RE:CM

_REGARDING CAPITAL MANAGEMENT

No 7 West Quay Office Block, West Quay Road, V&A Waterfront, Cape Town 8002
PO Box 51615, Waterfront 8002
_TELEPHONE +27 21 425 7953 _FAX +27 21 425 7956 _WEB www.recm.co.za
_Regarding Capital Management (Pty) Ltd. _REG. NO. 2001/028924/07
_DIRECTORS Piet Viljoen, Theunis de Bruyn, Werner Stals.

"Deregulation" of the SA Telecommunications Market

***Legal Monopoly*: A company which the government has granted exclusive rights to offer a particular service in a specific region. In return, the company agrees to have its policies and prices regulated.**
***Yin and Yang:* The cyclical nature of yin and yang means that all phenomena change into their opposites in an eternal cycle of reversal.**

"*As a country too, we do not have a choice but to position ourselves to meet the challenges of global competition by developing ICT strategies that will ensure our competitiveness in the global market*" Dr Ivy Matsepe-Casaburri, June 2002.

Our take on Communications Minister Dr Ivy Matsepe-Casaburri's statements is that one of government's principle goals is to lower telecommunication costs in South Africa. The best way to do so would be for government to allow the eventual development of a freely competitive market, an outcome that we would like to see but is still very difficult to imagine at this point.

At RE:CM, we think in principle that any attempt by the government to de-monopolise the telecommunications industry would be of great benefit to the South African economy. For most businesses the telecommunications expense is indeed very material, and a reduction in these costs will help to improve the competitiveness of domestic companies in the global marketplace. Increased globalisation and free trade zones have made a low cost base an imperative to doing business.

Another aspect of lowered telecommunication costs is increased usage, both in numbers of users and time spent per user. This would benefit the entire chain of service providers to the telecommunications industry, including equipment providers for both voice and data communication and ISP's (Internet Service Providers).

A fantastic advantage that telecommunications businesses in South Africa have in this respect is that there is no need to re-invent, we are playing catch-up to the world and we can and should learn from the many lessons of history. At RE:CM we remind ourselves once again that there will be winners but also losers, and we are extremely careful in assessing this opportunity.

It is perhaps not surprising to learn that Telkom has dedicated large resources to studying the development of the UK telecommunications market (Courtesy of research provided by Noah's independent global telecommunications consultant, Steve Wallage), especially when you consider the fact that after 11 years of complete deregulation British Telecom (BT) is still by far the dominant player with over 70% market share. If we make an attempt to understand why this is so we can formulate an opinion on the likely outcome for our own market.

In 1984 the UK government licensed a competitor, Mercury, at the same time as the initial privatisation of BT occurred. The regulatory environment allowed for inflationary linked price increases (sounds familiar doesn't it?). Over the next 10 years the government progressively tightened BT's price regulations, while Mercury focused on the highly profitable international and corporate markets without having to cross-subsidise unprofitable local access services.

An already established modern telecommunications infrastructure is a natural monopoly. Rival systems have to reproduce expensive networks along the same access route as the incumbent if they want to compete head-on, and history is littered with such corporate disasters. Investors get carried away by the hype and provide 'easy' capital to chase the hot opportunities. This has the effect of oversupplying the market and prices and margins fall for all the market players. It is usually the incumbents that survive and the start-ups that disappear as soon as the cash runs out. BT retained high market share because they provided a competitively priced and high quality infrastructure backbone that service providers (ISP's, mobile phone operators etc) could rely on to service their clients. Given this outcome, it should be no surprise that our opinion is that Telkom will remain a dominant player. They have both a technically sound infrastructure backbone (natural monopoly) and appreciation of history that would suggest this outcome, regardless of consumer disillusionment with past experiences when Telkom could afford to behave like a monopolist bully.

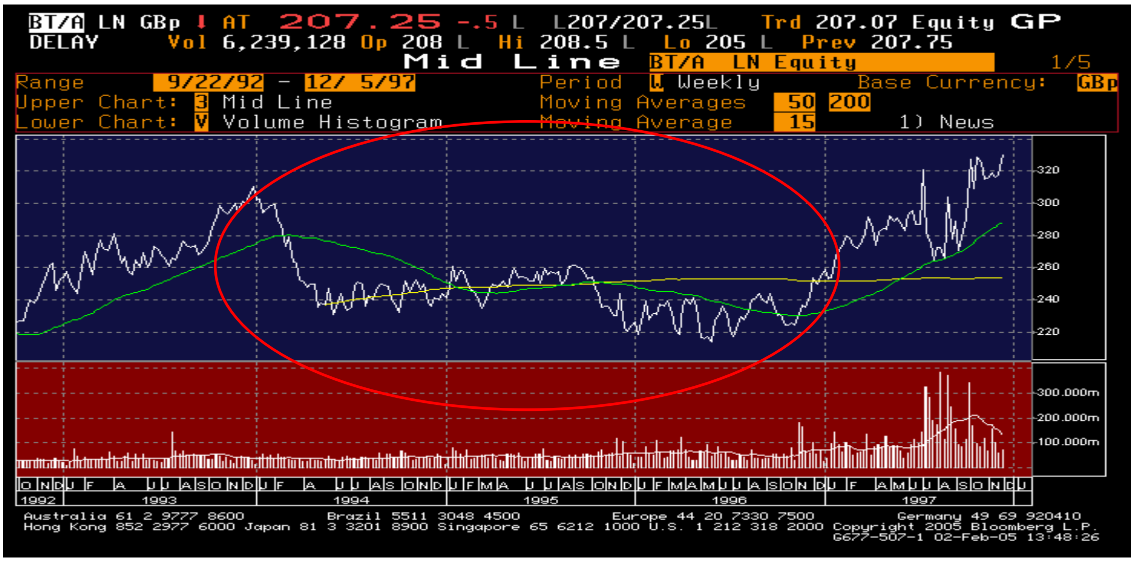
What should matter most to an investor is not the potential outcome, but what expectations are already priced into share prices. Based on the fact that Telkom, at a price/sales ratio of 1.6 times and a price/book ratio of 2.9 times (see the circles in table 1 below), is valued at the same average post-total-deregulation valuation of BT, it is our view that the current Telkom share price already more than reflects this optimal outcome. Importantly, this assumes the best regulatory outcome for Telkom, which is by no means certain.

One of the defining characteristics of a legal monopoly (such as Telkom) is that it is a two-way agreement. Life is about balance, and in business especially so - Yin and Yang. What is very important to understand is that what government gives, government can also take away – Governments are not and should not be in the business of sustaining artificially high rates of return, particularly not if such rates may be to the direct disadvantage of the long-term economic performance of the country. What will happen to Telkom's high margins if government sells off its remaining shareholding and then completely deregulates the industry (as happened in 1993 in the UK example)? Again we look to history as our guide:

Table 1: Selected Financial ratio's of British Telecom and Telkom

British Telecom Source: Bloomberg	Pre-deregulation 1988 - 1993 average	Post-deregulation 1994 - 1997 average	1994 - 2004 average	Telkom 2000 - 2004 average	2004 actual (at FYE)	11511 At current share price
% sales growth (nominal)	5.5	3.1	3.2	10.8	8.8	
operating margin	24.1	21.0	19.2	15.8	22.0	
net profit margin	13.5	13.3	9.9	6.0	11.1	
price/sales	1.07	1.26	1.54		1.13	1.57
price/book	1.32	1.48	2.88		2.07	2.89

Chart 1: Share price in GBP of British Telecom 1992-1997



Source: Bloomberg

When looking at BT's history one can clearly see (from the dotted circle in table 1 above) the effect of complete deregulation in 1993 on the company's profitability. It is in fact surprisingly low, and took longer than expected. BUT investors sold the share down 30% during 1994-1996 as can be seen in chart 1 above. This was in fact a really good buying opportunity, and could indeed happen with Telkom at some future point in time.

The biggest risk inherent in any industry deregulation from an investor's perspective is that some new entrants to the industry, while offering a great product and service to the consumer but subject to oversupply and severe competition, will ultimately fail to make any money from such business activity. History has shown that such a business model generally benefits only the consumer by lowering prices, and certainly not the hapless shareholder. Witness the birth and demise of a multitude of technology companies in the late 90's funded by easy money from venture capital funds and investors that never asked any difficult questions as to where, how and when profits were being made.

There are quite a few listed companies that compete in and could benefit from the deregulation of the telecommunications industry in SA: Telkom, MTN, Vodacom (through Telkom and Venfin), Didata (through its subsidiary Internet Solutions), DataPro, Reunert, Altech, Jasco, Datacentrix, Mustek, Pinnacle and ERP.com to name a few, as well as numerous unlisted ones.

In this still uncertain regulatory environment we believe it is prudent to remain invested in high quality companies where we feel comfortable that management relies on sound business principles and that the markets they operate in are not characterised by excessive capital commitments and resulting oversupply. We will not chase after blue-sky opportunities and share prices that already discount optimal outcomes.

Daniel Malan March 2005