M&G Insights

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MultiChoice: A strong investment case as Rest of Africa rebounds

Africa's largest pay-TV broadcaster

Founded in 1986, the MultiChoice Group (MCG) spun out of Naspers and listed on the JSE in 2019. It is present in 50 countries across sub-Saharan Africa and consequently has a large pay-TV subscriber base of 22.1 million[1], comprising 9.1 million (41%) households in South Africa and 13 million (59%) households in the Rest of Africa. MultiChoice SA is highly profitable, while Rest of Africa is loss-making but is expected to return to profitability soon. With its strong balance sheet, substantial subscriber base and unmatched production capability and technical knowhow, MCG broadcasts wide-ranging local and international content offerings that cater to households with varying income levels.

Complex cost structure

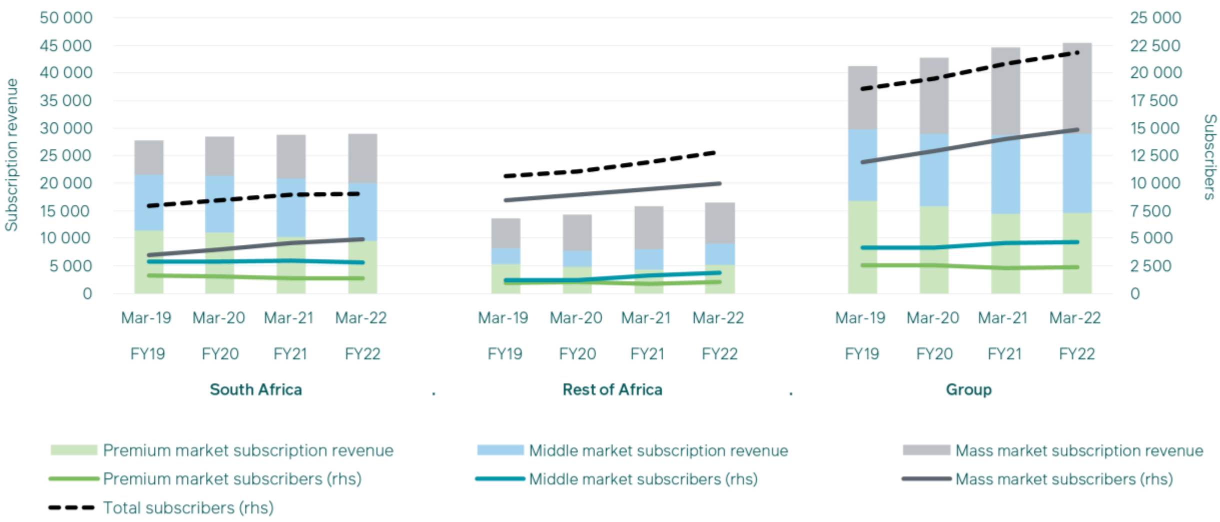
Because the bulk (80%) of MCG's cost structure is fixed, attracting new subscribers, retaining and encouraging them to upgrade to higher priced packages is key to achieving operating leverage.

The *Premium*, *Middle* and *Mass-market* segments[2] each contribute a third to the group subscription revenue (see Graph 1). *Mass-market* subscribers have grown in South Africa, but this has largely been offset by the decline in *Premium*[3] subscribers (see Graph 1). Similarly, the Rest of

Africa's *Middle*and *Mass-market* subscriber segments have grown, but this market remains sub-scale and has lots of upside potential.

A large part (44%) of the group's cost base is denominated in US dollars. Hard currency costs are primarily programming and film rights acquired from international studios and sports rights holders, satellite transponder lease cost and decoder purchases. Local and hard currency input costs are serviced from local currency revenues which are at risk of currency devaluations, especially within the Rest of Africa. MCG hedges foreign currency cashflows on a rolling basis to mitigate the effect of short-term fluctuations in exchange rates, but there can be no complete hedge against long-term currency fluctuations.

Graph 1: MultiChoice subscription revenue and subscribers



Source: Company data and M&G Investments calculations

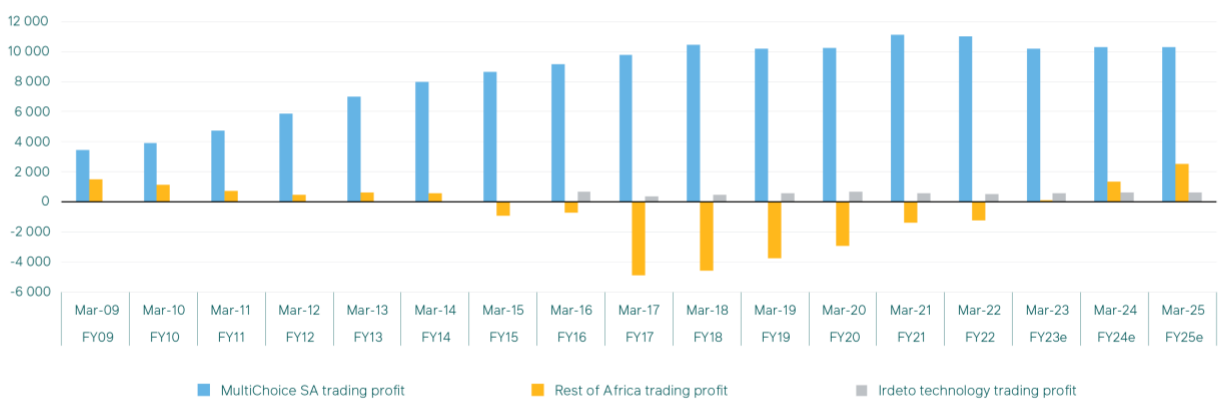
The investment case - Rest of Africa returns to profitability

During 2015, 2016 and 2017, certain markets such as Nigeria, Angola and Zambia experienced significant economic headwinds (including high inflation and currency depreciation) from the commodity crisis. Revenue was worth less due to sharp currency devaluations and furthermore, revenue pressure came about from a decline in the Rest of Africa's high-end *Premium-market* subscriber base as they could no longer afford the ensuing price increases. The strategy at the time was built around the small *Premium-market* segment, and passing through above-inflation price increases no longer worked effectively. Hence, the group introduced a new value strategy aimed at building scale in the *Middle* and *Mass-market*segments and passing through *marginally below-inflation* price increases. The implementation of this new value strategy led to a further reduction in revenue, as product price points were lowered in some markets to make the product more affordable to a larger part of the market.

Costs simultaneously escalated due to the impact of increased cost of sports rights that had to be renewed, increased satellite capacity costs and upfront subscriber acquisition costs associated with the implementation of the new value strategy. This cost base couldn't be reduced fast enough for the lower level of revenue being generated because some agreements were locked-in and/or long term in nature. Simply put, Rest of Africa's revenue declined, *and* costs increased, resulting in huge losses (see Graph 2).

Subscriber growth, cost-cutting initiatives[4], less severe currency devaluations and more recently price increases in key markets, have all played a role in the narrowing of losses within Rest of Africa over the past few years. MCG management have guided for Rest of Africa to record trading profit break-even for the year ended March 2023 and cash break-even a year later.

Graph 2: MultiChoice trading profit stagnant in SA but improving in Rest of Africa



Source: Company data and M&G Investments calculations and forecasts

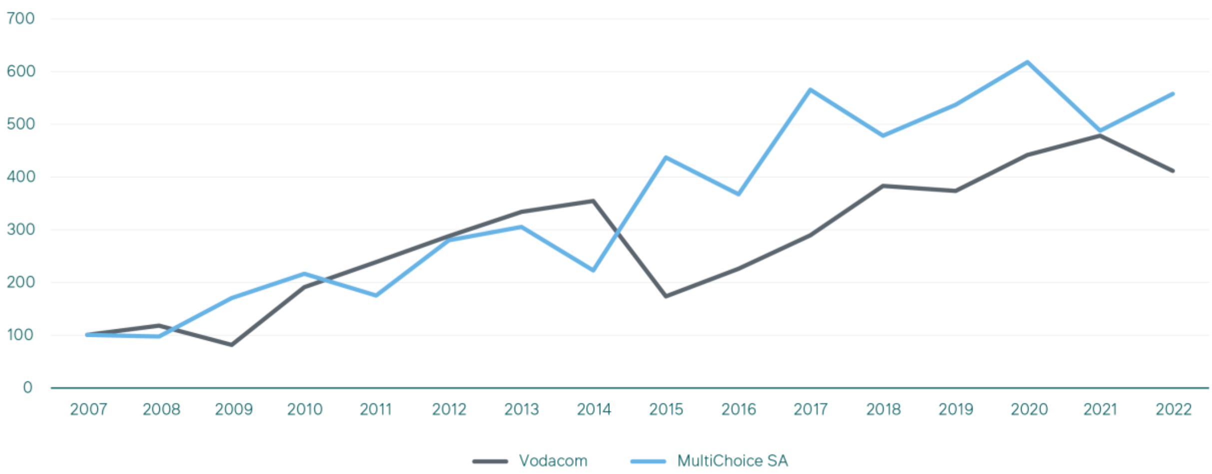
MultiChoice SA subsidises the Rest of Africa

We calculate that MultiChoice SA generates, on average, annual free cashflow of R7.8 billion. Because R2.2 billion of this cash is needed by MultiChoice Group to fund the losses within the Rest of Africa, MultiChoice Group's free cashflow only amounts to R5.6 billion. On average, R3.9 billion of the R5.6bn is paid out as a dividend. That is, Phuthuma

Nathi[5]shareholders receive an annual dividend of R1.5 billion from MultiChoice SA and MultiChoice Group declares an annual dividend of R2.4 billion to its shareholders, thus totalling R3.9 billion. Once Rest of Africa is able to fully fund its own operations, we think that at least R2.2 billion of MultiChoice SA's free cashflow will be freed up and could possibly be declared to MultiChoice Group's shareholders as a further dividend.

MultiChoice SA's free cash flow growth outpaces that of Vodacom
Graph 3 shows that, since 2007, MultiChoice SA has grown its free cash flow at a faster rate than Vodacom[6]. MultiChoice SA's superior free cash flow generating ability is due to its low capital intensity[7], high margins and ungeared balance sheet. Once MultiChoice SA no longer needs to subsidise Rest of Africa's operations, the Group's free cash flow should match that of MultiChoice SA. The Group's trailing free cash flow yield[8] would thus increase from 9.7% to 13.7%, which is very attractive compared to Vodacom's 5.7% free cash flow yield.

Graph 3: MultiChoice SA's free cash flow superior to Vodacom

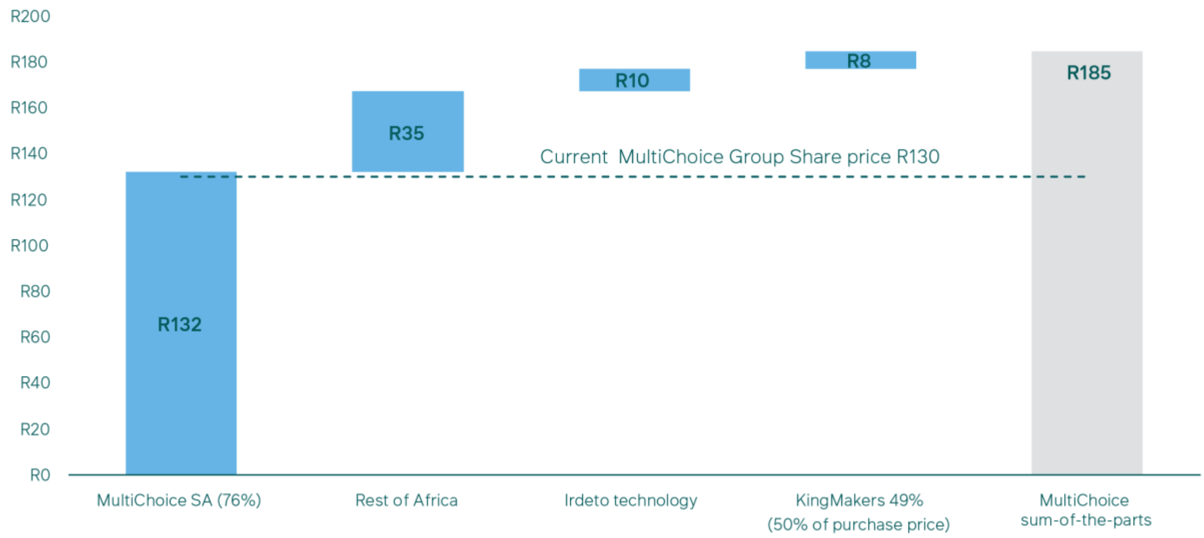


Source: Company data and M&G Investments calculations

Sum-of-the-parts valuation
Our sum of the parts valuation for MCG is R185 per share, as depicted in Graph 4. As such, we believe upside of 42% exists from the current share price of R130 per share[9]. The current share price only captures the value of the highly profitable and stable South Africa business of R132[10], but doesn't attribute any value to *Rest of Africa*, *Irdeto technology*[11] or *KingMakers*[12]. Once Rest of Africa returns to profitability

and KingMakers builds up an adequate profit track-record, the market will be forced to attach a value to these businesses.

Graph 4: MultiChoice sum-of-the-parts valuation shows 42% upside potential

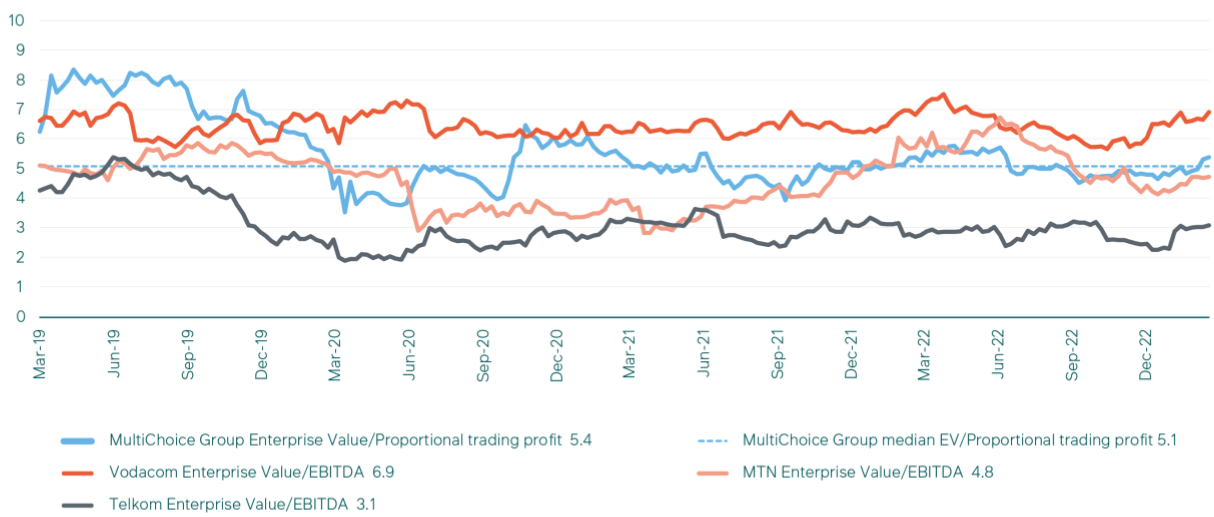


Source: Source: Company data, Bloomberg, M&G Investments calculations and forecasts

MultiChoice remains undervalued by the market

Graph 5 shows that MCG is trading on a 5.4X valuation multiple, which is below the 8.0X multiple that it traded on during the first few months of its listing. The market continues to erroneously value MCG on a telecommunications valuation multiple, despite it having a much stronger balance sheet and a low capital intensity[13].

Graph 5: MultiChoice valuation versus telecommunication companies



Source: Company data, M&G Investments calculations and Bloomberg

Potential corporate action supports the MultiChoice valuation and share price

Canal+[14], which also has a growing African pay-TV footprint[15], has become the largest shareholder (30%) in MCG recently, but the ultimate end-goal surrounding this stake is not known. In 2018, it was rumoured that Canal+ had bid USD $1 billion[16] for MCG's Rest of Africa operations, so interest in this part of the business probably still exists. Canal+ has the potential to accelerate the unlock of value from the Rest of Africa.

High-conviction overweight position in MultiChoice

Given all of the above factors, we believe the investment case for MultiChoice is a strong one, especially on our typical five-year view. The counter remains an important part of many of our client portfolios, which has made us one of the top five shareholders in the company[17].

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[1] As per MultiChoice Group's September 2022 interim results presentation, MCG entertains more than 100 million individuals (22.1 million subscribers multiplied by an average of 4.6 individuals per household equals 101.7 individuals).
[2] Subscribers are segmented into 3 types, namely *Premium* (DStv Premium and DStv Compact Plus packages), *Middle* (DStv Compact) and *Mass-market* (DStv Family, DStv Access, DStv EasyView and GOtv).
[3] The valuable DStv Premium package subscriber base stabilised after historic declines, while DStv Compact Plus package included within the Premium market segment continues to decline, possibly due to affordability constraints.
[4] Cost-cutting initiatives include tailoring content offerings to better suit market-specific needs, replacing expensive international content with local content (telenovelas and reality-TV shows), re-denominating cost from hard currency into local currency and reducing overall overhead costs.
[5] MCG owns 76.8% of its South African operations and Phuthuma Nathi Investments (black economic empowerment scheme) owns the remaining 23.2%.
[6] MultiChoice SA is similar to Vodacom in that both companies have highly profitable and mature South African businesses.
[7] Capital expenditure-to-sales ratio
[8] Free cash flow-to-market capitalisation ratio
[9] As at 17 February 2023
[10] Once Rest of Africa returns to middle-teen trading profit margin profitability, MultiChoice Group's headline earnings would then match that of South Africa, which has been on average R13.2 per share over the past few years. If one multiplies R13.2 of earnings by a *low-growth* price-to-earnings multiple of 10X, one arrives at a valuation of R132 for the South African business.
[11] Irdeto technology is highly profitable and services not only the group's digital security and anti-piracy needs, but also some of the world's best video entertainment, mobile, gaming and connected transport service providers.
[12] MCG recently spent R6 billion on acquiring a 49% interest in KingMakers, a digital sports betting platform which owns its own intellectual property. It has operations in Nigeria, Kenya and Ethiopia, with plans to enter South Africa soon.
[13] MultiChoice Group's capital intensity is 2% as compared to Vodacom's 15%.
[14] Canal+ is owned by French media conglomerate, Vivendi. As per page 12 of Vivendi's 30 June Interim 2022 financial report, Canal+ has a 23.9 million subscriber base comprising 9.6 million households in France (40%), 7.8 million households in Rest of Europe and Asia Pacific (33.3%) and 6.5 million households in Africa (27%).
[15] There is very little geographic overlap as MCG's footprint covers the mainly English-speaking countries while Canal+ broadcasts in mostly the French-speaking countries within Central and West Africa.
[16] R18 billion or R40 per share using 17 February 2023 exchange rate of 1USD:18ZAR.
[17] M&G Investments current shareholding in MultiChoice Group is 7.9%.