Global Weekly Review: 50-100% upside in Emerging Market Telcos

By Chris Hoare | October 29, 2021

We published a note earlier in the week calling the end of the 12 year bear market in EM Telcos. If you only read one note from the EM Telecom team in the next 12 months it should be this one as it describes why we think the 10-12 year bear market in EM Telcos stocks is over and we are at the beginning of a meaningful bull market in EM Telcos. If, as we believe many investors are, you are underweight in the space we recommend you take 5 minutes to read further…

Several things have happened that mean that the bear market in EM telcos which lasted for 10-12 years is now over in our view. We are starting to see this in share price performance, with many EM Telcos up sharply in the last 3-6 months. Yet the sector as a whole still trades on a material discount to historic averages. With growth returning & return on capital rising there is still scope for substantial equity returns going forward (50-100% in the key names in the next few years we think). Sentiment is slowly starting to shift but we still think the majority on the buyside are bearish, and underweight. We have talked to PM after PM who own no EM Telcos. The set up in stock market terms if trends continue to improve therefore is very bullish. In our view, the best environment for making money on the long side in EM Telcos for 15-20 years.

So, what has happened?

Firstly and most importantly, consolidation. This is happening in all regions and countries, with the majority of EM telco markets consolidating from 4 or 5 to 3 or even 2 players. To understand why, we have to look at history. During the last EM Telco bull market revenues dramatically beat expectations as penetration surprised to the upside. As often happens, this drew in capital, and governments eager to capture auction proceeds were keen to oblige with spectrum. By 2010 therefore, many emerging markets had far too many players. The most extreme example of this was India which at one stage had 13 MNOs, but Indonesia with 8, and Bangladesh with 6 or Nigeria & Brazil with 5 are also good examples. These new entrants all needed to gain market share to reach scale, and in a consumer market had only one means of doing so: price. This is why life in these markets has been so difficult for so long, with a constant giving away through price of any volume-based growth. However, almost all of the challengers (Jio in India perhaps being the obvious exception) have failed to gain sufficient market share to cover their cost of capital. They have typically funded themselves by selling assets (towers/fibre etc), raising debt and issuing equity. But these options are no longer possible (assets have been sold, debt is already high, equity has fallen). As a result, all the challengers are left with is merging with their competitors and moving to less price competitive strategies. This means market structures consumer monetisation improves relative to the past. As a result, we are seeing price declines slow or reverse, and ARPUs stabilize/inflect. India is the extreme example, with ARPU up 50% from the lows, but similar, albeit less dramatic improvements are also happening across many EM Telco markets. However, to be clear our thesis is not predicated on rising consumer ARPU, but rather that consumer ARPU stabilizes allowing growth in non-consumer mobile to be additive to overall revenues, rather than replacing declines in consumer.

At the same time as consumer is stabilising growth opportunities outside of consumer mobile have improved. Enterprise revenues are set to boom as middle-income economies digitise post-Covid. Our view is that Enterprise revenues (which are currently only 0.1-0.2% of GDP in most Emerging markets) are set to close the gap with most DMs where they contribute between 0.5-1% of GDP. With GDP also growing this implies very strong growth for these revenues and we are seeing the signs coming through already in those EM telcos which have reported this quarter. Our work on this suggests it could add 10-25% to telco revenues, as EM countries close the digital gap with DM. There are other growth drivers however. Fintech, which is a driver in Africa and Latin America as well as parts of Asia is generating high growth at high ROIC. We estimate that large African Telcos such as MTN or Airtel Africa are now generating 35-40% of profit from mobile money. Finally, fixed broadband is also becoming a driver for a number of EM Telcos, now generating 10-20% of revenues and in many cases growing at double digit rates, and without the competitive tension seen in the mobile market. What links all three of these opportunities is that they are predominantly open to the leader (or possibly number 2) in each market. As a result they are increasing the scale benefits we already see in most emerging markets.

Thirdly, capex/sales is falling for leading EM telcos which coupled with lower levels of competition is leading to improving return on capital. In almost all cases the leading telco in each EM telco market now generates well above their cost of capital. As growth recovers ROIC is likely to trend higher. In practice therefore we see a future where ROIC for the leader can continue to rise which coupled with growth means that EM Telcos are actually good businesses, generating rising returns and improving growth.

And the final piece of the puzzle; valuation. Because the bear market in EM telcos has lasted so long, the sector has gradually de-rated. A sector that used to trade on over 7x LTM EV/EBITDA now trades on just over 5x. Thus, given leverage and growth, if the sector is to recover to historic multiples there is the potential for 50-100% returns in the equity of exposed EM Telcos. Top picks: Telekom Indonesia, Bharti, TIM Brasil, AIS.

Full 12-month historical recommendation changes are available on request

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