



What WACC for Telkom SA?

- **Setting**
 - February 1997
 - Post-apartheid, privatization phase in South Africa
 - Bidding war for 30% ownership in Telkom
 - currently owned 100% by the SA government
- **Protagonists**
 - South African government
 - SBC Communications Inc.
 - Telekom Malaysia



Assumptions used in Valuation

Beta	1.2
Risk Free Rate of Return	15.39%
Market Premium	7%
Return on Equity	23.79%
Return on Debt (before tax)	16.73%
Tax Rate	35.00%
Return on Debt (after tax)	10.87%
Debt to Equity Ratio	0.71

Answer: 20.11%


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Coming to terms with SA's new low cost-of-capital reality

A recent government-led analysis of binding constraints to more rapid growth in South Africa highlighted the fact that there are too few investment projects – this despite relatively high local-investment returns.

Businesspeople argue that the dearth of projects relates to the fact that, on a risk-adjusted-return basis, the hurdle rates have to be significantly higher in South Africa than in more developed parts of the world, with this hurdle rate determined by the weighted average cost of capital (Wacc), itself a combination of equity and debt costs.

A recent OECD Centre for Development analysis shows that, as of July 2004, South Africa's average Wacc for an ungeared entity was about 15,5%, comprising a 10% yield on the ten-year South African government bond, and a 5,5% equity-risk premium. By comparison, an equivalent US company had a hurdle rate of 8,5%, while a UK firm's hurdle was around 9%.

As a consequence of this relatively high cost of capital, large companies, such as BHP Billiton, Anglo American, SAB, Investec, Dimension Data and Old Mutual, successfully, albeit controversially, petitioned the authorities to allow them to change their domiciles from Johannesburg to London. This change of address, it was argued, supported a lowering in the cost of capital and increased their "true profitability", which, in turn, made them more competitive and would facilitate the realisation of more marginal South Africa projects.

However, since July last year, there has been a dramatic narrowing in the cost-of-capital gap between South Africa and the developed world. In fact, Investec's Prof Brian Kantor points out that total risk premium, or the difference between the US ten-year government bond, trading at 4,5%, and the equivalent South African bond, now trading at 7,6%, is now only 3,1%. Meanwhile, the real cost of capital – the comparison between the long-term inflation-indexed bonds in the US and the R189 domestically – is only 50 basis points, with a yield in the US of 2,1%, compared to 2,65% on the R189.

The problem, Kantor admits, is getting business to believe it, and for executives to change their perceptions about the true hurdle rates needed to achieve value for shareholders.

"When will South African business wake up to the fact that the cost of capital is so low," Kantor asks, pointing out that South Africa's cost of capital is now also significantly lower than most other emerging markets. He argues that South African companies need to come to terms with a lower cost of capital and that there is a real danger that they are currently exaggerating their costs of capital by seeking higher returns actually required.

"There are two kinds of errors you can make as an investor: firstly, you can invest in projects too optimistically . . . which is the type-one error. "But the type-two error is where you don't invest because you have established too high a hurdle rate. I think the type-two error is the most relevant one at the moment in South Africa. "The cost of capital has come down, but the required returns of companies in their investment budgeting has not fallen in sympathy," Kantor argues.

He believes increased competition and the prospects of faster South African growth will help bring greater alignment, where companies will invest more and expect and accept lower returns.

The only pity is that it has occurred too late to prevent those South African giants from moving to London – Terence Creamer, Deputy Editor.



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