019 saw the company deliver its first growth in service revenues in five years. Fuelled by 15.5% y-o-y growth in average revenue per user (ARPU), EBITDA margins rose 7pp in FY19 while underlying profits and cash flow grew c 80%. COVID-19 and the slump in the oil price may slow progress in FY20 but we think profit growth is still likely. We see data-driven ARPU growth, scope for synergies within the enlarged KT group and falling depreciation and amortisation sustaining healthy profit and cash flow growth.

A stable competitive environment = improving performance

The numerous changes to the structure of the Kazakhstan mobile market over the last decade (see Exhibit 16) have directly affected Kcell's financial performance. With little near-term risk of regulatory intervention or a resurgence in aggressive competition, the current structure appears sustainable. Sales of minority stakes in KT and Kcell are possible but are unlikely to prompt a shift in strategy or market conditions in our view. This stable environment prompted the churn rate to fall in 2019, helped ARPU rise 15.5% y-o-y and Kcell to report its first growth in service revenue in five years.

Full consolidation benefits yet to play out

We believe the full benefits of consolidation are yet to play out. Demand for unlimited access to social media should drive adoption of Kcell's premium bundles, helping to raise ARPU by 13% in FY20e, 8% in FY21e and 5% in FY22e. Rising ARPU on a flat subscriber base leads us to forecast mid-single-digit revenue growth. Our assumption of a 41% EBTIDA margin sustained into FY22 looks conservative given these ARPU trends and the scope for further synergies within the KT group not currently factored into our forecasts. Assuming depreciation and amortisation charges (19% of sales in FY19) trend towards forecast capex levels (14%), adjusted EBIT margins should rise from 21% in FY19 to 26% in FY22. Our FY22 adjusted EPS forecast of KZT138 implies a 10% CAGR from FY19. Higher margins result in an FY22 FCF forecast of KZT35bn.

COVID-19 and the oil price slump

With a quasi-utility revenue base, telcos should be relatively resilient in the current environment. However, we expect the surge in traffic seen by mobile operators in the US and Europe to fade, and measures to contain COVID-19 and the oil price slump to damage the Kazakh economy. Our current forecasts factor in 6% and 20% y-o-y falls in business and handset sales, respectively. A more aggressive downside scenario (12% and 40% y-o-y falls in handset and business sales, respectively) generates FY20 adjusted EPS of KZT93, a 10% y-o-y fall and 14% below our current estimates. Consensus forecasts assume a y-o-y decline in EPS in FY20.

Valuation: Relative resilience

Year to date, telcos have outperformed markets globally and Kcell's shares are largely unchanged. How much Kcell's share price reflects its low liquidity is difficult to tell. At US$5.9, the share price implies a 9.0x FY20 consensus EV/EBITDA multiple, more than double its nearest listed peers (Veon, MTS, Rostelecom and KT). This premium largely reflects 1) Kcell's lower capital intensity, 2) its better fundamentals (growth and rising margins) and 3) the scope to beat consensus. On our estimates it trades at 11.9x FY22 EBIT. A DCF-based valuation using a WACC of 13% suggests the share price assumes nominal revenue growth of 7.6% until 2030 and an EBITDA margin of 54% in 2030, assumptions we believe are feasible given the current market structure.

Market background

As a standalone entity, Kcell is Kazakhstan's second largest mobile operator with 8.0 million subscribers at the end of Q120. Following the acquisition of a 75% stake in the company by state-controlled Kazakhtelecom (KT) in December 2018, it is now a subsidiary of the dominant player in the domestic telecom market. This consolidation has triggered significant improvements in the mobile market and transformed Kcell's financial prospects.

Kazakhstan: Political and economic backdrop

Kazakhstan is the ninth largest country in the world but with a population of just 18 million. Its economy is the largest in Central Asia and dominated by natural resource extraction. Of c $55bn in annual exports, oil and gas accounts for c 65%, with crude oil production currently running at 2mmbd. Rising demand for energy has generated generally steady economic growth over most of the last decade (2009–19 real GDP growth averaged 4.1%), but the slump in oil prices in 2015 and 2016 saw growth slow to just over 1%. The annual inflation rate (year-end CPI) has averaged 7.3%.

In 2016 the government agreed to reduce state ownership of the economy from 30–40% of GDP to 15% by 2021, in line with OECD recommendations. Selling down the 51% stake in KT held via the country's sovereign wealth fund, Samruk-Kazyna, is part of this programme. In 2019 Kassym-Jomart Tokayev was elected as president (succeeding the longstanding President Nursultan Nazarbayev) with a mandate to deliver political reform. The programme to reduce state ownership remains, but the timing of any asset sales appears to be primarily driven by the need to maximise valuation.

The Kazakh mobile market

The number of active mobile subscriptions in Kazakhstan stood at 26.0m in 2019, representing a penetration (SIM cards/population) of 139%. Due in part to low data prices and low-value SIM cards used for social media click farms, activations grew rapidly between 2010 and 2012 peaking at 30.4m in 2013. Activations fell in both 2014 and 2015 but have been broadly flat since then. Total market revenue and monthly ARPU of KZT1,324 (US$3.52) have also been stable.

The structure of the market has changed many times over the last decade (see Exhibit 16). The merger of Altel's fledgling 4G service with Tele2 in 2015 created a well-funded third player (Altel is owned by KT) that sought to aggressively increase scale. This competition lowered prices and margins for all players including Kcell. It began to abate in 2018 (as the JV gained scale) and KT's acquisition of a 75% stake in Kcell in December 2018 saw conditions improve further. Aside from adding Kcell's mobile operation to its dominant fixed-line business, the deal triggered a non-compete clause in the terms of KT's joint venture contract with Tele2, which led to Tele2 selling its stake to KT in May 2019. The change in ownership also triggered the end of the network sharing agreement between Veon and Kcell. With KT now controlling a c 60% share of the mobile market through its Kcell and Tele2 subsidiaries, competition has reduced dramatically.

Exhibit 1: Current structure of the Kazakhstan mobile market 2019

Parent company	Veon	Kazakhtelecom (KT)*		
Operator	Veon	Kcell	Altel/Tele2 JV***	
Controlling owner	Veon 75%	KT 75%	KT 100%	
Other shareholders	ATF Bank (25%)	Free float (25%)		
Brands	Beeline	Kcell (Business), Activ	Altel	Tele2
Est subs (y/e 19)**	10.4m	8.3m	7.3m	
Market share (%)	40.0%	31.9%	28.1%	
Est service revenue (KZTbn)****	150.3	137.6	144.4	

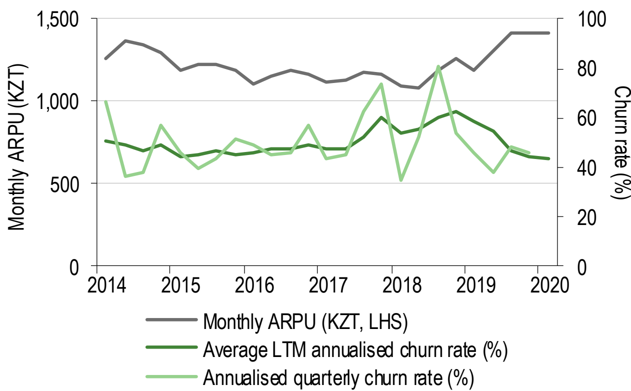
Source: Company data, Edison Investment Research. Note: *Combined KT has 15.6m subscribers, a 60% share of the market. **Altel and Tele2 were combined as a joint operator in 2015 but remain separate brands. ***Based on Veon FY19 annual report pg22. ****Tele2 stopped reporting financials after Q418 and Veon discloses only headline metrics via Vimpel-Communications financial statements. FY19 estimates for Beeline are based on annualising 9M mobile results (adjusting for KZT14.6bn termination agreement).

The consolidation catalyst

Intense competition in the mobile market between 2014 and 2018, combined with an economic slowdown, saw Kcell's subscriptions and revenues fall 20%. From a peak of KZT105bn in 2014 (56% margin), adjusted EBITDA halved to just KZT51bn (34% margin) in 2018. Annual churn rose 20pp over the same period.

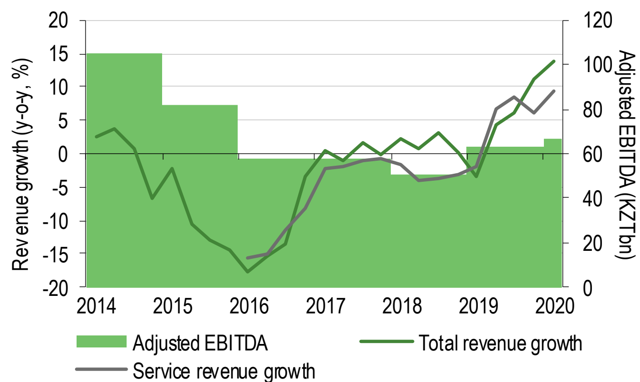
KT's acquisition of Kcell was the catalyst for a dramatic turnaround. Market conditions improved as direct competition between the two KT subsidiaries reduced. New CEO Kaspars Kukelis, formerly head the of B2C Division at KT, shifted the strategy to focus on higher-value customers. A new bundled voice and data package ('Super Comfort'), which offered better value (unlimited access to social networks but at higher price), proved highly popular, lifting ARPU (15.5% y-o-y in FY19) and reducing churn. FY19 saw the number of high ARPU post-paid (business) subscribers tick up and the return to year-on-year service revenue growth for the first time in five years.

Exhibit 2: Improving market conditions and shifting strategic focus has seen ARPU rise and churn fall…



Source: Kcell data, Edison Investment Research

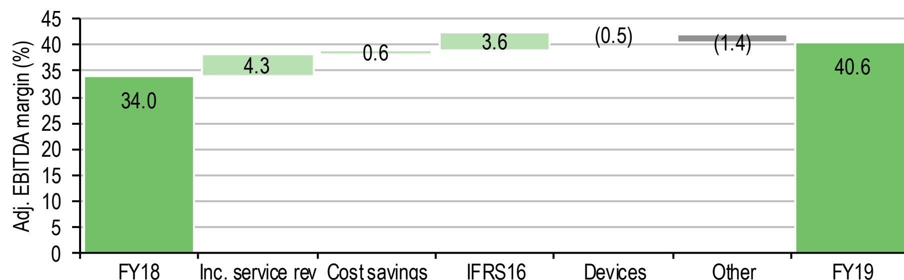
Exhibit 3: …and driven a sharp rise in revenue growth and absolute EBITDA



Source: Kcell data, Edison Investment Research

These effects also significantly boosted profitability. The incremental revenue generated by higher ARPU is 95% gross margin. Growth here lifted adjusted EBITDA margins by 4.3pp. Initiatives from new management to cut costs, reducing marketing, consultancy and other fees, added 0.6pp and the introduction of IFRS 16 (capitalising leases) added another 3.6pp. Kcell's adjusted EBITDA margin rose a total of 6.5pp y-o-y in FY19. Combined with revenue growth, this margin expansion saw adjusted EBITDA grow 25% y-o-y (14% stripping out the benefit of IFRS 16). Adjusted EPS grew 77% y-o-y and with capex down to KZT20bn (19% of FY19 sales), free cash flow (FCF) nearly doubled to KZT15bn (despite a KZT19bn working capital outflow).

Exhibit 4: EBITDA bridge in FY19



Source: Kcell data, Edison Investment Research

The potential impact of COVID-19 and the oil price

It is difficult to understand the full impact of these shocks on Kcell at this point. The analysis below draws on relevant historical and international data to highlight three potential impacts and uses this to develop a credible downside scenario to our forecasts:

1. **Customer traffic.** Many mobile operators experienced growth in both voice and data traffic during the initial phases of the pandemic. AT&T, Verizon and Sprint reported (as of 23 March) 10–44% y-o-y voice traffic and rises in data from Wi-Fi calling. However, there is also some evidence of fixed-line substitution for customers in 'lockdown' and lower roaming revenue.

   We expect rising traffic to boost revenue but, with an estimated 60% of Kcell's customers on bundled packages, the majority of the incremental traffic just generates incremental costs (interconnection and capacity). Our core scenario assumes voice traffic per subscriber rises 2% in FY20 and data usage per subscriber rises 36% (vs 4% for voice and 40% for data in FY19). If higher traffic volumes are sustained, the impact could be positive for Kcell, but we do not include this in our downside scenario.

2. **Wider economic downturn.** The previous 2014–17 decline in the oil price (below $30/barrel) saw Kazakhstan GDP growth drop from just over 4% to just 1% and the currency depreciate by 50% against the US dollar. Kcell's revenue and profits dropped significantly during this period, but as this coincided with a period of aggressive competition in the mobile market it is difficult to isolate the impact of the economic downturn on Kcell's financials.

   The tenge has fallen 15% since February and Brent crude is currently at c $25/barrel. At this price, Kazakhstan's oil producers will need to cut spending sharply to preserve cash flow and this, combined with actions to limit the spread of COVID-19 and pressure on state budgets, is likely to reduce economic activity and increase unemployment. The tenge devaluation directly affects Kcell by raising the cost of both US dollar denominated handsets (affecting demand) and network equipment, but is also likely to squeeze consumer disposable income.

   Our current forecasts assume no change in subscribers but a 6% y-o-y fall in Kcell's business revenue in FY20 (up 16% in FY19). Our downside scenario assumes a 0.5 million fall in subscribers and a 12% drop in business spending.

3. **Disruption to operations.** We do not expect significant or prolonged disruption to Kcell's operations from COVID-19. Handset supply chains in both China and South Korea appear to be resuming production and, while Kcell stores are expected to be closed for at least a month, this may be partially offset by sales shifting online. Our current forecasts assume a 20% y-o-y reduction in handset revenues in 2020 as a result of closed stores, lower footfall and higher prices (see above). Our downside scenario assumes a 40% reduction. As handset revenue is relatively low margin, we forecast this additional 20% reducing FY20 EBITDA by just KZT0.6bn.

Exhibit 5: How COVID-19 and economic downturn could affect FY20

KZTbn	FY19	Central scenario			Downside scenario		
		Change vs FY19	FY20e	Comments	Change vs central scenario	FY20e	Comments
– Consumer bundles	59.4	12.5	71.9	Subs. on bundles rising	(2.2)	69.7	0.2m fall in consumer subs
– Consumer traffic	59.5	(4.7)	54.8	Per sub: voice +2%, data +36%	(1.7)	53.1	Per sub: voice +2%, data +36%
– Handset	19.1	(3.8)	15.3	20% yoy decline	(3.8)	11.5	40% yoy decline
– B2B	18.6	(1.1)	17.5	6% yoy decline	(1.1)	16.4	12% yoy decline
Total revenue	**156.7**	**2.8**	**159.5**		**(8.8)**	**150.6**	
– Consumer bundles	25.7	7.3	32.9	Rising w/subs increase	(1.6)	31.4	Traffic modestly affects margin
– Consumer traffic	25.7	(3.3)	22.4	Falling w/subs decrease	(1.3)	21.1	Greater traffic
– Handset	2.9	(0.6)	2.3	15% margin	(0.6)	1.7	15% margin
– B2B	9.3	(0.6)	8.7	50% margin	(0.6)	8.2	50% margin
Total EBITDA	**63.5**	**2.8**	**66.4**		**(4.0)**	**62.4**	
Adj EPS (KZT)	**102.8**		**107.9**			**92.8**	

Source: Edison Investment Research

Sustaining the improvement in fundamentals

Aside from the impact of COVID-19 and the oil price slump, the main question for potential Kcell investors is whether the turnaround seen in FY19 can be sustained into FY20 and beyond. We consider five factors:

1. Monetising mobile data growth
2. Scope for sustainable differentiation
3. The threat of regulatory intervention or renewed competition
4. Economies of scale within KT
5. Margins vs international peers

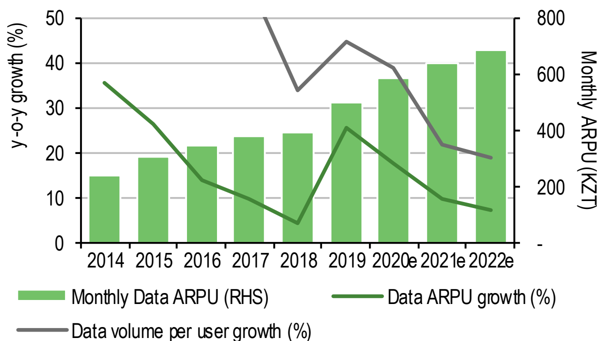
1. Monetising mobile data growth

Mobile data growth remains healthy. Kcell's total traffic rose 30% y-o-y in FY19 and reaccelerated to 40% on a per subscriber basis (see Exhibit 6). Per subscriber traffic rose 48% in Q120. Driving this acceleration is the increasing adoption of 4G phones and the more attractive bundled data packages introduced in early 2019. Over half the customer base are now on bundled offers and nearly 20% on its 'Super Comfort' package.

We would expect this rapid growth to continue. While data usage in Kazakhstan is already high compared to its Central Asian neighbours, in part reflecting historically low prices (see Exhibit 7), it remains below western European averages (3.5GB per month). LTE phone penetration (64%) is partially constrained by LTE network coverage (62%) and has scope to rise further. We forecast average data per user volumes rising 34% in FY20 and a further 22% in FY21.

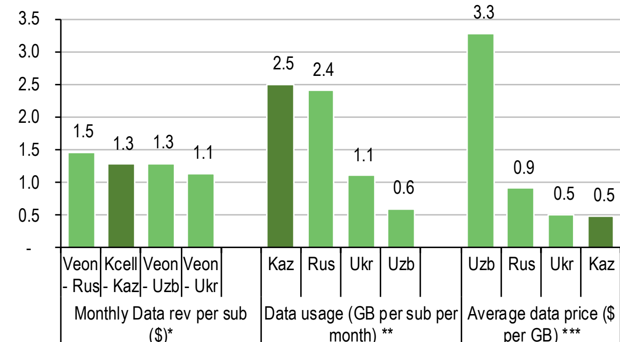
More significantly, we believe that following the change in market structure, Kcell is now in a better position to monetise this demand. Historically, rising volumes have largely been offset by falling prices. A data revenue CAGR of 9% between FY14 and FY19 (16% on a per subscriber basis) has been insufficient to offset the impact of falling voice prices and subscriptions. However, the acceleration in data revenues in FY19 highlights consumers' appetite for more data and, in the absence of aggressive competition, their willingness to pay for it. We would expect demand for these higher value unlimited packages to rise further as LTE coverage steadily grows. We forecast growth in data ARPU of 22% in FY20 and 13% in FY21.

Exhibit 6: Data growth per user accelerated in FY19



Source: Kcell data, Edison Investment Research

Exhibit 7: Data ARPU, usage and prices comparison



Source: *Edison Investment Research estimates, **Analysys Mason, ***Worldwide mobile data pricing from Cable.co.uk

There are several caveats here. As Kcell's existing packages are already unlimited, so there may be modest scope to launch new, 'higher value' tariffs. Openly raising prices, without offering a better service or more features, risks attracting regulatory scrutiny and inviting market share loss. As customers adopt these 'unlimited' plans, the direct link between rising traffic and revenue is lost.

Kcell's ability to sustainably differentiate its service on metrics other than price is crucial to overcoming these obstacles in our view.

2. Scope for sustainable differentiation

Greater control over the distribution channel should help Kcell differentiate. The company opened its first branded store in Almaty in 2015 and now has 33 across the country. In H219 it launched its online store for handset sales and its first co-branded store with Samsung. Handset revenue (12% of total in FY19) is relatively low margin but the customers buying through the stores tend to be significantly more profitable than those acquired through other channels. A greater proportion (90%) opt for expensive phones with high-margin subscription packages and they are also more loyal (lower churn). In 2018 Kcell launched its first TV marketing campaign for five years with an 'Always with you' tagline that sought to reposition 'Active' as a more empathetic brand.

Kcell's new parent should enhance its ability to differentiate. It already claims a leadership position in the telecom sector. The ability to bundle its mobile services alongside KT's fixed-line products should further improve its proposition. In the consumer segment bundling mobile with broadband, telephony and TV services ('quad play') also makes sense (KT has 3m fixed line and 1.7m broadband customers). Kcell launched standalone content (music and film) services in 2017 under the mobi brand and has 0.6m OTT ('over the top') customers, while KT has 0.8m payTV customers. Cross-selling KT's content would create a proposition that Veon (Beeline) may struggle to match.

KT's scale should also help Kcell improve its network quality and coverage. KT has the most extensive transmission network and in a country as vast as Kazakhstan coverage is a huge challenge (Kcell's 3G population coverage currently stands at 80%). Returns on investment in network coverage upgrades improve with scale (more customers benefit from the enhanced service). Signing a new network sharing agreement with Tele2/KT (replacing the terminated one with Veon/Beeline) could enable Kcell to extend 3G and 4G coverage at lower cost than Veon.

This scale advantage could prove particularly critical as 5G is deployed. We are not convinced that 5G offers 'game changing' user experiences, and a date for a licence issue in Kazakhstan has not even been set. Nevertheless, some (high ARPU) customers may be willing to pay a premium for a faster service with greater capacity. Higher frequency 5G networks require greater base station density and are therefore more costly to construct. A larger operator (Kcell plus Tele2) could exploit its scale advantage and differentiate by offering better 5G coverage.

3. The threat of regulation or renewed competition

We believe the current market conditions, a three-player market but with two players owned by KT, are sustainable. The Kazakhstan regulator (the Telecommunication Committee of the Ministry of Digital Development, Defense and Aerospace or MIDDDAI) seems content for KT to enjoy a dominant share of fixed-line and broadband markets (76% and 71%, respectively) and approved the original acquisition of Kcell. One condition of the approval was that Kcell and Tele2/Altel are operated independently. Another imposed a three-year moratorium on raising the prices of legacy bundles. This constrains Kcell's ability to increase prices on about 1m customers (12%) and is due to lapse late in FY21. Rebasing these plans could help accelerate Kcell's growth in FY22. With data prices low by international standards we see little justification for regulatory intervention in this area.

Kcell's direct competitor Veon appears to be behaving rationally. Saddled with corporate debt and dividends to service it is not in its strategic interest to provoke aggressive competition against a larger rival. KT looks unlikely to sell stakes in its recently acquired mobile assets (thereby prompting renewed competition) and Kazakhstan's national security law prevents a single foreign company owning a majority stake in an operator. A new entrant would also need a spectrum licence. We see limited appetite for a new entrant to fight dominant and well-established incumbents.

4. Economies of scale within KT

Working more closely with KT has the potential to not only improve Kcell's service but also raise its returns. Sharing product development costs, joint marketing, cross-selling bundled products, procurement and streamlining central functions all offer opportunities to improve operating margins.

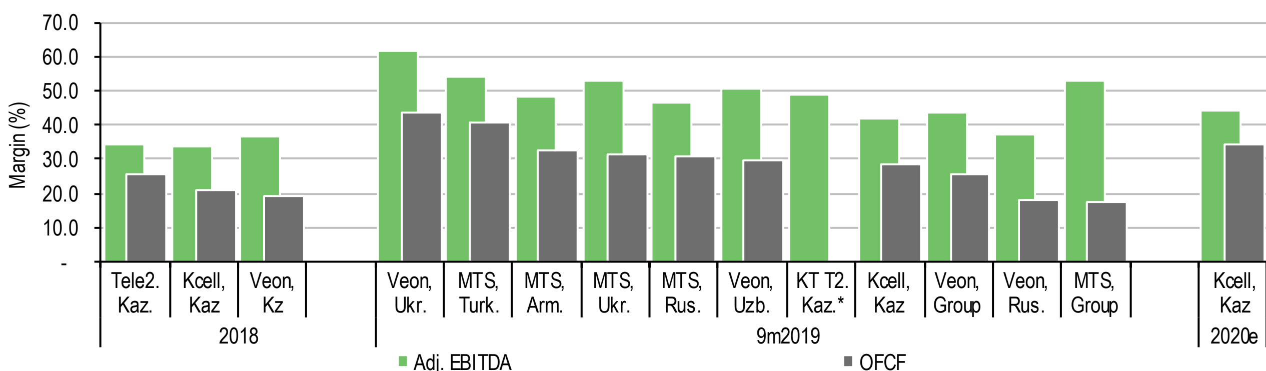
In our view, network capex offers the biggest scope for long-term savings. Kcell's standalone capital investment (including capitalised software costs) averages 12% of sales (based on FY18–19), near the bottom of the range of its closest peers. This average falls to 11% (bottom of the range) when Tele2's ratio is combined, suggesting limited scope to boost free cash flow margins by cutting capex further. However, the level of spending relative to peers is not the only important metric to consider; absolute spending is also relevant. Kcell and Tele2's combined absolute spend (KZT30bn in 2018) was 40% more than Beeline. Sharing infrastructure with Tele2 could keep costs under control, with savings re-invested to boost network quality, enhancing the competitive differentiation with Beeline.

Perhaps the greatest potential savings are likely to be realised in the roll-out of 5G. In 2018 KT's CEO suggested a single 5G network in Kazakhstan would benefit society by driving down the costs for consumers and accelerating deployment. The creation of a 'netco', which pooled network construction and management functions for both or all three operators, could do this. It would not be straightforward to establish (costs could rise in the near term) but could potentially significantly cut both Kcell's capex and opex (network maintenance costs were 5% of sales in FY19).

5. Margins vs regional peers

Other Central Asian markets highlight the potential for better returns at Kcell. Exhibit 8 shows just how much lower margins were in Kazakhstan in 2018 compared to its nearest neighbours and the impact of better market conditions in 2019. EBITDA margins for Kcell and Tele2 rose by 5pp and 11pp, respectively and now stand in the middle of the range. However, Ukraine, Uzbekistan and Turkmenistan all feature operators with EBITDA margins above 50% and operating free cash flow (OFCF) margins are above 40% for Veon in Ukraine and MTS in Turkmenistan.

Exhibit 8: Kcell's profitability vs international peers



Source: Kcell reports. Note: EBITDA metrics vary between companies making direct comparison difficult. *KT Tele2 subsidiary estimated by backing out Kcell's EBITDA from KT's mobile profits for Q319. OFCF = EBITDA – capex.

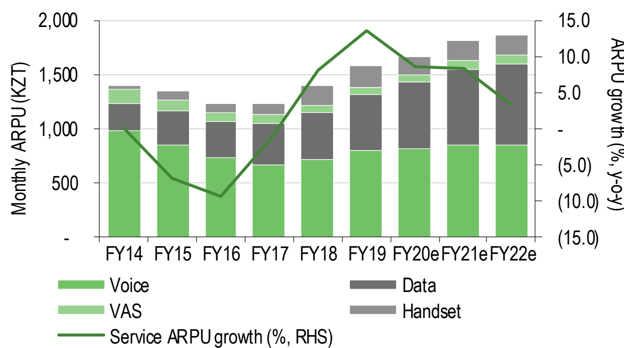
Q1 results and forecasts

Q1 saw the trends of FY19 continue. Subscriber numbers drifted down another 0.3m, but service revenue grew at its strongest rate yet (9.4% y-o-y) fuelled by an 18.9% rise in ARPU. Approximately a third of the y-o-y growth reflected a particularly strong B2B performance (up 34% y-o-y). In addition to the strong service revenue performance, handset sales rose 54%. Reflecting the 14% year-on-year increase in total sales, adjusted EBITDA rose 14% and adjusted EBIT rose 31%.

However, Q1 is likely to have been only modestly affected by COVID-19 (emergency measures began on 16 March). Our forecasts assume the current benign market structure continues but there is an impact from COVID-19 and the low oil price in FY20. In our base case scenario, we forecast a broadly stable subscriber base with adoption of better value (ie higher priced) bundled packages, driving 13% y-o-y growth in service ARPU. However, this will be offset by weakness in business spending (down 6%) and handsets (down 20%) resulting in just 2% growth overall. A recovery in business and handset revenue sees growth accelerate in FY21 and FY22.

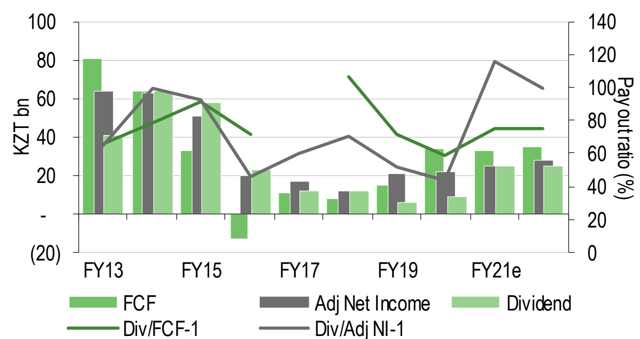
We still believe Kcell can deliver profit growth in this environment. Incremental ARPU is high margin and a 20% y-o-y fall in low-margin handset sales only reduces EBITDA by KZT1.1bn. At the same time, we expect depreciation and amortisation charges to fall steadily from 19% of sales in FY19 to 15% by FY22 as it catches up with historically lower levels of capex (see Exhibit 11). As a result, we see adjusted EBIT margins rising from 21% to 26% and a 10% CAGR in adjusted EPS between FY19 and FY22.

Exhibit 9: ARPU trends should sustain growth



Source: Kcell data, Edison Investment Research

Exhibit 10: Historical pay-out ratio is 80% of FCF



Source: Kcell data, Edison Investment Research

Exhibit 11: Rising ARPU and falling depreciation should deliver healthy EPS growth

KZTbn	FY14	FY15	FY16	FY17	FY18	FY19	FY20e	FY21e	FY22e
Subscribers (m)	11.2	10.4	10.0	10.0	9.0	8.3	8.0	7.8	8.0
Growth (%)	(6.9)	(7.5)	(3.6)	0.2	(10.4)	(7.7)	(3.4)	(2.1)	1.9
Monthly ARPU (KZT)	1,321	1,216	1,148	1,129	1,133	1,330	1,497	1,612	1,697
Growth (%)	2.5	(8.0)	(5.6)	(1.6)	0.4	17.4	12.6	7.7	5.3
Revenue									
Voice & VAS	149	118	96	90	85	86	86	88	90
Data	33	39	41	46	46	51	58	65	71
Service total	182	157	137	135	131	138	144	153	161
Growth (%)	(2.7)	(13.8)	(12.7)	(1.4)	(3.1)	4.9	4.8	6.0	5.3
Handset	5	11	10	12	18	19	15	17	17
Total	**188**	**168**	**147**	**147**	**150**	**157**	**159**	**170**	**178**
Growth (%)	(0.0)	(10.2)	(12.7)	0.3	1.5	4.6	1.8	6.4	4.8
Adjusted EBITDA	**105**	**82**	**58**	**58**	**51**	**64**	**66**	**70**	**73**
Margin (%)	56.1	48.6	39.4	39.1	34.0	40.6	41.6	41.2	40.9
D&A	(25)	(25)	(24)	(23)	(26)	(30)	(30)	(28)	(27)
Adjusted EBIT	**80**	**57**	**34**	**35**	**24**	**34**	**37**	**42**	**46**
Margin (%)	42.7	34.0	22.9	23.4	16.4	21.3	23.0	25.0	26.0
Interest	(1)	8	(8)	(9)	(9)	(10)	(8)	(11)	(11)
Tax	(16)	(14)	(6)	(9)	(4)	(3)	(7)	(6)	(8)
Adjusted NI	63	51	19	16	12	21	22	25	28
Adj. EPS (KZT)	**316**	**256**	**97**	**82**	**58**	**104**	**108**	**124**	**138**
Growth (%)	(0.4)	(18.9)	(62.2)	(15.1)	(29.5)	37.4	9.2	16.3	9.1
Capex	(20)	(23)	(44)	(23)	(19)	(18)	(25)	(24)	(25)
Margin (%)	(10.6)	(13.8)	(29.8)	(15.3)	(12.9)	(11.6)	(15.5)	(14.0)	(14.0)
FCF	**64**	**32**	**(13)**	**11**	**8**	**15**	**34**	**33**	**35**
Margin (%)	34.0	19.2	(9.0)	7.4	5.6	9.7	21.0	19.3	19.9

Source: Kcell data, Edison Investment Research. Note: VAS=value-added services.

We assume capital intensity remains constant at 14% of sales (slightly above the three-year average). The company has indicated that it needs to accelerate spending to improve call quality. However, a network infrastructure sharing agreement with KT could potentially offset a large share of the costs of extending 4G coverage and any early 5G spending. Higher margins and stable capital intensity result in an FY22 FCF forecast of KZT35bn. We assume a 75% dividend pay-out of the prior year's FCF based on historical trends.

Kcell's strategy

Kcell has set out a clear three-point strategy to drive growth and margins by essentially exploiting both its scale advantage and the scope for synergies with KT. Specifically:

- Market leadership in smartphones.
- Market leadership in B2B (the business market).
- Unlocking synergies at the group level.

The smartphone strategy is a continuation of Kcell's shift to focus on higher value customers instigated by new management. Smartphone customers typically generate more data traffic, are more likely to purchase premium bundles, take subscription contracts and buy additional data services. Consequently, these customers generate higher revenue, more profits and lead to higher margins. It also represents a conscious shift away from chasing overall market share by going after less profitable market segments.

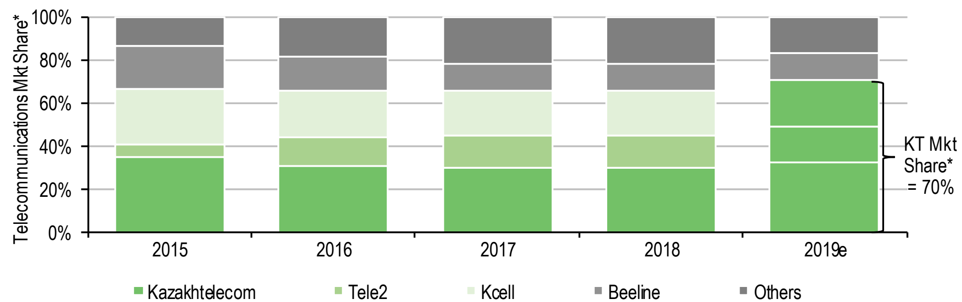
The (B2B) business market represents another high margin segment. Kcell already appears to have a strong position here – its one million post-paid (subscription) customer base is nearly double the size of Veon's (most post-paid subscriptions are business customers) – and, unlike the broader consumer market, there is evidence of significant growth. Kcell has sustained a 17% CAGR in B2B revenues since 2015, and it now represent 12% of total revenue. The economic impact of the oil slump and COVID-19 notwithstanding, this segment should sustain further growth and the ability to cross-sell products with KT should enhance its competitive advantage still further.

Alignment in the business market is just one element of Kcell's strategy to exploit synergies with KT. The company has not set quantifiable targets, but we see scope for both revenue and cost synergies. As previously highlighted above, there should be scope for reducing both network maintenance costs and ultimately capex (integration costs may lead to a short-term increase) through signing a network infrastructure sharing agreement with Tele2. These savings could be reinvested to improve network quality, supporting its ambition to lead in the premium segments of the market, or passed to shareholders.

Kcell's strategy in context

Kcell's long-term strategy will be determined, to some extent, by its majority shareholder (KT). One of the conditions attached to the approval of KT's acquisition of its stake in Kcell is that it must operate both mobile subsidiaries independently. Nevertheless, Kcell's parent gives it several advantages. Including Kcell and Tele2 on a proforma basis, KT had a 70% share of the Kazakhstan telecommunications market in 2019 (see Exhibit 12) – its share in mobile nearly matches its dominance in fixed telephony and broadband. This scale should give it an advantage rolling-out 5G, something that we believe its ultimate owner (the Kazakhstan state) sees as a strategic imperative.

Exhibit 12: Recent M&A has doubled KT's share of the total telecoms market



Source: Adapted from pg.49 of Kazakhtelecom's (KT's) 2018 report. Note: *Market includes fixed, mobile and Pay-TV. 2019 share shown as pro-forma (as if Tele2 had been consolidated for all of 2019).

We see little risk of a further change in market structure. KT could cut its stake in Tele2 to 51% to realise KZT175bn (based on the acquisition price) and halve its interest costs. Selling its 25% stake in Kcell would realise KZT112bn, reduce interest costs by 34% and significantly improve Kcell's liquidity (c KZT0.1m per day) but sales of majority stakes look unlikely. Selling all or part of the government's 51% stake in KT is part of the privatisation programme. The timescale for this has not been established and it is not clear if a change in ownership would affect the outlook for Kcell.

Risks

We have addressed the potential impact of COVID-19 and the oil price on page 5. Here we consider several other downside risks.

- **A resumption of intense competition**. Between 2014 and 2018, Kcell's subscriptions and revenues fell 20% as aggressive competition from the combined Altel and Tele2 eroded market share and undermined prices. From a peak of KZT105bn in 2014 (56% margin), Kcell's adjusted EBITDA halved to just KZT51bn (34% margin) in 2018. We believe a resumption of intense competition in the current market is unlikely
- **Regulation.** While we see regulatory intervention to return Kazakhstan to a three-player market as unlikely, Kcell suffered a significant impact from regulatory intervention on excess charging for usage above allowances on pay-as-you-go tariffs in 2018. Raising prices directly (without offering incremental features) could prompt additional scrutiny and a re-evaluation of the current market structure. The terms under which Kcell will get access to 5G frequencies is not yet clear and may require a licence fee that, due to the inability to predict timing and size, we have not factored into our forecasts.
- **Macro-economic impacts (demand/currency/inflation).** The Kazakhstan economy is highly dependent on the export of natural resources particularly oil. Both demand and prices can be highly volatile. A downturn in commodity prices would have an impact on both the value of the Kazakhstan tenge and domestic demand, which is likely to affect the value of Kcell's GDRs particularly. The average inflation rate in Kazakhstan over the last decade has been 7%, meaning Kcell has to deliver substantial growth in nominal profits to generate real profit growth.
- **Low liquidity.** Average daily turnover of Kcell's shares are just KZT0.1m on the Kazakhstan and London stock exchanges (KASE and LSE, respectively) and the shares have hardly traded at all since mid-February. Low liquidity is likely to dissuade many institutional investors from building up positions. KT selling down its stake to 51% might help but the placing could have a negative impact on the share price in the near term.
- **Valuation.** We believe that Kcell's premium rating is justified by a revenue growth rate that is above its nearest regional peers and the prospect for earnings upgrades, but it does create the

risk that any negative surprise could have a big impact on the share price. Our DCF valuation, which is generally supportive of the current price, is highly sensitive to assumptions on WACC and long-term margins in particular.

Efforts to improve liquidity

While KT selling down its Kcell stake would boost liquidity, measures taking place outside the group should also help. As part of the preparations for its privatisation programme other organisations are seeking to improve both the liquidity of Kazakhstan equities more generally and access for international investors. The Astana International Exchange, founded in November 2018, is seeking to supplant the incumbent Kazakhstan Stock Exchange (KASE) as the primary platform for issuers and international investors. Key to this is leveraging the Astana International Financial Centre (AIFC), which has a legal framework based on the principles of English law. Kcell listed its shares on the Astana International Exchange (AIX) in February 2020.

Valuation

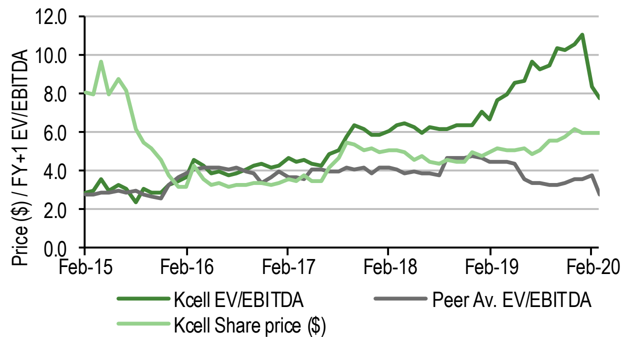
Kcell's share price rose 26% in 2019, reflecting its improving financial prospects. However, since the beginning of 2020, liquidity has dried up almost completely and both the international and local share prices (US$5.9 and KZT2,574) are currently essentially unchanged year to date. Given globally telecoms stocks are down on average c 20% year to date (as of 23 March) as a result of COVID-19 and Kcell's nearest peers have fallen 17%, it is unclear whether the current price truly reflects current circumstances. Assuming a (sector average) 20% fall in the local listing price combined with a 12% devaluation in the currency would suggest a 30% fall in the international share price to US$4.21. The current US$5.9 price implies an FY+1 consensus EBITDA multiple of 8.3x, a 50% premium to Kcell's historical average and over double (130%) its peer group.

Kcell's large headline premium EBITDA rating is partially mitigated by the fact that it is historically a less capital-intensive business than its peers. Our FY20e depreciation and amortisation/sales ratio of 17% is 9–18pp lower than its peers. Using a multiple that reflects this, such as EV/EBIT, lowers this premium. Kcell trades at 17.0x FY1 consensus adjusted EBIT, slightly more than double its peers.

In addition, we believe its fundamentals are better than its nearest peers. Consensus expects Kcell profits to fall year-on-year in FY20 due to the impact of COVID-19. Forecasts are highly uncertain at present but our forecasts, which assume 9.8% adjusted EBIT growth, imply an FY1 multiple of 15.0x.

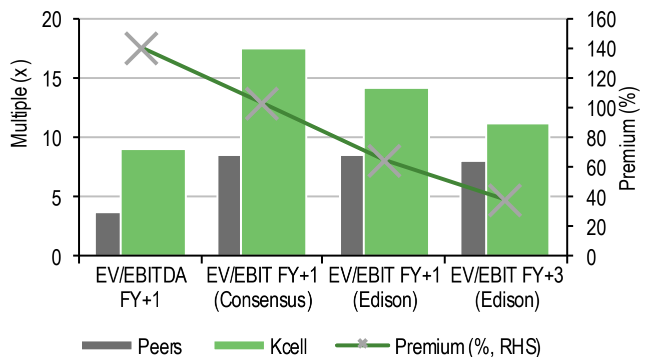
Finally, we believe that Kcell's fundamentals (growth plus rising margins) are likely to outstrip its peers over the longer term. Kcell trades at a FY22 EV/adjusted EBIT multiple of 11.9x, a 39% premium to its peers.

Exhibit 13: A growing EV/EBITDA premium to its peers



Source: Refinitiv, Edison Investment Research

Exhibit 14: Explaining Kcell's premium



Source: Refinitiv, Edison Investment Research estimates for KCEL

We also calculate a DCF-driven valuation to understand the assumptions factored into the current share price. Using a WACC of 12.7% we estimate a $5.9 share price assumes nominal revenue growth of 7.6% until 2030 (marginally below the rate of inflation) and EBITDA margins in 2030 of 54%, in line with some of the more profitable assets held by its peers.

Finally, we believe it is also worth comparing Kcell's valuation to recent transactions in the market. KT bought its 75% stake in Kcell for a net consideration of KZT159bn, implying an EV of KZT270bn or 5.3x last 12 months (LTM) EBITDA. KT's acquisition of Tele2 implied a KZT300bn EV or 7.2x LTM EBITDA. Kcell currently trades at 8.7x LTM EBITDA.

Exhibit 15: DCF valuation

KZTbn	2018	2019	2020e	2021e	2022e	2030e		KZT (bn)	US$m
Revenue	149.7	156.7	159.5	169.7	177.9	318.4			
Growth (%)	1.5	4.6	1.8	6.4	4.8	7.5	Unlevered FCF	3,521	
EBITDA	50.9	63.5	66.4	69.9	72.8	170.6	WACC (%)	12.7	
EBITDA margin (%)	34.0	40.6	41.6	41.2	40.9	53.6	NPV	552	1,295
Capex	(19.3)	(18.2)	(24.8)	(23.8)	(24.9)	(38.2)	FY19 net cash/(debt)	(53)	(125)
Capex/sales (%)	(12.9)	(11.6)	(15.5)	(14.0)	(14.0)	(12.0)	Current market cap	498	1,170
WC	(20.6)	(19.3)	(2.7)	(1.9)	(1.5)	-	Shares (m)	200	200
Tax	(3.7)	(2.8)	(6.8)	(6.2)	(7.6)	(22.7)	Current price (KZT/$)	2,492	5.9
Tax rate (%)	15.4	8.2	18.6	14.6	16.3	17.0			
FCF	7.4	23.3	32.0	38.0	38.9	109.7			
			132.5	130.6	130.5	137.2			
NCI	128.8	124.7	20.5	26.3	28.5	80.9			
RoIC (%)	(0.0)	9.1	159.5	169.7	177.9	318.4			

Source: Edison Investment Research

Exhibit 16: The evolving structure of the Kazakhstan mobile market

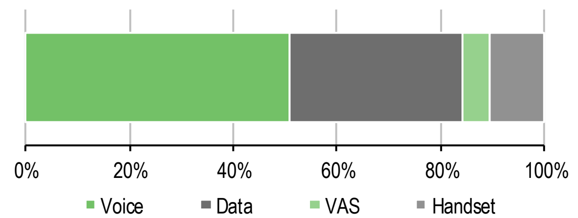
Company	Veon	Kazakhtelecom (KT)	Kcell	Tele2
Feb-99		Launches mobile service. Joint venture between Fintur (51%) and KT (49%). Fintur is a Sonera (58.5%) and Turkcell (41.5%) joint venture		
Feb-04	VimpelCom acquires KaR-Tel			
Apr-05	VimpelCom sells 50% stake to Crowell, owned indirectly by ATF, Kazakhstan's fourth largest bank			
Jul-08	VimpelCom increases stake from 50% to 75% for $562m			
Dec-09				Tele 2 acquires stake in NEO
Feb-12		KT sells its 49% stake in KCELL to Sonera, a subsidiary of TeliaSonera		
Dec-12			Dual listing on the KASE and LSE. Sonera sells a 25% stake	
Jan-13		KT launches LTE in Almaty		
Feb-16		KT's fledgling Altel merges with Tele2. Brands kept separate but it allows the roll out of network to be accelerated		KT acquires 51% and 49.5% voting share. Stake is equity accounted by KT. Agreement contains a non-compete clause
May-16			Sonera sells its remaining 24% stake to TeliaSonera Kazakhstan (TSK)	
Feb-16	VimpelCom fined by the US Dept of Justice US$795m under Foreign and Corrupt Practices act for activities in Uzbekistan			
Aug-16	Signs network sharing agreement with VimpelCom for 4GLTE		Signs network sharing agreement with VimpelCom for 4GLTE	
Jan-17	VimpelCom renames as Veon			
Nov-18	Veon reaches 10m subscribers and becomes the largest operator			
Dec-18		KT acquires 75% of Kcell (24% from TSK and 51% from Fintur) for net consideration of KZT159bn ($430m) implying an EV of $573m or $2.87 per share.		KT's acquisition of Kcell triggers the non-compete clause with Tele2. Tele2 initiates exit process
Apr-19	Veon receives payment from Kcell of KZT14.6bn (US$38m), which will be allocated to incremental network investment		Change of control triggers termination of Kcell's network sharing agreement with Veon and KZT14.6bn one-off payment	
May-19		KT acquires 49% share (50.5% voting) of Tele2's Kazakhstan subsidiary from Tele2		KT acquires Tele2's stake for KZT169bn (US$450m) implying an EV of $800m
Jun-19				Committee on Regulation of Natural Monopolies and protection of Competition approves deal and KT begins consolidating Tele2
Oct-19	Veon claims revenue leadership	Pilot 5G service launches in Nur-Sultan (capital)		Pilot 5G service launches in Nur-Sultan (capital)
Mar-20	Signs frequency sharing agreement with Kcell (5MHz in the 1,800MHz range)	Signs frequency sharing agreement with KaR-Tel (5MHz in the 1,800MHz range)		

Source: Kcell data, Edison Investment Research. Note: Light grey shading denotes a KT joint venture in the mobile market; green is a fully controlled subsidiary.

Exhibit 17: Financial summary

KZTbn	2017	2018	2019	2020e	2021e	2022e
31-Decemebr	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
INCOME STATEMENT						
Revenue	147.5	149.7	156.7	159.5	169.7	177.9
Cost of Sales	(67.0)	(82.8)	(79.2)	(80.4)	(86.0)	(89.8)
Gross Profit	80.5	66.9	77.4	79.1	83.7	88.0
EBITDA	57.6	50.9	63.5	66.4	69.9	72.8
Operating Profit (before amort. and except).	34.5	24.3	33.6	36.7	42.4	46.3
Amortisation of acquired intangibles	0.0	0.0	0.0	0.0	0.0	0.0
Exceptionals	(2.7)	(3.3)	(10.6)	0.1	0.0	0.0
Share-based payments	0.0	0.0	0.0	0.0	0.0	0.0
Reported operating profit	31.8	21.1	23.0	36.8	42.4	46.3
Net Interest	(9.4)	(8.9)	(10.1)	(8.2)	(11.5)	(11.1)
Joint ventures & associates (post tax)	0.0	0.0	0.0	0.0	0.0	0.0
Exceptionals	0.0	0.0	0.0	0.0	0.0	0.0
Profit Before Tax (norm)	25.1	15.4	23.5	28.5	31.0	35.2
Profit Before Tax (reported)	22.4	12.1	12.9	28.6	31.0	35.2
Reported tax	(8.6)	(3.7)	(2.8)	(6.8)	(6.2)	(7.6)
Profit After Tax (norm)	16.5	11.6	20.7	21.6	24.8	27.6
Profit After Tax (reported)	13.8	8.4	10.2	21.8	24.8	27.6
Minority interests	0	0	0	0	0	0
Discontinued operations	0	0	0	0	0	0
Net income (normalised)	16.5	11.6	20.7	21.6	24.8	27.6
Net income (reported)	13.8	8.4	10.2	21.8	24.8	27.6
Average Number of Shares Outstanding (m)	200	200	200	200	200	200
EPS - basic normalised (KZT)	82	58	104	108	124	138
EPS - diluted normalised (KZT)	69	42	51	109	124	138
EPS - basic reported (KZT)	69	42	51	109	124	138
Dividend per share (KZT)	58	59	30	45	126	123
Revenue growth (%)			4.6	1.8	6.4	4.8
Gross Margin (%)	54.6	44.7	49.4	49.6	49.3	49.5
EBITDA Margin (%)	39.1	34.0	40.6	41.6	41.2	40.9
Normalised Operating Margin	23.4	16.2	21.4	23.0	25.0	26.0
BALANCE SHEET						
Fixed Assets	138.6	132.7	147.1	136.8	133.0	131.4
Intangible Assets	43.1	40.1	38.8	35.7	34.9	34.3
Tangible Assets	93.7	88.4	82.3	75.7	72.8	71.8
Investments & other	1.9	4.2	26.0	25.3	25.3	25.3
Current Assets	42.3	34.4	44.2	58.1	67.2	79.0
Stocks	3.4	4.7	6.6	4.5	4.9	4.9
Debtors	26.2	23.6	23.8	16.3	17.3	18.3
Cash & cash equivalents	12.7	6.0	8.8	27.5	35.1	45.8
Other	0.0	0.0	5.0	9.9	9.9	9.9
Current Liabilities	(87.2)	(81.2)	(39.4)	(21.1)	(21.5)	(22.0)
Creditors	(28.8)	(29.4)	(21.2)	(13.9)	(14.3)	(14.7)
Tax and social security	0.0	0.0	0.0	0.0	0.0	0.0
Short term borrowings	(58.4)	(51.8)	(6.4)	(4.0)	(4.0)	(4.0)
Other	0.0	0.0	(11.8)	(3.2)	(3.2)	(3.2)
Long Term Liabilities	(18.0)	(17.8)	(80.4)	(87.8)	(93.2)	(99.9)
Long term borrowings	(12.0)	(14.9)	(55.5)	(70.0)	(70.0)	(70.0)
Other long-term liabilities	(6.0)	(2.9)	(24.8)	(17.8)	(23.2)	(29.9)
Net Assets	75.6	68.1	71.6	85.9	85.5	88.6
Minority interests	0.0	0.0	0.0	0.0	0.0	0.0
Shareholders' equity	75.6	68.1	71.6	85.9	85.5	88.6
CASH FLOW						
Op Cash Flow before WC and tax	57.6	50.9	63.5	66.4	69.9	72.8
Working capital	(13.8)	(22.6)	(19.3)	(2.7)	(1.9)	(1.5)
Exceptional & other	12.3	9.8	0.8	16.6	12.4	15.1
Tax	(12.9)	(2.4)	(2.2)	(13.7)	(12.4)	(15.1)
Net operating cash flow	43.2	35.8	42.8	66.5	68.0	71.3
Capex	(22.6)	(19.3)	(18.2)	(24.8)	(23.8)	(24.9)
Acquisitions/disposals	0.0	0.0	0.0	0.0	0.0	0.0
Net interest	(9.7)	(8.2)	(9.4)	(8.2)	(11.5)	(11.1)
Equity financing	0.0	0.0	0.0	0.0	0.0	0.0
Dividends	(11.7)	(11.7)	(6.0)	(9.0)	(25.2)	(24.6)
Other	0.0	0.0	0.0	0.0	0.0	0.0
Net Cash Flow	(0.8)	(3.4)	9.3	24.5	7.6	10.7
Opening net debt/(cash)	56.9	57.8	60.7	53.1	28.6	21.0
FX	(0.0)	0.1	(0.1)	0.0	0.0	0.0
Other non-cash movements	(0.0)	0.3	(1.6)	0.0	0.0	0.0
Closing net debt/(cash)	57.8	60.7	53.1	28.6	21.0	10.2

Source: Company data, Edison Investment Research

Contact details	Revenue by mix
Irina Shol, Investor relations 100, Samal-2 Almaty The Republic of Kazakhstan +7 727 258 2755 www.investors.kcell.kz/en	

Management team

CEO: Kaspars Kukelis

Kaspars was appointed as CEO in January 2019, shortly after KT acquired control of Kcell. He was formerly head of the B2C Division at KT as well as a director at Altel and commercial officer at Kcell between 2013 and 2014. He graduated from Harvard with an EMBA in 2004.

Principal shareholders	(%)
Kazakhtelecom (KT)	75.0
Free float	25.0

Companies named in this report

Kazakhtelecom (KT, KZ:KTK), Veon (VEON:US), Rostelecom (RS:RTK), MTS (RS:MTO)

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