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HUGE GROUP LTD

RECOMMENDATION: BUY

- Huge operates in the fast-growing managed telecoms sector, and is able to make substantial reductions in telecommunications costs for its clients. This creates demand for its services, as high telecommunication expenses are notoriously a major cost of doing business.
- All income is of an annuity nature.
- Although Huge has its own niche to a fair extent, it is in many ways a competitor of Vox Telecom. The latter's impressive earnings record suggests that Huge could enjoy similar success.
- In contrast to Vox Telecom, Huge only makes acquisitions if it considers that they fit well and give exceptional opportunities. It is reluctant to dilute its share capital more than necessary.
- Although Huge only started to operate in its present form on 1 August 2007, its component parts have been in business for over fifteen years. Accordingly, although it does not as yet have a track record, it is by no means a start-up operation.

Year end February	2008A*	2009F	2010F
HEPS (in cents)	44,15	59,90	78,20
Dividend (in cents)	12,00	30,00	39,00
PE on current price 390c	8,8	6,5	5,0
Dividend yield on 390c	3,1%	7,7%	10,0%

*7 months annualised

Listed on AltX.

Issued share capital 111.76m shares.

Market capitalisation R436m.

12 month high 565c; 12 month low 293c.

BUSINESS

Huge is a managed telecommunications company and the second largest of four similar companies which dominate this segment of the industry, with a market share of about 18%. This segment of the market is estimated to total R3bn at present.

It offers corporate customers in SA and Namibia the management of mainstream voice, data, video and mobility services, as well as the efficient outsourced management of the telecommunications companies that provide them.

It is an entirely annuity-based business where products and services are supplied to over 6 000 corporate clients on a monthly contracted subscription basis. Contracts signed usually cover an initial term of 24 months and are renewed after that for additional terms of 24 months.

Huge's managed telecommunications service includes but is not limited to:

- The elimination of business waste from the misuse of client company resources by using propriety private call prediction technology. In other words, it can frequently spot when a staff member is making a business call and when he is making a private one.
- The introduction of alternative cheaper forms of communication, like SMS.
- The elimination of cross-network phone calls (eg. Vodacom to MTN and vice versa) which incorporate interconnection fees or service charges. These include international, national, mobile and local calls.

Huge is not an infrastructure player and does not face any competitive infrastructural risks.

THE MARKET

This is a fast-growing industry, though it is fragmented and there is plenty of competition. There is likely to be a consolidation as regards the number of players, with many of the smaller operators being taken over.

There are many telecommunications management and telecommunications cost-saving opportunities. Telkom and the cell phone companies continue to charge high prices. Interconnection fees arise when a call is made from one cell phone company to another (eg. From Vodacom to MTN), and these are particularly expensive. LCR enables the customer to avoid these.

The LCR market is growing at about 22% per year with this growth rate expected to continue for the next two to three years.

The use of two networks will always exceed the cost of using one network. An on-network telephone call will invariably always be cheaper than a cross-network telephone call.

POLICY

Huge has considered the introduction of VoIP, which is cheaper and more efficient than traditional methods. However, it has decided that the benefits are not sufficient at present to warrant its use. Huge is not a network operator and does not intend to become one, so VoIP presents neither a potential threat nor a potential opportunity.

Of the other listed telecommunications companies, the one that most readily comes to mind is Vox Telecom, though to some extent this company serves a different market. Vox has expanded through several acquisitions which have brought about very considerable dilution of capital, but have nevertheless created rapid growth in HEPS. Its aim is to set itself up as an alternative to Telkom. Huge has rejected such a policy. This may sound like sour grapes as Vox would have got first run, but it considers that Vox's operations create a conflict of interest which arises from owning their own network and product and selling the services and product of third parties (hence a least cost routing or telecommunications management service). In any event, Huge is carving out a niche of its own which creates relatively little dilution of capital.

COMPETITION

The network operators Internet Solutions, Telkom, Neotel and Verizon for fixed line services and Vodacom, MTN and Cell C for mobile-cellular and WiMax services, are not seen as competitors but are simply suppliers of communication products that are ultimately used by Huge's customers. Huge represents one of the larger single customers of all the network operators. Its involvement with them is to add value to their services.

The alternative telecommunications companies, including Vox Telecom and ECN, will remain competitors so long as they continue to provide some form of managed telecommunications services.

The function of Autopage and Nashua as distributors to the network industry is regarded as being limited to the supply of network products, but they are still considered to be meaningful competitors.

The managed telecoms market is split up as follows:

Vox Telecom 39%
Huge 18%
Nashua 17%
Autopage 7%
Telemasters (an Autopage Super Dealer) 5%
Intelligence (an Autopage Super Dealer) 5%
Dupont 3%

Other 6%.

ACQUISITIONS SINCE LISTING

Shortly after listing, Huge bought the LCR provider Centracell, whose activities are complementary to Huge's TelePassport division. This has given Huge greater critical mass in corporate managed telecoms.

On 5 May 2008, Huge acquired 25% of Eyeballs Mobile Advertising, with an option to buy another 15% within the next 24 months.

Eyeballs delivers media advertising to cellular smart phones using technology developed within the last two years. This is a start-up operation so it is somewhat speculative, but Huge has high hopes that it will be successful.

The proposed acquisition of iTalk is still pending but is subject to a pre-emptive process by MTN (who have the right as the remaining shareholder in iTalk to acquire the shares that Huge intends acquiring), and an adjudication by the Competition Tribunal. Huge intends to oppose the proposed merger between MTN and iTalk at the Competition Tribunal adjudication stage. In the event that Huge's opposition to the proposed MTN/iTalk merger is successful, it will acquire iTalk and add an estimated R600mn in annual revenue to its top line.

Huge does not intend to be purely acquisitive, and it intends to focus on growing organically rather than by buying other companies. It will only consider additional strategic acquisitions where it makes sense, fits well and does not significantly dilute shareholder wealth. There would therefore have to be a very specific advantage to any proposed acquisition.

RESULTS FOR THE 7-MONTHS ENDED 29 FEBRUARY 2008

	R000
Revenue	243 544
	=====
Gross profit	54 179
Other income	2 163
Operating costs	(31 115)

EBIT	25 227
Finance costs	(6 267)
Interest income	10 841
Equity accounted investments	915

Profit before tax	30 717
Tax	(4 465)

Headline earnings	26 252

Issued share capital 106,76m shares.

HEPS (in cents)	44,15 ⁺
EBIT margin	10,4%

⁺7 months annualised

CASH FLOW

Net operating cash flow last year was R29,3m, which exceeded headline earnings of R26,25m. Huge generates negative working capital with creditors' days exceeding the combination of debtors and inventory days. This permits Huge to adopt a two-times dividend cover, which is less than it would otherwise have been.

TAX

The effective rate of tax last year was 14,54%. However, one should not be worried that it will quickly climb to the full tax rate. There is an additional R42m in assessable losses acquired as part of the Centracell acquisition which can be set off against future taxable income.

PROSPECTS

It has been suggested that Huge's segment of the industry is mature and now lacks scope for growth. Huge's management consider that this argument is fallacious, pointing out that, true managed telecoms services are still an emerging service and market niche. It is expected to become an essential service for SA companies.

Mobile-to-mobile on-net routing can expand from the current R3bn to R7bn. This is because the number of alternative communications companies operating in SA using different methods of communication is increasing, and so are the standards being adopted. The number of on-network and cross-network routing possibilities is increasing exponentially, to Huge's potential advantage.

The SA telecoms market for mobile voice traffic is growing at about 22% per annum according to reliable research reports.

There is scope to increase profit margins, and I have allowed for this in my forecasts.

A COMPARISON WITH VOX TELECOM

Huge has stated that its expansion policy is different from that of Vox Telecom which has advanced by several substantial acquisitions. These involve a major dilution of capital but nevertheless have assisted with a rapid growth in HEPS. However, the two operate to a fair extent in similar industries. Huge does not yet have a track record, but Vox is beginning to develop one.

For what it is worth, I am showing Vox's record since listing.

Year end August	HEPS (c)	% increase
2005	2,1	n/a
2006	3,4	62
2007	7,67	126

With considerable reservations, one might argue that this could give a clue to Huge's future growth.

It is perhaps worth noting that, apart from an interim dividend of 1c for 2005, which was probably a mistake, Vox has yet to declare a dividend, while Huge has already declared a maiden dividend of 12c, 2,7 times covered, and intends to follow a cover of 2 in future years.

MY EARNINGS FORECAST FOR 2009

I have assumed:

Revenue of R640m, an increase of 12% on last year, as predicted by management. .

EBIT margin of 12% (10,4% last year).

Net finance income of R7m.

Equity accounted investment income of R1,5m

A tax rate of 25%.

Issued share capital unchanged at 106,8m shares.

Dividend cover at 2x - as predicted by management

This would give us:	Rm
EBIT	76,8
Net finance income	7,0
Equity accounted investments	1,5

Profit before tax	85,3
Tax	21,3

Headline earnings	64,0

HEPS (in cents)	59,9
Dividend (in cents)	30,0

MY EARNINGS FORECAST FOR 2010

I have assumed:

Revenue for 2010 up 20% to R768m.

An EBIT margin of 14%.

Finance income and equity accounted investments unchanged.

A tax rate of 28%.

Issued share capital unchanged at 106,8m shares.

This would give us:	Rm
EBIT	107,5
Finance income	7,0
Equity accounted investments	1,5

Profit before tax	116,0
Tax	32,5

Headline earnings	83,5

HEPS (in cents)	78,2
Dividend (in cents)	39,0

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There is no limitation on the distribution of this report, and you may use it as freely as you wish, provided only that you attribute its authorship to me. You may quote me by name, and I welcome questions about what I have written and about the company's prospects in general.

I have taken every care in the writing of this report, but those who act upon it must do so entirely at their own risk and on their own responsibility.