Telecommunication

Breaking of Merger Dreams

NEUTRAL

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By Clement Chua l clement.chua@kenanga.com.my

AXIATA and Telenor have withdrawn from realising a merger amongst their Asian operations, citing "complexities" which management refrains from commenting. We suspect that this could be due to: (i) national interests being put into question, (ii) political pressures in Indonesia, (iii) complications in spectrum allocation, and (iv) long-term loss of jobs in the country. The non-cash deal would have resulted in a merged entity with presence across nine countries, and was expected to have yielded cost synergies of up to RM20b. As we previously did not account for any synergistic benefits into our assumptions, we make no changes to our SoP and DCF-driven calls on AXIATA (MP; TP: RM4.80) and DIGI (MP; TP: RM4.70). However, should this headline news trigger selling pressures, we recommend looking for buying opportunities. Between them, DIGI stands as our preferred pick, owing to its: (i) better operating efficiency; (ii) exemplary ROE (>200%); and (iii) dividend yields (3-4%). We maintain NEUTRAL on the telecommunication sector.

End of the line. As described in its media release, AXIATA and Telenor have mutually agreed to end discussions on a non-cash merger of their telcos and infrastructure assets in Asia. Management cited having experienced "complexities" which appeared to have put a stop to the due diligence process. The deal was earmarked to be finalised by November 2019. If it were to materialise, the deal would have resulted in a merged company (MergeCo) with presence across nine countries with a cross presence in Malaysia (i.e. Celcom and DIGI) and cost synergies of up to RM20b to be enjoyed.

Possible speed bumps. Although AXIATA management declined to comment further on the nature of the complexities, we suspect it could have been an accumulation of issues, including: (i) thoughts of national interests being put into question, as AXIATA would have a less than 50% stake in the MergeCo which had the intention to move its headquarters in Singapore; (ii) political pressures in Indonesia arising from the MergeCo indirectly having an influence in XL Axiata, as there are ongoing hostilities there with Norway and the European Union with regards to palm oil imports; (iii) complications in spectrum allocation given that an enlarged share of licenses by the MergeCo from Celcom and DIGI could raise competitive imbalances; and (iv) potential loss of jobs in the long-term possibly arising from the moving of operations outside of Malaysia and voluntary separation being a likely approach to trim staff redundancies as the consolidated organisation becomes more efficient.

Chances for future tie-ups? Although the merger plan with Telenor has come to a close, management did not discount the possibility of consolidating with other regional players in the market, should there be opportunities, which make business sense. In fact, Hong Kong's conglomerate, CK Hutchinson Holdings Ltd reportedly expressed interest for a tie-in with XL Axiata, though as an informal remark at this juncture.

Business as usual. Our prior channel checks with DIGI learned that the earlier due diligence process was not disruptive to operations and hence we continue to expect business to be as usual. During its 2Q19 results, its management trimmed the group's FY19 guidance in anticipation of a persistently challenging market landscape for more data-hungry subscribers. Regardless, we believe DIGI has flexed significant amounts of legwork in keeping costs tightly controlled and could ride with the shifts in market trends readily. On AXIATA, the group remains firm in keeping its target to focus on revenue and profit growth. XL appears to be seeing returns from its investments in expanding its ex-Java presence. This should be supported by the group's network upgrades for continual growth in network capabilities and coverage. Operating costs moves to be leaner on procurement and direct cost management while tapping on IT efficiencies. Additionally, management is hopeful that its digital arms could bring profits this year.

Post announcement, our calls for AXIATA (MP, TP: RM4.80) and DIGI (MP, TP: RM4.70) remain unchanged as we did not factor any synergistic benefits into our assumptions prior to this development. Assuming that the market reacts negatively, we recommend investors to look for buying opportunities with a preference towards DIGI. Amongst all other mobile operators, DIGI takes the lead with its: (i) greater operating efficiency (EBITDA margin at +50% vs industry avg. of mid-40%), (ii) superior ROE (>200% vs industry avg. 10-20%), (iii) better overall dividend yields (3%-4% vs industry average of 2%-3%).

Maintain NEUTRAL on the telecommunications sector. We anticipate prospects within the sector to be largely driven by a race for cost efficiency. Celcos continue to be challenged by competitive pricing and the migration of subscribers towards more value-for-money packages while sector-wide operational cost fixing comprises mainly rationalising network and squeezing direct costs. While we leave our assumptions unchanged at this moment, we direct attention towards **TM (TP: RM3.95)** which saw huge selling pressures following the fixed-line operator's decision to heavily invest in the mobile business (Unifi Mobile), which as mentioned above, is facing troublesome headwinds while also being highly saturated. While this is expected to crimp into any cost savings it worked hard for (on greater infrastructure and marketing spending), we remain steadfast from assuming the worst given that it is not an entirely fresh venture for the group, with Unifi Mobile being in the market since Jan 2018. Further, it was anticipated that 2H19 would see lesser cost improvements as compared to 1H19 as the cost reduction quantum is typically highest during the initial stage of each rationalisation program. On this premise and that there could be an overreaction from the market, **we upgrade our call for TM to OUTPERFORM from MARKET PERFORM, leaving our DCF-driven TP of RM3.95** (based on WACC: 9.7%, TG: 1.5%) unchanged.

Peer Table Comparison

Name	Last Price (RM)	Market Cap (RM'm)	Shariah Compliant	Current FYE	Revenue Growth		Core Earnings Growth		PER (x) - Core Earnings			PBV (x)		ROE (%)	Net DivYld (%)	Target Price (RM)	Rating
					1-Yr. Fwd.	2-Yr. Fwd.	1-Yr. Fwd.	2-Yr. Fwd.	Hist.	1-Yr. Fwd.	2-Yr. Fwd.	Hist.	1-Yr. Fwd.	1-Yr. Fwd.	1-Yr. Fwd.		
Stocks Under Coverage																	
AXIATA GROUP BHD	4.88	44,547.9	Y	12/2019	5.4%	0.2%	4.7%	22.0%	43.8	41.8	34.3	1.9	1.9	4.5%	2.0%	4.80	MP
DIGI.COM BHD	4.89	38,019.7	Y	12/2019	-6.3%	3.1%	-9.2%	0.9%	24.7	27.2	26.9	56.5	55.3	205.7%	3.6%	4.70	MP
MAXIS BHD	5.55	43,403.7	Y	12/2019	-1.7%	0.6%	-11.1%	4.4%	24.6	27.6	26.5	6.1	5.9	21.6%	3.1%	4.90	UP
OCK GROUP BHD	0.595	518.5	Y	12/2019	8.3%	12.5%	15.0%	7.8%	19.4	16.9	15.7	1.0	1.0	6.0%	0.0%	0.630	MP
TELEKOM MALAYSIA BHD	3.47	13,065.6	Y	12/2019	-4.9%	0.6%	34.4%	4.5%	20.7	15.4	14.8	1.9	1.8	11.8%	2.9%	3.95	OP
Simple Average					**0.1%**	**3.4%**	**6.8%**	**7.9%**	**26.6**	**25.8**	**23.6**	**13.5**	**13.2**	**49.9%**	**2.3%**		
Stocks Not Under Coverage - Consensus																	
TIME DOT COM BHD	9.00	5,269.8	Y	12/2019	11.3%	11.2%	11.2%	9.3%	18.3	16.4	15.0	2.0	1.9	12.1%	2.2%	10.28	BUY

Source: Kenanga Research

AXIATA Sum-of-Parts Valuation

Companies	Methodology	Earnings Multiple	Equity Value (RM'm)	Effective Stake (%)	Effective Value (RM'm)
Celcom (Malaysia)	DCF	WACC: 7.9%, TG: 1.3%	24,288.3	100.0%	24,288.3
XL (Indonesia)	DCF	WACC: 9.9%, TG: 2.5%	14,959.9	66.4%	9,927.4
Robi (Bangladesh)	EV/EBITDA	5.0x	7,763.6	68.7%	5,333.6
Dialog (Sri Lanka)	EV/EBITDA	4.8x	5,208.7	83.3%	4,339.9
Ncell (Nepal)	EV/EBITDA	5.0x	6,889.2	80.0%	5,511.4
Smart (Cambodia)	EV/EBITDA	6.0x	4,369.8	72.5%	3,168.1
edotco	EV/EBITDA	7.0x	4,129.4	63.0%	2,601.5
Vodafone Idea (India)	Market Price		22,930.8	1.6%	371.5
			Total Effective Value		**55,541.5**
			(-) Net Debt		12,098.1
			Total Equity Value		**43,443.5**
			No. of Axiata Shares ('m)		9,058.6
			Value/Share (RM)		**4.80**

Source: Kenanga Research

Stock Ratings are defined as follows:

Stock Recommendations

OUTPERFORM	: A particular stock's Expected Total Return is MORE than 10%
MARKET PERFORM	: A particular stock's Expected Total Return is WITHIN the range of -5% to 10%
UNDERPERFORM	: A particular stock's Expected Total Return is LESS than -5%

Sector Recommendations***

OVERWEIGHT	: A particular sector's Expected Total Return is MORE than 10%
NEUTRAL	: A particular sector's Expected Total Return is WITHIN the range of -5% to 10%
UNDERWEIGHT	: A particular sector's Expected Total Return is LESS than -5%

******Sector recommendations are defined based on market capitalisation weighted average expected total return for stocks under our coverage.***

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KENANGA INVESTMENT BANK BERHAD (15678-H)
Level 17, Kenanga Tower, 237, JalanTunRazak, 50400 Kuala Lumpur, Malaysia
Telephone: (603) 2172 0880 Website: www.kenanga.com.my E-mail: research@kenanga.com.my