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Telecom Italia & Telefonica: November 8th 2014-2016 Strategy Outline: Moral Hazard Ahead?

Ticker	Rating	CUR	23 Oct 2013 Closing Price	Target Price	TTM Rel. Perf.	EPS 2012A	EPS 2013E	EPS 2014E	P/E 2012A	P/E 2013E	P/E 2014E	Yield
TIT.IM	O	EUR	0.72	1.00	-22.5%	0.14	0.03	0.10	5.1	24.0	7.2	2.8%
TITR.IM	O	EUR	0.56	0.90	-34.8%	0.14	0.03	0.10	4.0	18.7	5.6	5.5%
MSDLE15			1334.36			93.30	91.45	102.99	14.3	14.6	13.0	3.3%
TEF.SM	O	EUR	12.80	14.00	4.5%	0.87	1.06	1.05	14.7	12.1	12.2	5.9%
TIMP3.BZ	O	BRL	11.50	13.50	61.6%	0.58	0.60	0.71	19.8	19.2	16.2	2.7%
TSU	O	USD	26.28	30.00	49.2%	1.46	1.31	1.55	18.0	20.1	16.9	2.6%
MXEF			1030.82			82.27	89.03	99.27	12.5	11.6	10.4	2.7%
SPX			1752.07			103.15	108.63	120.50	17.0	16.1	14.5	2.0%
AMX	U	USD	21.13	15.50	-42.9%	1.82	1.87	1.87	11.6	11.3	11.3	1.7%
AMXL.MM	U	MXN	13.73	10.00	-22.9%	1.19	1.19	1.20	11.5	11.5	11.4	1.6%
O2D.GR	O	EUR	5.92	6.90	-20.3%	0.28	0.10	0.10	21.1	59.2	59.2	7.6%
KPN.NA	O	EUR	2.27	2.85	-50.8%	0.49	0.16	0.19	4.6	14.2	11.9	NA

O – Outperform, M – Market-Perform, U – Underperform, N – Not Rated

AMX estimates are 2011A/2012E/2013E

Highlights

Moral Hazard Ahead. Telefonica's current position within Telecom Italia is temporary … and unsustainable. TI's debt burden and junk rating, its historical disservice to its country, potential changes to the law regarding Italian take-overs, and the very long timelines required to approve any Brazilian sale, strengthen the case to de-risk Telecom Italia with a small (roughly €2bn) rights issue. We expect this announcement to come with a sale of towers and buildings, a new cost-cutting effort, a suspension of the dividend, an accelerated fibre and 4G rollout, and the cancellation of the network spinoff project. They could announce a strategic review of assets but it seems more likely that they will limit themselves to answering, if asked, that they are pragmatically open to all offers if attractive enough. Anyone who can do basic math would be able to read between the lines that a small rights issue only makes sense in the context of the sale of TIM Brasil … after which TI's Net Debt/EBITDA would fall to 1.9x by YE 2014; making a merger between Telefonica and TI very attractive for both sides. In our view, this and the clear upside potential make the near term risk of a rights issue modest, and any participation in it, attractive.

- **Telefonica is in an unsustainable situation:** Telco could be dissolved by the Italian banks as soon as June 2014 (unlikely, but possible), but a Brazilian sale process, were the winning bid to be one or several of the current players in Brazil, could take up to 330 days to win approval. Politically Telefonica cannot stand by and watch in the interim as TI fails to improve parlous Italian infrastructure. Practically, Telefonica must guard against the risk that it will have to defend its stake against opportunistic feints by various shareholders and outside interests, with an offer for the whole company sooner than they hope. The only rational thing to reduce that risk is to help management to come up with a good turnaround plan and encourage them to de-leverage a little now.

- **In the last five years Telecom Italia's domestic capital allocation and commercial strategy have been almost perfectly wrong.** Constant increases in wireline prices and a dramatic lack of investment in wireline infrastructure have left Italy with the worst price/value ratio of wireline offers in the major markets of Europe. In combination with an undifferentiated wireless network and dramatic price

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competition, this strategy has resulted in the highest pace of fixed line loss in Europe and the sad truth that Italy is the only major market to see a decline in absolute broadband subscribers in the past two years. Meanwhile cost cutting that got off to a good start in 2008, tapered off to practically nothing in the last three years.

- **But, Telecom Italia's domestic business is a turnaround story dying to break out:**
  - The Italian environment has more positives than immediately meet the eye. We think that the wireless market is close to bottoming for four reasons. First, wireless pricing is so low and churn so high (nearly 40%) that with €13 ARPU TI does not have a backbook problem. Second, WIND market share is now high enough and their share under enough attack in the South that peace could break out. Third, TI has faced a main competitor (Vodafone) that has under-invested. But if, as we think likely, Vodafone is sold to AT&T, that under-investment is likely to come to a halt encouraging companies and consumers out of their high churn less for less mentality and into a more for more quality and capacity. Fourth, Hutchison Whampoa is selling assets in Hong Kong and appears intent on buying up rather than selling out in European Telecoms; Wind Italy and its owners are probably ripe for a deal to consolidate Italy.
  - In wireline the shame of a shrinking broadband national market (shrinking!) could be remedied while fundamentally improving the business. With the network spinoff dead, and potential change in Wind ownership, the new Swisscom CEO would be right to take his (or just for a laugh, her!) time in choosing a partner. With no other game in town, we believe that Fastweb is worth not less than 10x EBITDA to wireless players.
- **To turn around, Telecom Italia needs to change investment, pricing, cost strategies and capital allocation.** TI must urgently increase its wireline investment in urban areas where we estimate that they currently have only 23% market share. Fortunately a fibre roll to the first 40% of Italy would cost just €1.4bn. They will also need to reduce the price of broadband on slower speed (more rural) lines in order to reaccelerate broadband growth (as we have seen in Spain and the UK) and reduce line losses. Separately they should accelerate 4G network roll out in more rural parts of Italy to ensure that they can capture those customers who will not receive fast enough speeds over wires. We think that they could reduce their opex by some 10-15%, allowing flexibility to reinvest for growth like peers. Lastly, they should reduce their capital structure where they can – selling TIMB (>€9bn), buildings (€1bn), towers (€5bn) and a small €2bn rights issue, to help restore their balance sheet to <2.0x levered.
- **Under the right leadership Telecom Italia ordinary shares could easily be worth €1.20 (on a 12 month horizon, and €1.70 on a 3 year horizon),** compared to a downside case of €0.55. Several stakeholders, direct and indirect, are trying to derail Telefonica's plan to de-lever TI through a TIM Brasil sale. This seems utterly self-defeating. The time in which TI could afford a 'front-footed' rights issue to buy GVT has been and gone, in our opinion. Putting a stick in Telefonica's wheels only increases the risk that they might later abandon TI to its fate. Instead, it is obvious that were TI to set itself on a better operational path, sell TIM Brasil and de-lever, the Company would be (1) significantly more valuable as a standalone vehicle in the same vein as BT which trades at 6.0x EBITDA and (2) a very attractive target for a full take-over by Telefonica within 12-18 months. Without Telefonica's industrial expertise there is little hope of either; Asati and Findim should take a step back and ask themselves why (presumably) Bollore and Sawiris are agitating for them to kick out Telefonica and Telco. In our opinion, it is not for the good of small shareholders.
- **Participating in a small rights issue should prove a good investment.** We think TI could raise capital in a 1-for-4 rights issue at €0.55, a ~25% discount to the current value of TI shares (and above at par value so potentially avoiding an EGM). The rights issue would just be for the ordinary shares, as the par value of savers makes it nigh on impossible, or extremely awkward. A rights issue of this size would cost

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Telefonica €272m, and would not impact Telco's voting stake within Telecom Italia. We aren't convinced that an announcement of a rights issue will drive the shares down. In our view, it should not, as it will – in essence – be a confirmation of two important parts of a long thesis: (1) that TIM Brasil will likely be sold and (2) that Telefonica is fundamentally interested in the Italian assets of the company.

Investment Conclusion

We think that the case for underlying value at Telecom Italia is much stronger than appears at first glance. With the right strategy and leadership TI could be worth close to twice its current share price, notwithstanding a more than 60% rise on August lows. We expect a small rights issue at November 8th results, but view this as confirmation of two important parts of a long thesis: (1) that TIM Brasil will likely be sold and (2) that Telefonica is fundamentally interested in the Italian assets of the company. In combination with a dividend suspension (and hence accumulation of dividend at the savers), the spread between savers and ords may well narrow, making savers modestly more attractive near term.

Details

Telefonica's current position within Telecom Italia is unsustainable.

What has happened?

At Telco? Telefonica and the other shareholders of Telco recently agreed to an increase in Telefonica's share of Telco from 46% to 66% at an implied TI price of €1.09. The new shares are issued as C class shares and come with no voting rights, keeping TEF's voting share at 46%. In a second phase, Telefonica have the option from January 2014 to increase their voting stake in Telco to 64.9% subject to any regulatory approvals. In the interim, a standstill agreement has been reached preventing Telefonica from acquiring more shares unless a third party acquires a 10% or greater stake. See **Quick Take - Telefonica in Telco - Wide Ranging Implications and a Step towards Brazilian Consolidation** for more information.

Although unlikely (the banks surely want Telfonica to exercise its option to buy the rest of Telco) Telco could be dissolved by the Italian banks as soon as June 2014, but a Brazilian sale process (were the winning bid to be one or several of the current players in Brazil) could take up to 330 days to win approval; politically, Telefonica cannot stand by and watch in the interim as TI fails to improve parlous Italian infrastructure. Practically, Telefonica must guard against the risk that it will have to defend its stake against opportunistic feints by various shareholders and outside interests, with an offer for the whole company sooner than they hope.

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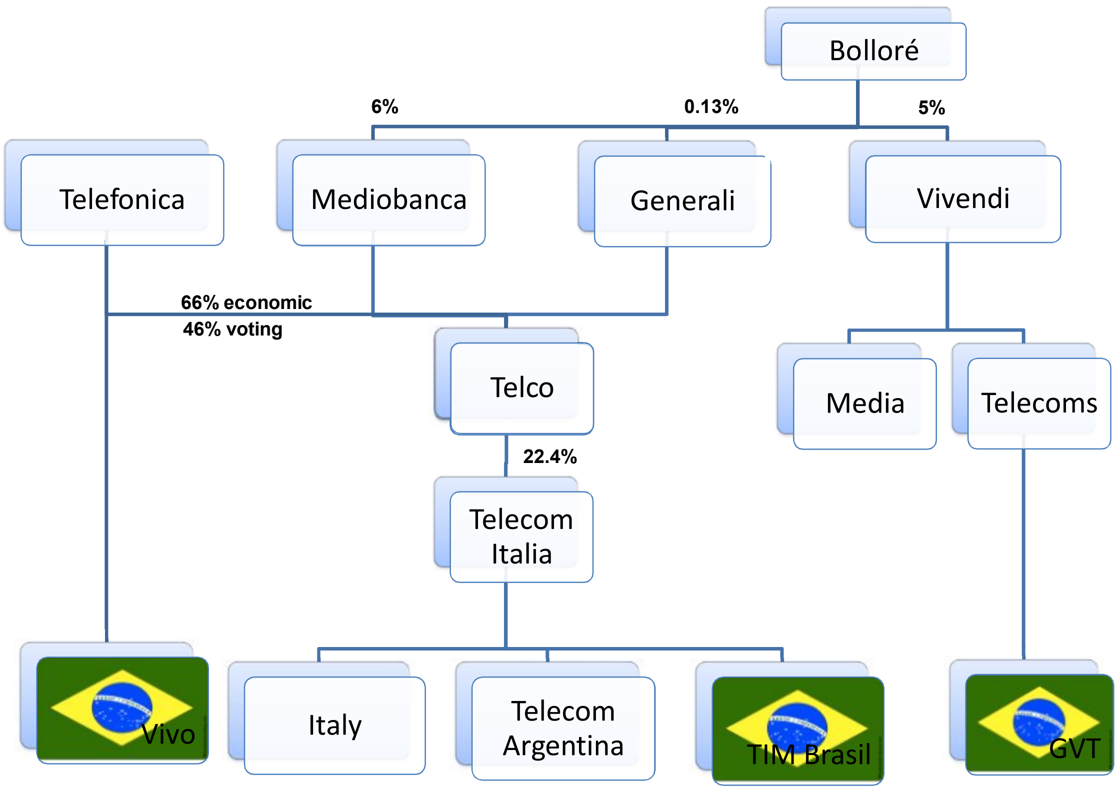
Exhibit 1

Vincent Bolloré seems to have a conflict of interest



Source: Bernstein analysis, Reuters, Bloomberg, Company reports

Several stakeholders, direct and indirect, appear to be trying to derail Telefonica's plan to de-lever TI through a TIM Brasil sale. Findim (owners of 5% of TI) have called a meeting of TI's shareholders calling for the removal of the directors appointed by Telco. In order to do this they need a simple majority of shareholders present (and through proxy votes); there is no quorum. The last shareholder meeting had 44% turnout, so at this level Telco (with 22.4% of voting shares) could rest easy. Assuming a 65% turnout Findim would need 72.5% of the remaining non-telco shareholders present to vote alongside them to win a majority. If turnout was 100%, Findim would need 55% of other shareholders to vote with them...

Without Telefonica's industrial expertise, there is less hope of a turnaround at TI. Asati and Findim should take a step back and ask themselves why (presumably) Bolloré and Sawiris are agitating for them to kick out Telefonica and Telco. In our opinion, it is not for the good of small shareholders.

In Italy? The Italian government has not got a golden share (those are illegal now), but instead a much more poetic (and entirely nebulous) "Golden Power" that states that the government in certain cases (including the network) has special powers; but failing to specify what those powers might be, see **Quick Take - Telecom Italia and the Golden Power**.

In Brazil? Brazil has become more important to PT and AMX. The planned Oi/PT merger means that Brazil is now central to that investment case, and also increasingly important to AMX given the withdrawal of their offer for KPN. See **KPN and America Movil: My Big Fat Mexican Wedding... Cancelled** and

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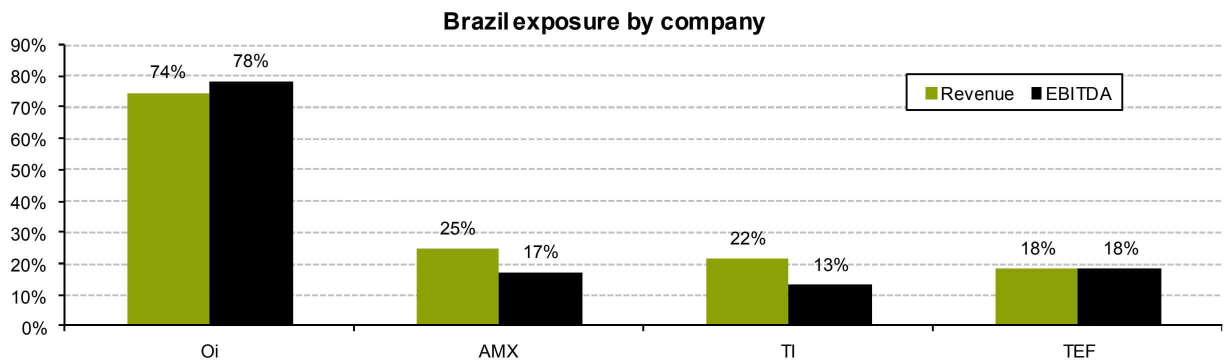
Portugal Telecom-Oi & Telefonica-Telco: Methodically Making the Uninvestable...Attractive. Raising PT&TEF Price Targets. This to us means they have more incentive than ever to improve the market structure of Brazil...

Exhibit 2

Brazil is of critical importance to Oi/PT and AMX



Source: Company reports, Bernstein analysis

In the last five years Telecom Italia's domestic capital allocation and pricing strategy has been almost perfectly wrong

Constant increases in wireline prices and a dramatic lack of investment in wireline infrastructure has left Italy with the worst price/ value ratio of wireline offers in the major markets of Europe (**Exhibit 3)**. This is in part due to TI's large relative exposure to wireline, and lack of competitive infrastructure (**Exhibit 4)**.

The reason for these high prices is simple – low and expensive unbundling because of infrastructure topography, high and rising ULL, a fragmented ULL market, and weak service from TI to unbundlers.

Italy is a country with relatively low population density and many, many small towns. The average number of lines per exchange is actually relatively high (the more lines per exchange the better the economics of the unbundler); below 10,000 lines it is difficult for an unbundler with just 15% share to break even.

Unbundling fees are the second highest in major European markets; but Italy is one of the few countries where ULL fees have risen over the last 7 years, despite starting at a point in the middle of the range, with average increases of 5% a year over the past 4 years.

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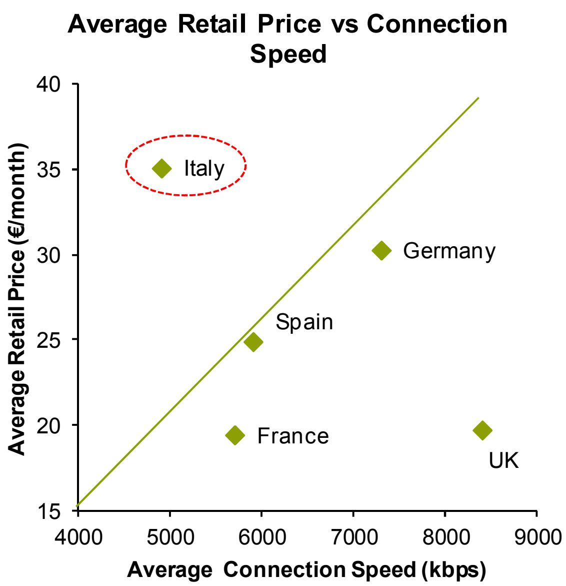
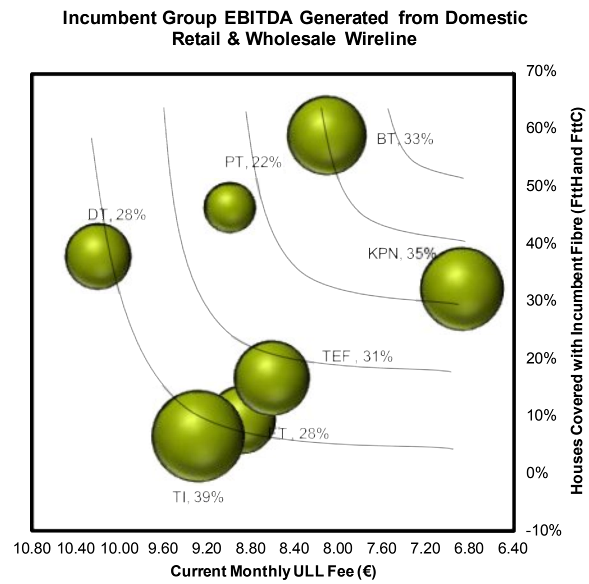
Exhibit 3
Italians have the worst price / quality in broadband



Source: : Akamai State of the Internet Q2 2013, Bernstein analysis, company reports

Exhibit 4
TI has a larger exposure to consumer wireline than peers



Source: Company reports, Bernstein analysis

In combination with a totally undifferentiated wireless network and dramatic price competition, this strategy has resulted in the highest pace of fixed line loss in Europe (**Exhibit 5**) and the sad truth that Italy is the only major market to see a decline in absolute broadband subscribers in the past two years (**Exhibit 6)**. The relationship between higher wireline prices and line losses is undeniable.

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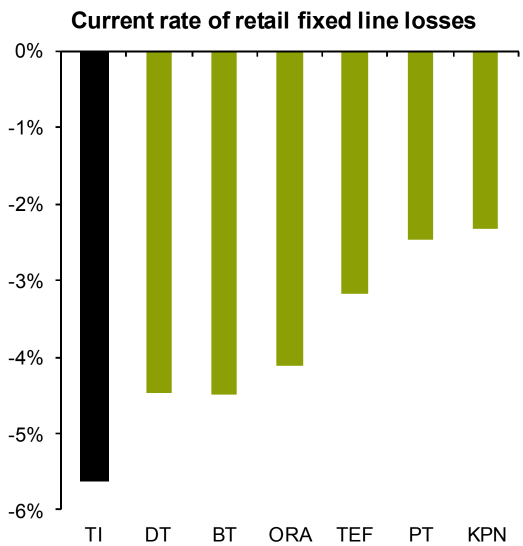
Exhibit 5

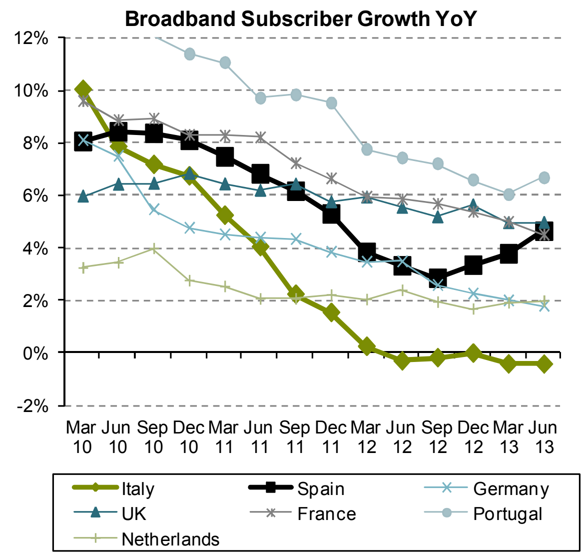
TI is losing more fixed line voice customers than peers



Source: Company reports, CMT, Anacom, Bernstein analysis

Exhibit 6

Italian broadband growth has not only lagged the rest of Europe, it went net negative!

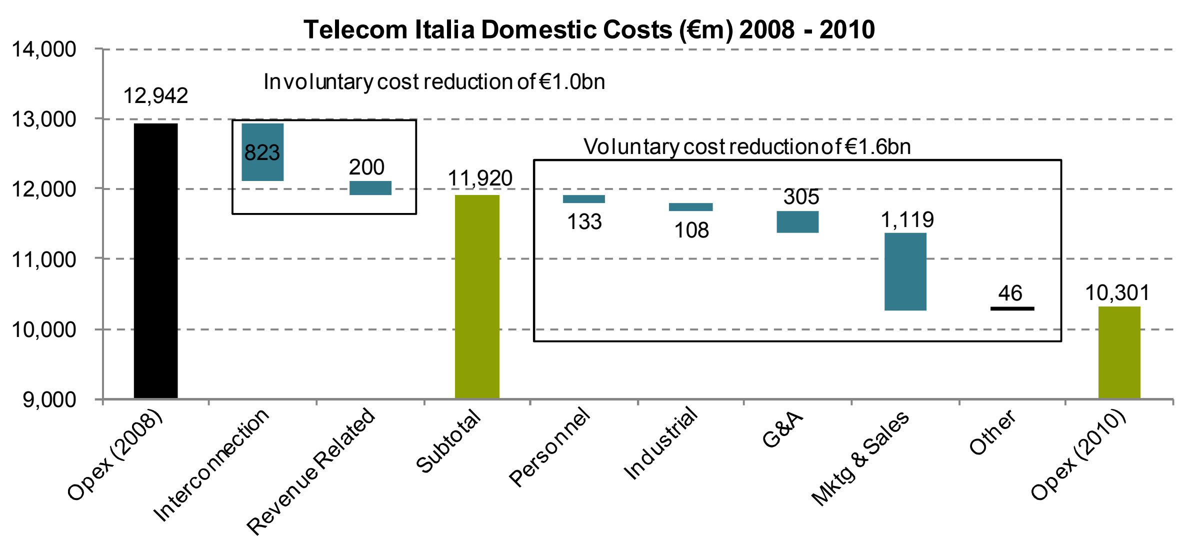


Source: Company reports, CMT, Anacom, Bernstein analysis

Cost cutting has been astonishingly poor. Over the period 2008-2010 TI reduced costs by a cumulative €2.6bn – but nearly 40% or €1bn of this came from involuntary cost declines – falling interconnect rates and revenues and the small direct costs related to revenue (**Exhibit 7**). Real cost reduction amounted to €1.6bn or 12% over two years after a spurt of headcount reductions, further subsidy reduction and disposal of stores.

Exhibit 7

Between 2008-2010 TI took 12% out of its cost base



Source: Company reports, Bernstein estimates and analysis

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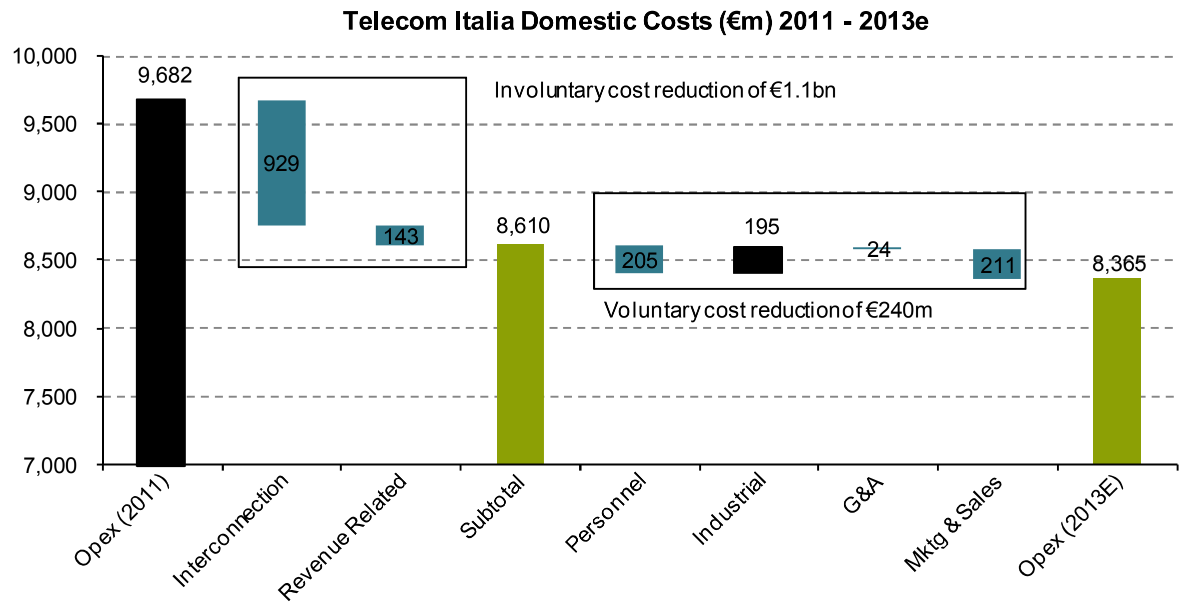
Since 2011 the company has failed to tackle its domestic fixed costs at all. We estimate that adjusting for interconnect and the variable costs associated with lost revenue, that TI has reduced its fixed cost base by just €240m or 2.7% between 2011 and 2013, **Exhibit 8**. Efforts to lighten the capital structure by selling towers, buildings and/or businesses have been slow and far short of sufficient.

Exhibit 8

The last three years have seen little reduction in costs by 2.7% or €240m since 2011



Source: Company reports, Bernstein estimates and analysis

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Telecom Italia's domestic business is a turnaround story dying to break free. Whilst this is certainly a challenging prospect, there are a few good things in TI's environment.

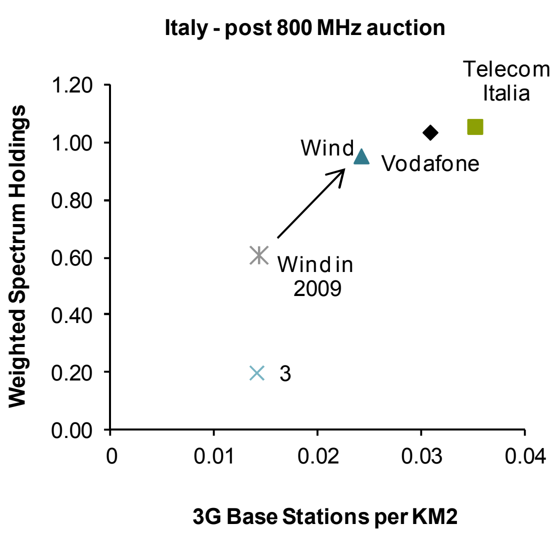
Wireless pricing is also now so low, WIND market share high enough in the north and churn so high that TI does not have a huge backbook problem and wireless revenue trends could indeed be bottoming.

Fortunately TI has faced a main competitor that has systematically under-invested, but if as we think likely, Vodafone is sold to AT&T that under-investment is likely to come to a halt. We would view renewed investment as a good thing for the market overall and for TI in particular who can, while Vodafone is in limbo, accelerate its own efforts. With Hutchison Whampoa selling assets in Hong Kong and apparently intent on increasing investment in European telecoms, WIND looks an obvious target

The biggest change in Italian wireless over the last few years has been Wind's expansion into Northern Italy (55% of GDP), and general network improvement (**Exhibit 9).** Few investors realise that Wind was historically a southern Italian operator with almost 50% market share of subscribers in some regions. Since 2011 they have expanded their network and distribution into the far richer north of Italy. This has helped them to grow market share of subscribers by 3.2% over the three and a half years (**Exhibit 10)**. Their increase in share of revenues has been steeper. Vodafone have been the biggest loser in this process.

Exhibit 9

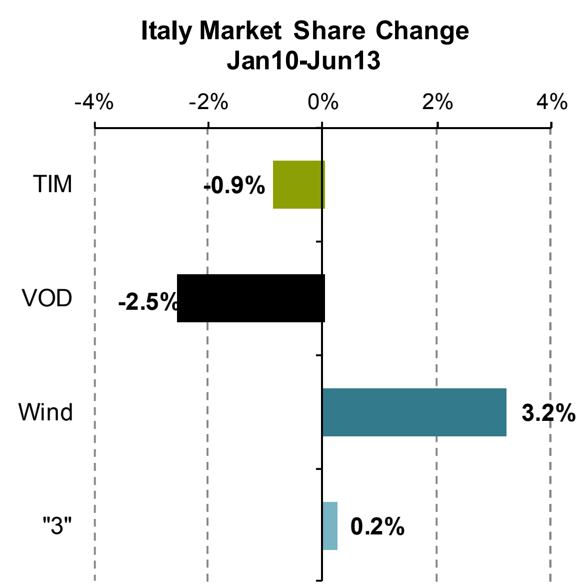
Wind have increased base stations as they went from southern regional to national footprint



Source: Company reports, Bernstein analysis and estimates

Exhibit 10

Wind have captured 3.2% of market share since this expansion



Source: Company reports, Bernstein analysis and estimates

Between April 2012 and April 2013, our proprietary consumer survey results show that Vodafone lost nearly 1/3rd of their market share in the northwest (going from 45% market share to 30%) and lost 3.3% of their market share in the northeast, **Exhibit 11**. We think the loss of likely higher spending customers in the

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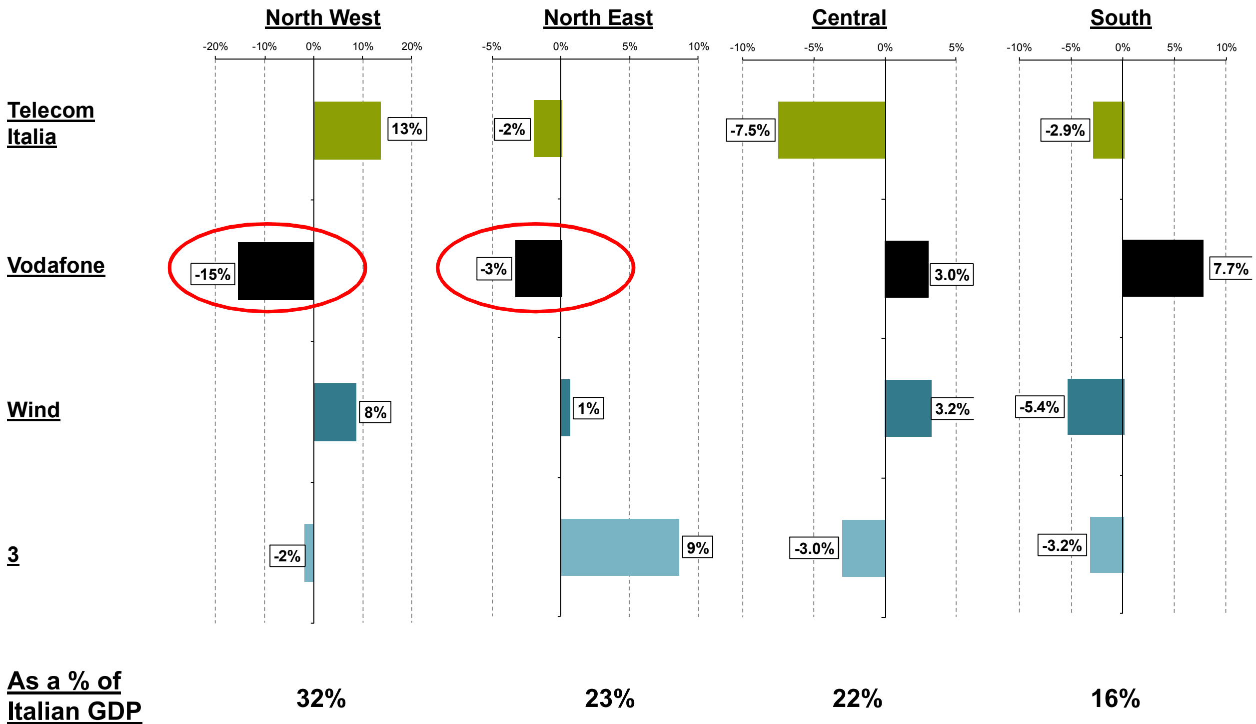
north is likely to continue to contribute to a drag on earnings over the near term. With Vodafone's customer satisfaction levels materially lower than peers a turnaround remains challenging.

Exhibit 11

In the 12 months to April 2013 Vodafone lost significant market share in Northern Italy



Source: Bernstein proprietary consumer surveys, Bernstein analysis, OECD

TI's wireless customers are somewhere in the middle when it comes to satisfaction levels – they are clearly happier than Vodafone customers, but not as satisfied as Wind or 3 customers, **Exhibit 12**. TI do screen as having the best network in Italy (**Exhibit 13**). Meanwhile, TI's blended ARPU has shrunk by 30% in the last five years and, at ~€13 today, it is close the lowest price point in the market. (All four operators offer a SIM only deal with ~200mins, ~200 SMS and 1GB of data for €10 a month.) At the same time, blended churn rates in Italy have risen dramatically (some 30%) over the last three years, making it increasingly necessary for everyone to take a step back and consider the long term economics. With Hutchison Whampoa selling assets in Hong Kong and apparently intent on increasing investment in European telecoms, WIND looks an obvious target and would be a more than rational target for them, we think.

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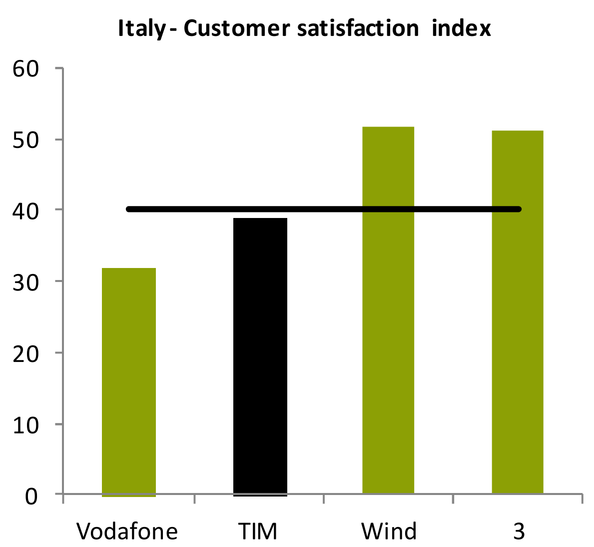
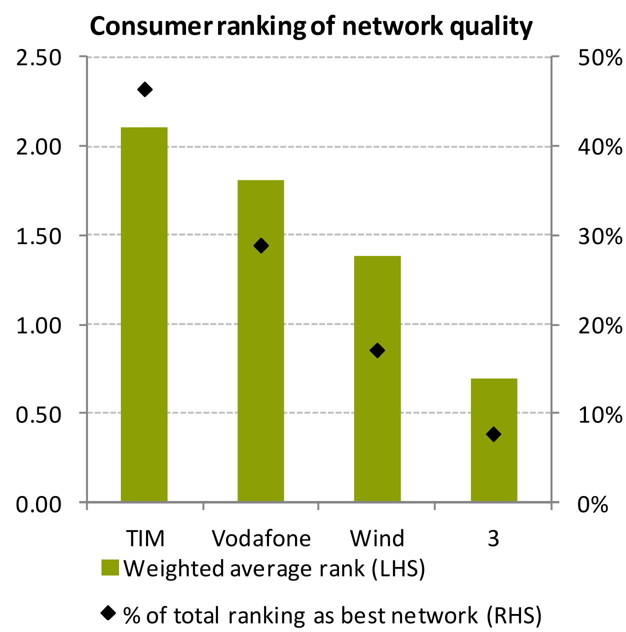
Exhibit 12
Middle of the road probably best describers TI's customer satisfaction



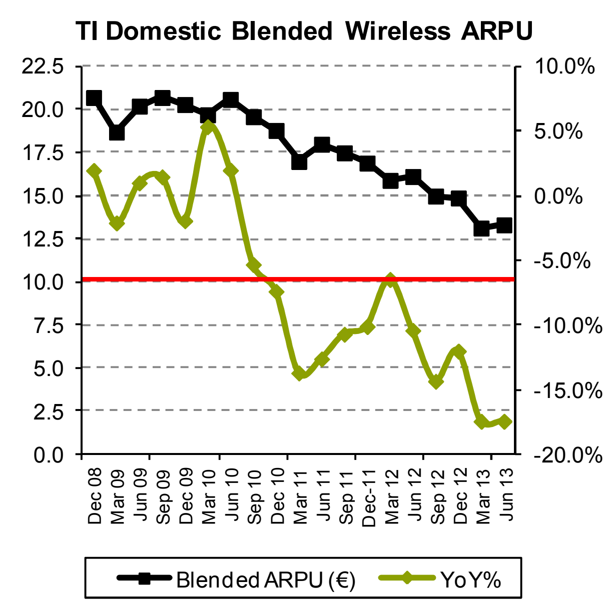
Source: Bernstein proprietary consumer survey 2013

Exhibit 13
ARPU nearly mirrors the lowest price in the market...



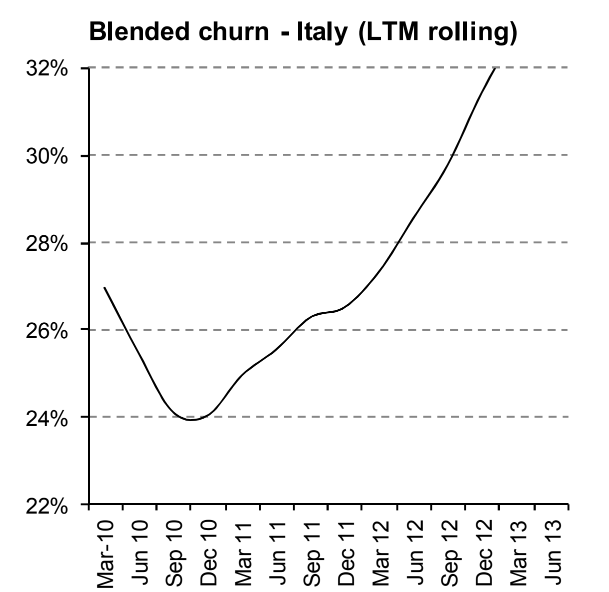
Source: Bernstein proprietary consumer survey 2013

Exhibit 14
TI's ARPU nearly mirrors the lowest price in the market...



Source: Company reports, Bernstein estimates and analysis

Exhibit 15
... and churn rates in Italy have risen dramatically



Source: Company reports, Bernstein estimates and analysis

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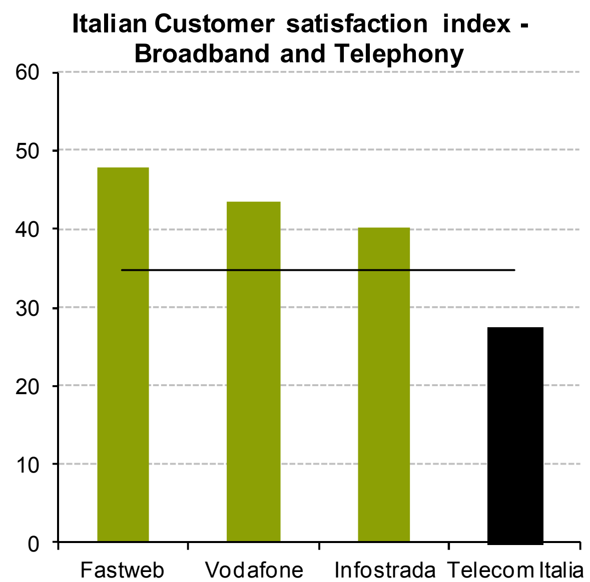
The task facing TI in the wireline business is by no means trivial

Telecom Italia suffer from the most unsatisfied customers in broadband and telephony (**Exhibit 16**), and there is little to separate the operators in terms of consumers' perception of network quality and price (**Exhibit 17**). This is in stark contrast to most incumbents across Europe, which are perceived as offering a significantly better network quality product to consumers (**Exhibit 17**).

In recent months, TI has continued to press ahead with price increases in their wireline business. As a result the decline in access and traffic revenue has eased, but this has caused a faster decline for both broadband subscribers and line losses – making it clear this is an unsustainable path for TI and Italy.

Exhibit 16

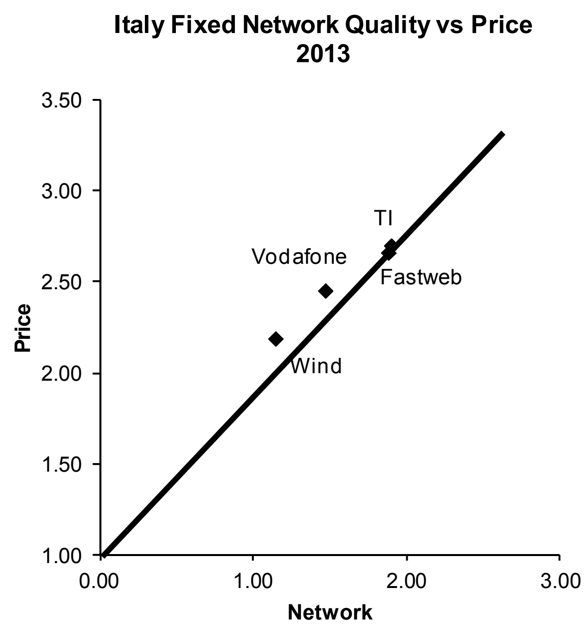
TI has the most unsatisfied customers



Source: Bernstein proprietary consumer survey 2013

Exhibit 17

Consumers see little difference in network vs price perception



Source: Bernstein proprietary consumer survey 2013

Fastweb looks a likely acquisition candidate for Vodafone and has a couple of features that would make it attractive, and expensive (~10x EBITDA). Firstly, it has some 200k FTTP fibre customers in two Northern Italian cities and a credible plan to extend FTTC coverage if Telecom Italia were to stall further in its own deployment. Secondly, there is a good overlap with Vodafone's enterprise business given Fastweb's focus on corporate fixed line customers. Vodafone would be a good partner for Fastweb, but Swisscom should be in no hurry to sell low, knowing the structural challenges Vodafone faces and the potentially other deep pockets in Hutchison Whampoa. We estimate Fastweb would cost up to ~£5bn at a 10x EBITDA multiple (cheaper than KD8 in Germany). Swisscom should take its time, in our opinion.

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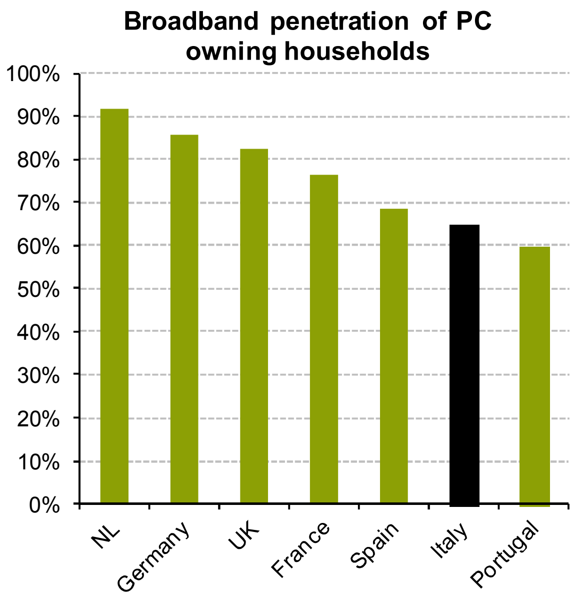
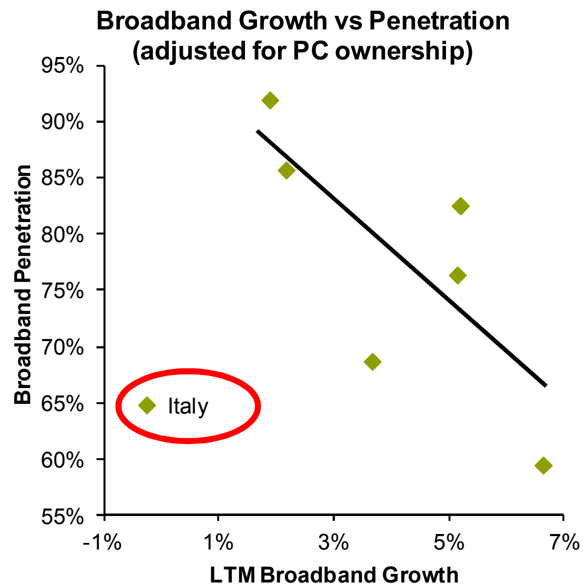
Exhibit 18
Penetration of computer owning households



Source: Company reports, Bernstein estimates and analysis

Exhibit 19
Italy is an outlier in terms of broadband growth vs penetration



Source: Company reports, Bernstein estimates and analysis

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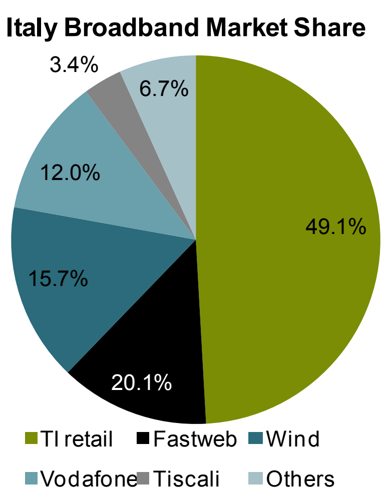
To turn around, Telecom Italia needs to change investment, pricing, cost strategies and their capital allocation

Invest in infrastructure

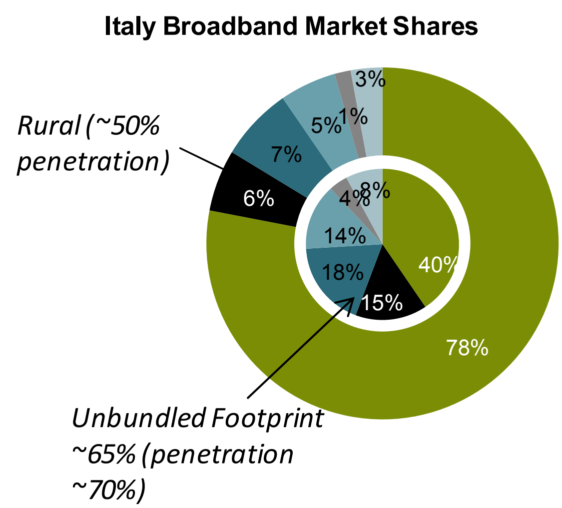
TI must urgently increase its wireline investment in urban areas (or the ~65% of Italy which we estimate has been unbundled today), where we estimate that they currently have only 23% market share (**Exhibits 20 & 21)**. This also means TI has a much higher market share in rural Italy, where we also estimate broadband penetration is lagging (70% within the unbundler footprint and ~50% outside it). This, we think, means TI should also accelerate 4G network roll out in more rural parts of Italy to ensure that they can capture those customers who will not receive fast enough speeds over wires, and also to defend against and future 4G rollout by competitors.

Exhibit 20
TI have 49% market share in broadband overall today



Source: Company reports, Bernstein analysis and estimates

Exhibit 21
TI has a much lower market share in urban areas



Source: Company reports, Bernstein analysis and estimates

Fortunately a fibre roll (FttC) to the first 40% of Italy would cost just €1.4bn (**Exhibit 22)**, and both TEF and BT have shown that with the right management it is possible to reduce overall capex spending while also increasing fibre coverage (**Exhibits 23 & 24)**.

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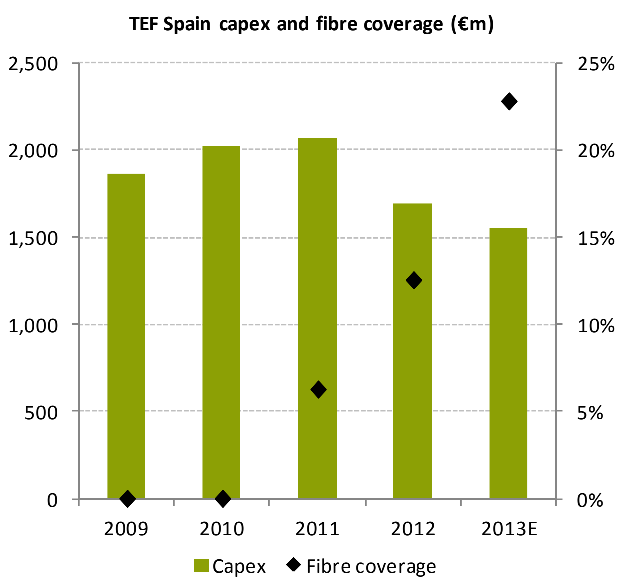
Exhibit 22
Rolling out fibre to 40% of Italy would cost TI ~€1.4bn

Telecom Italia fibre build	2012	2013	2014	2015	2016	2017	2018	2019	2020
FTTN build									
Homes passed	-	1,500	2,750	2,500	2,250	2,000	1,000	1,000	1,000
cumulative	-	1,500	4,250	6,750	9,000	11,000	12,000	13,000	14,000
Coverage	0.0%	6.2%	17.6%	27.9%	37.2%	45.4%	49.5%	53.6%	57.8%
FTTH build									
Homes passed	-	-	-	-	-	-	-	-	-
cumulative	-	-	-	-	-	-	-	-	-
Coverage	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Total									
Homes	-	1,500	2,750	2,500	2,250	2,000	1,000	1,000	1,000
Coverage	0.0%	6.2%	17.6%	27.9%	37.2%	45.4%	49.5%	53.6%	57.8%
Annual cost	-	210	358	375	338	300	150	150	150
cumulative	-	210	568	943	1,280	1,580	1,730	1,880	2,030

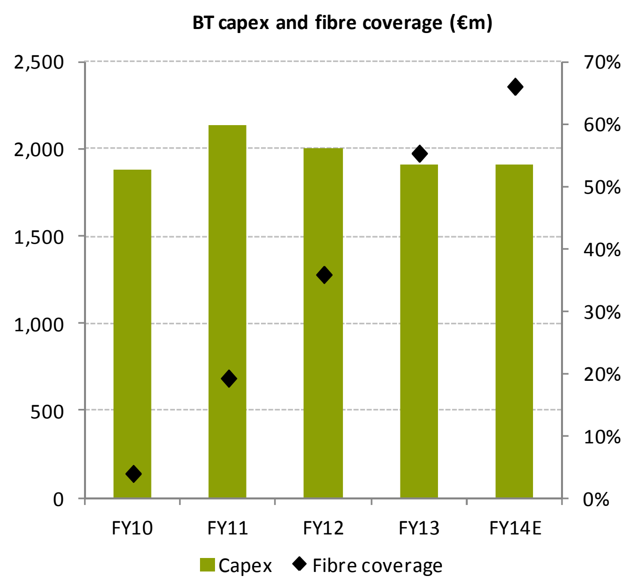
Source: Company reports, Bernstein analysis and estimates

Exhibit 23
TEF has built FTTH and cut capex by 25% in two years



Source: Company reports, Bernstein estimates

Exhibit 24
BT has also seen steady capex declines as fibre coverage has grown



Source: Company reports, Bernstein estimates

Note: Excludes Global Services capex

BT's fibre build in the UK helped them improve their network perception (**Exhibit 25)** and helped them recapture market share from the unbundlers (**Exhibit 26)**.

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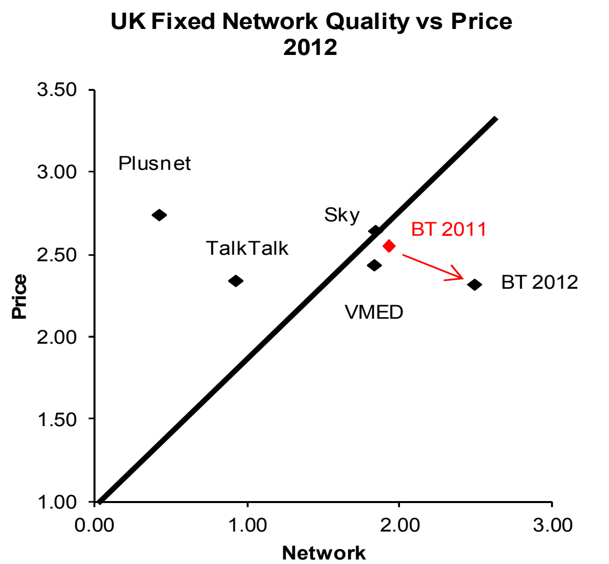
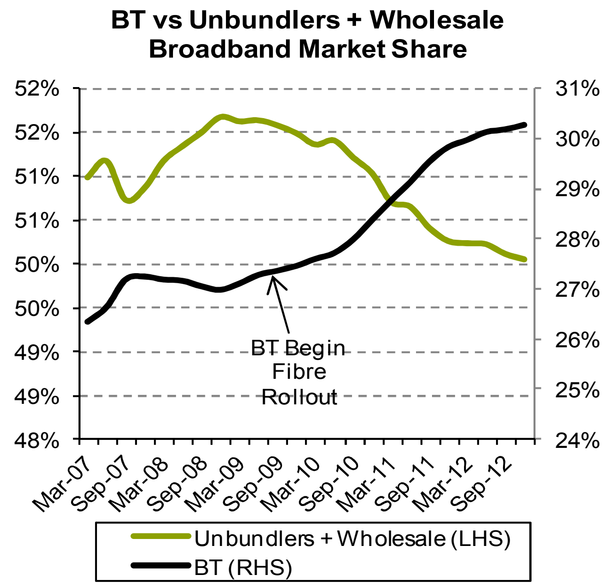
Exhibit 25
BT's fibre build helped them improve network perception



Source: Bernstein proprietary consumer survey 2013

Exhibit 26
BT recaptured market share with their fibre rollout

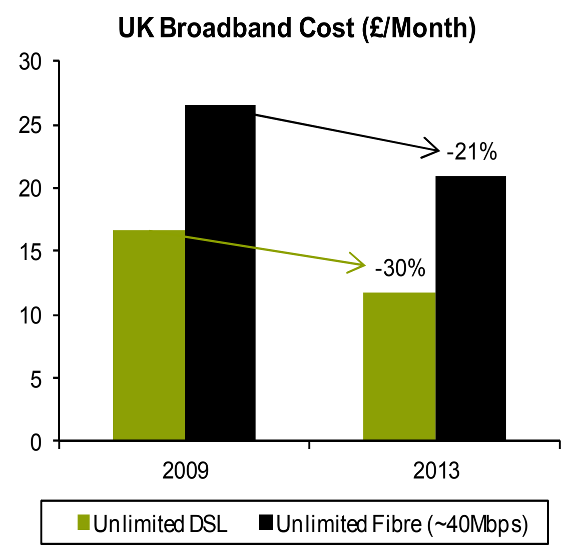


Source: Company reports, Bernstein analysis and estimates

Drop prices to drive up penetration

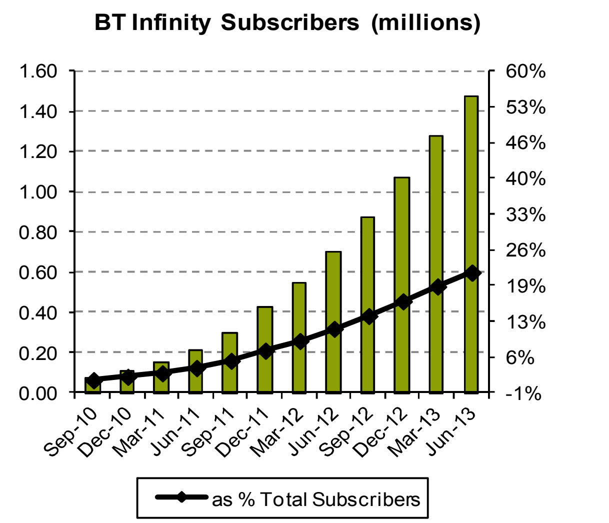
Over the past four years, broadband prices in the UK have fallen for like for like products (**Exhibit 27)**, but BT have benefitted from the mix shift of customers toward fibre (**Exhibit 28)**. With broadband penetration so low in Italy, TI could reduce the price of broadband on slower speed lines in order to help increase broadband uptake and reduce line losses.

Exhibit 27
In the UK broadband prices fallen...



Source: Company reports, Bernstein analysis

Exhibit 28
... but BT have benefitted from a positive mix shift towards fibre subs



Source: Company reports, Bernstein analysis

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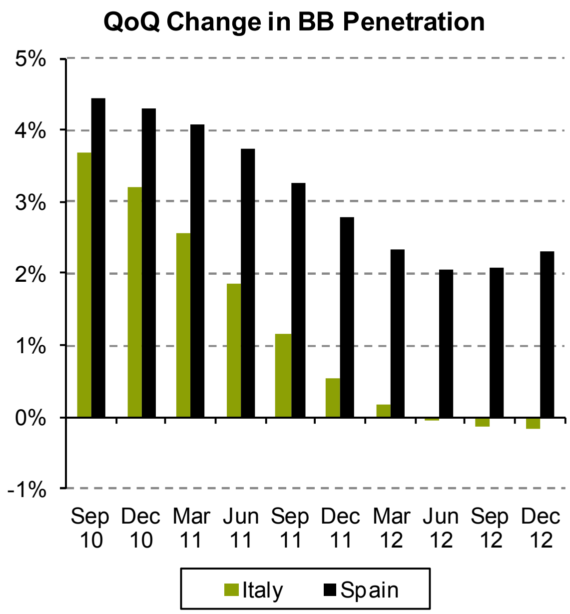
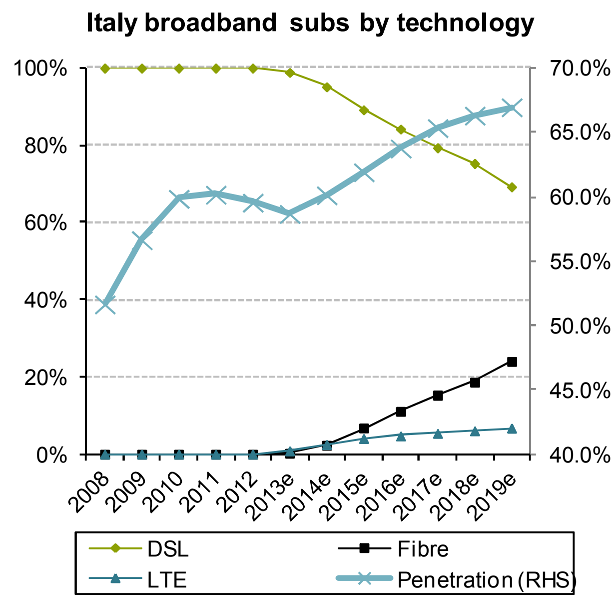
Telefonica's rollout of fibre in Spain has helped return increase the pace of broadband penetration growth in recent quarters, whilst the penetration in Italy has been falling (**Exhibit 29**). We think more fibre and more LTE would help boost broadband penetration levels in Italy (**Exhibit 30**).

Exhibit 29
Spanish broadband penetration enjoyed an acceleration in growth (as Italian penetration declined)



Source: Company reports, Bernstein analysis

Exhibit 30
We think more fibre and LTE would help grow the Italian market too



Source: Company reports, Bernstein analysis

A price reduction on DSL, together with more fibre and more LTE, would help TI grow their broadband customer base again, in our opinion (**Exhibit 31**). They would likely face some initial headwinds to their broadband ARPU from the price reductions (**Exhibit 32)** but the benefit of offering lower prices to some consumers and a higher ARPU fibre product would mean overall ARPU declines would be modest, and more than offset by higher subscriber growth, we think (**Exhibits 33 & 34**).

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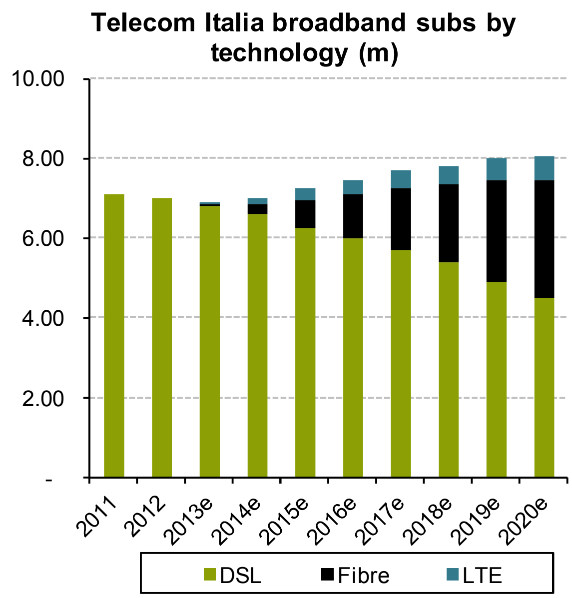
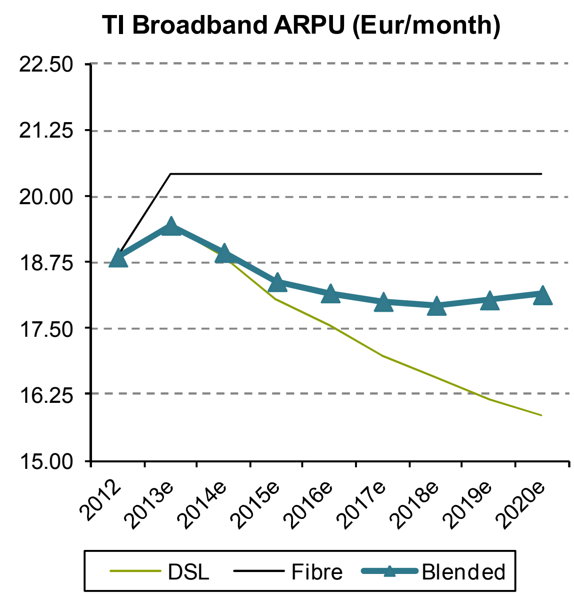
Exhibit 31
More fibre and LTE would help TI grow their customer base



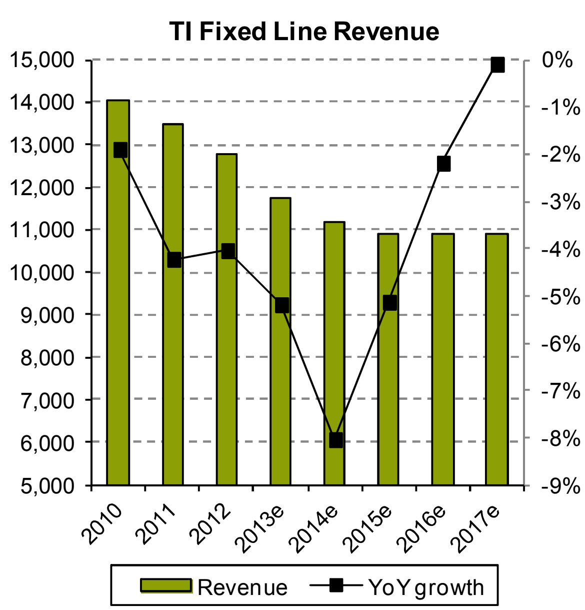
Source: Company reports, Bernstein analysis and estimates

Exhibit 32
They could keep broadband ARPU relatively stable, whilst reducing prices for slower DSL access



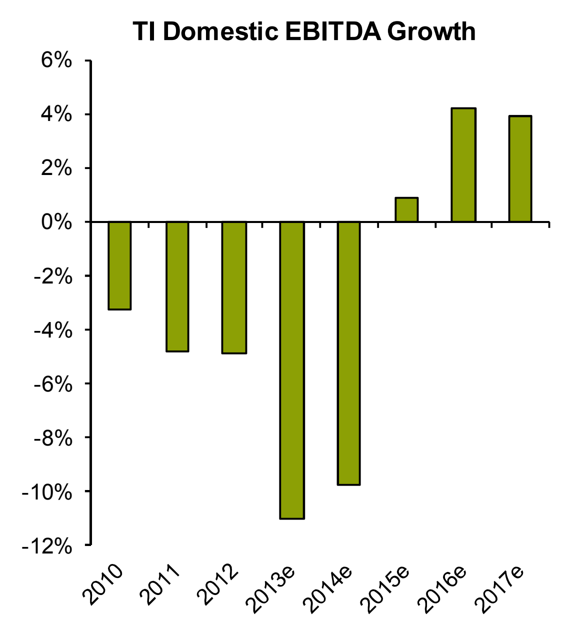
Source: Company reports, Bernstein analysis and estimates

Exhibit 33
This could cause revenues to bottom in 2014…



Source: Company reports, Bernstein analysis and estimates

Exhibit 34
Setting the foundation. for a return to EBITDA stability in 2015



Source: Company reports, Bernstein analysis and estimates

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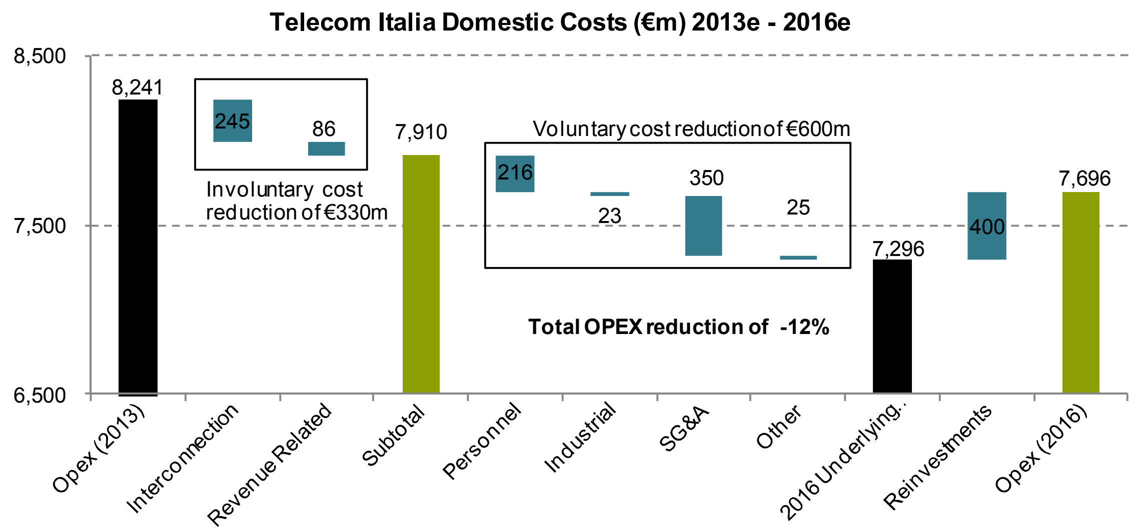
Opex discipline

TI need to significantly restructure the management of their networks and IT and dramatically reduce their costs. We think that they could reduce their underlying opex by at least 10-15% (**Exhibit 35)**, giving them flexibility to increase investments in advertising / brand improvement or alternatively in capex. To do this, TI would have to reduce tariffs and IT complexity and integrate its wireless and wireline networks (which should under no circumstances be run separately, in our opinion). They should, in addition, introduce more of the field force controls and management that PT has so successfully implemented. The combination of cost discipline and a return to top-line growth would help stabilise EBITDA and FCF trends after 2014 (**Exhibits 36** & **37)**.

Exhibit 35
We think TI could cut opex by 10-15%



Source: Company reports, Bernstein analysis and estimates

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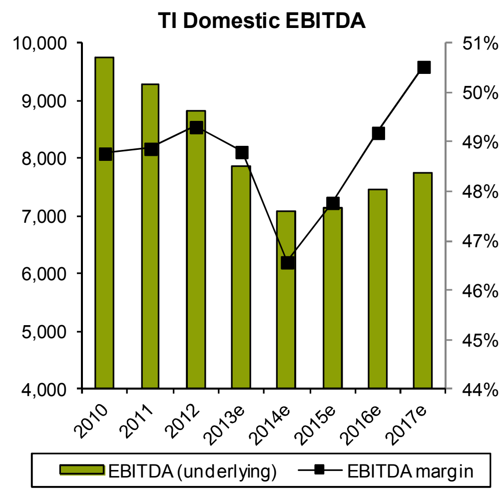
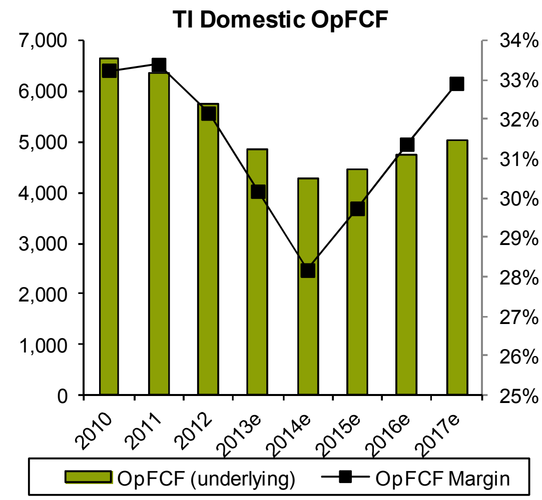
Exhibit 36
We would expect EBITDA stabilisation in 2015...



Source: Company reports, Bernstein analysis and estimates

Exhibit 37
... and a similar rebound in OpFCF



Source: Company reports, Bernstein analysis and estimates

Capital allocation

TI's debt burden and junk rating, their historical disservice to the country, potential changes to the law regarding Italian take-overs, and the very long timelines required to approve any Brazilian sale, strengthen the case to de-risk Telecom Italia with a small (roughly €2bn) rights issue. We think TI could do this by proposing a 1-for - rights issue at €0.55, a ~25% discount to the current value of TI shares – this would just be for the ordinary shares, and not for the savers. This would cost Telefonica €272m, and would not impact Telco's voting stake within Telecom Italia.

Exhibit 38
A small rights issue?

TI Rights Issue?				
Value (€m)	1,840		Cost (€m) to:	
Rights Price	0.55		TEF	272
# New Shares Issued	3,345		AG	80
New Share per Old Share	0.250	i.e. 1 for 4	MedioBanca	30
			Intesa Sanpaolo	30
Current Price (ords)	0.74			
Discount to Current Price	-26%			
TERP (€)	0.702			
Value of a right (€)	0.038			
New Shares in Issue:		Shares Before Rights Issue		
Total	22,779	19,434		
Ords	16,753	13,408		
Savers	6,026	6,026		

Source: Company reports, Bernstein analysis and estimates

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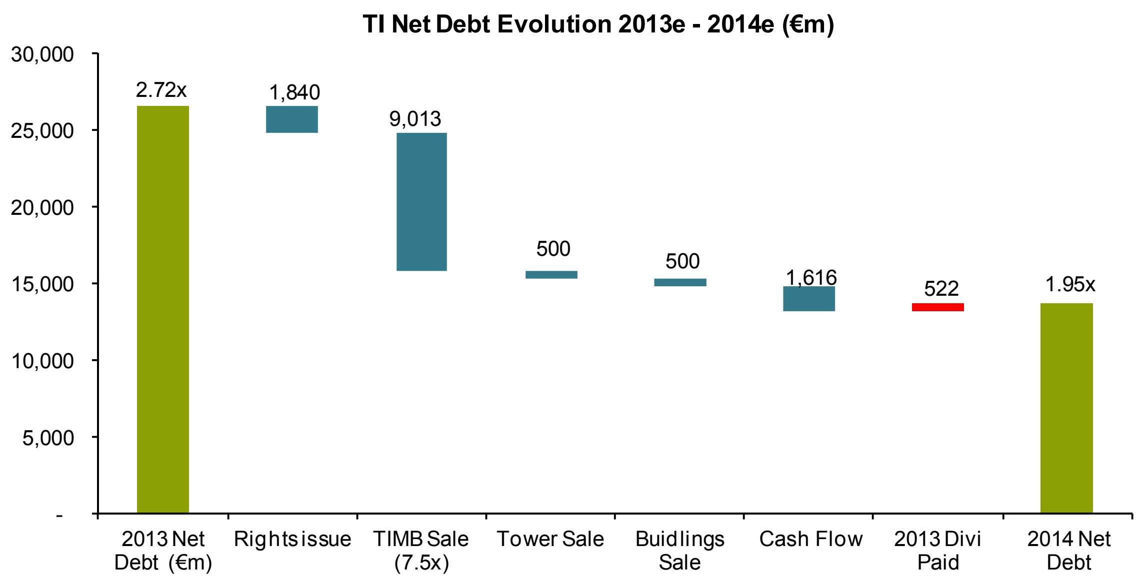
We expect this announcement to come with a sale of towers and buildings, a new cost cutting effort, an accelerated fibre and 4G rollout, the cancellation of the network spinoff project, and the suspension of any dividend for 2014. In doing this, we think the company could improve their leverage to ~1.95x EBITDA by the end of 2014, and then materially lower thereafter.

Exhibit 39

A small rights issue?



Source: Company reports, Bernstein analysis and estimates

An aside on the saver shares. Investors deciding between TI savers and ordinary shares must weigh the value of the higher dividend stream versus the voting rights. If a rights issue on the ordinary shares only does occur together with the suspension of the dividend for 2014, then we would expect the discount at which the savers trade relative to the ords to narrow. The savers are entitled to a higher dividend (1.1 cents/share) than the ordinary shareholders (€0.02 in 2012), and if a dividend is suspended for a year then the savers dividend is rolled over. The lack of voting rights will remain, and some discount should persist.

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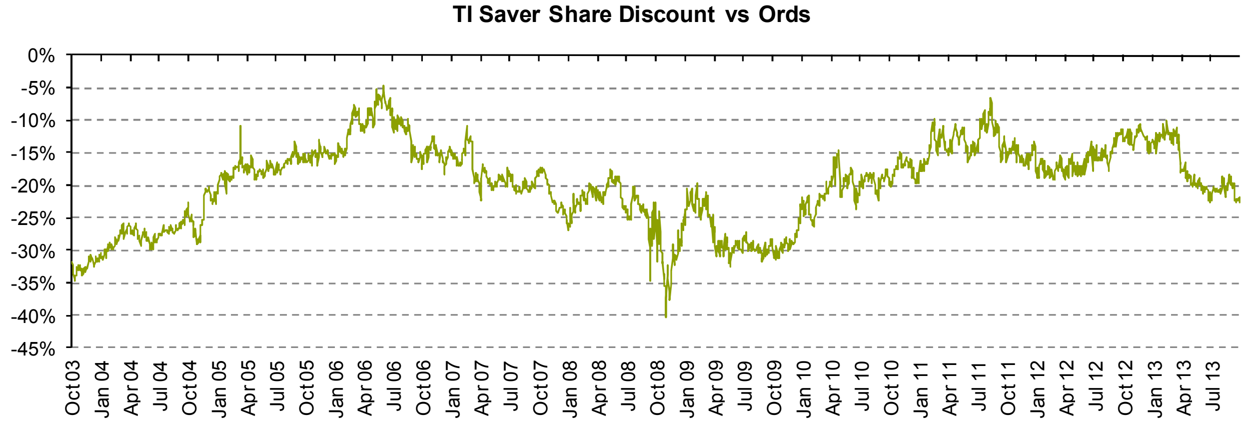
Exhibit 40

The savers have traded at an average discount of 20% to the ords



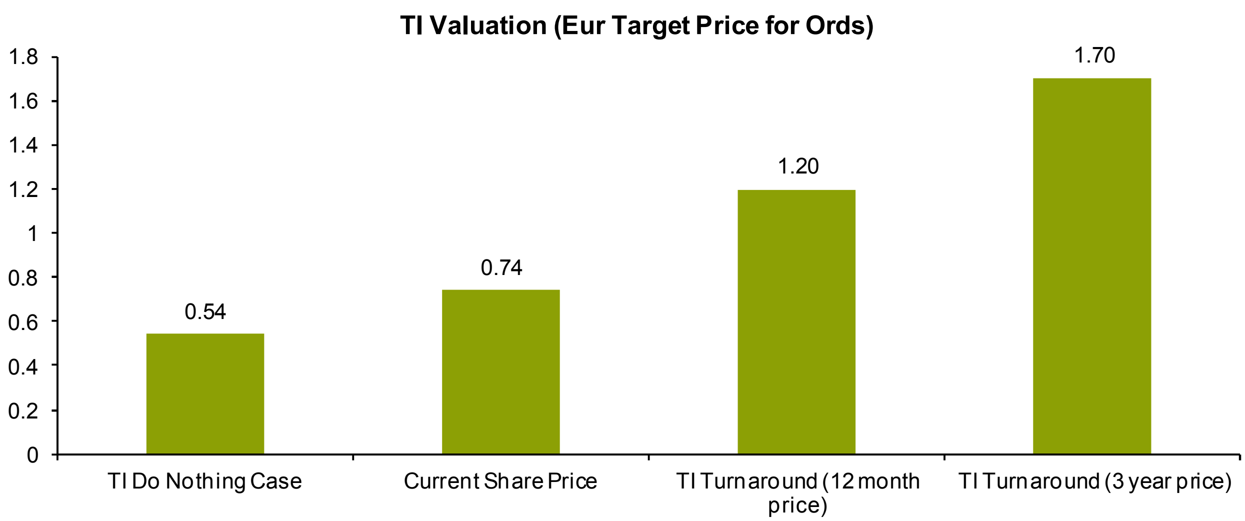
Source: Bloomberg

With all these things combined and a tiny bit of luck, Telecom Italia could, like BT, enjoy a great turnaround, and could be worth ~€1.20 per share (and up to €1.70 over the medium term)

TI has long suffered from endless political infighting at the top. This needs to stop. Under the right leadership Telecom Italia ordinary shares could easily be worth €1.20 (on a 12 month horizon, and €1.70 on a 3 year horizon) in our opinion, compared to a downside case of €0.55 (**Exhibit 41**).

Exhibit 41

We think TI would be worth materially more under the turnaround scenario outlined above



Source: Bernstein estimates and analysis

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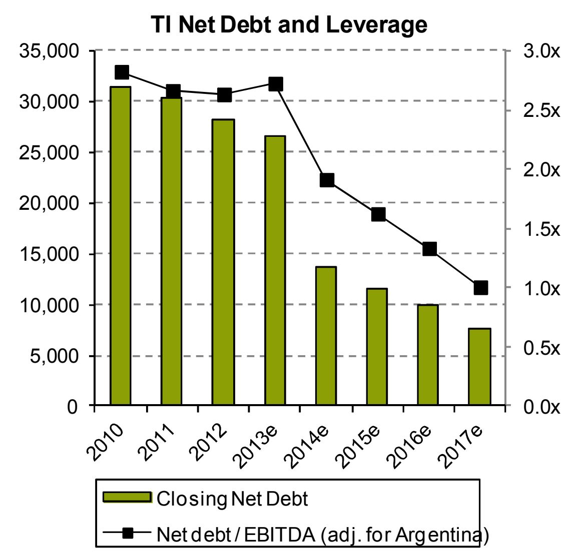
Several stakeholders, direct and indirect, are trying to derail Telefonica's plan to de-lever TI through a TIM Brasil sale. This seems utterly self-defeating to us. The time in which TI could afford a 'front-footed' rights issue to buy GVT has been and gone.

Putting a stick in Telefonica's wheels only increases the risk that they might later abandoned TI to its fate. Instead, it is obvious that were TI to set itself on a better operational path, sell TIM Brasil and de-lever, the Company would be (1) significantly more valuable as a standalone vehicle in the same vein as BT that trades at 6.0x EBITDA, and (2) a very attractive target for a full take-over by Telefonica within 12-18 months. Without Telefonica's industrial expertise, there is little hope of either, in our opinion. We think Asati and Findim should take a step back and ask themselves why (presumably) Bollore and Sawiris are agitating for them to kick out Telefonica and Telco. In our opinon, it is not for the good of small shareholders. TI minorities and Italy would be better off with Telefonica's plan … a foreign owner can be heavily influenced to do right in a way that Italians have demonstrated is not possible with Italians from La Balena Bianca.

Exhibit 42
Leverage and debt (Argentina adjusted)



Source: Company reports, Bernstein analysis and estimates

Exhibit 43
A SOTP analysis suggests there would be material upside even on the lowest year EBITDA

TI Sum of the Parts (€m) 2015

	EBITDA	Multiple	Stake	EV
Domestic	7,151	5.50x	100%	39,331
TIM	-	n/a	66%	-
Telecom Argentina	1,152	2.2x	23%	575
Net Debt				(11,509)
Adjustments				(1,129)
Equity value				26,835
# Ords				16,753
# Savers				6,026
Net Debt / EBITDA				1.6x
Ord Target Price (ex-rights)				**1.23**
Ord Target Price (cum-rights)				**1.26**
Saver Target Price				**1.04**

Source: Company reports, Bernstein analysis and estimates

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Exhibit 44

Our alternative valuation methodology yields a similar value (NB these are ex-rights) of ~€1.10 a share

TI DCF valuation (€bn)	
Cost of Equity	13.4%
NPV of 2013-20	**0.91**
2020 FCF	0.15
LT Growth %	0.5%
Cost of Equity	13.4%
NPV Perpetuity today	**0.57**
NPV of 2013-20	0.91
NPV 2020 onwards	0.57
Implied share price, ord (€)	**1.20**
Implied share price, saver (€)	**1.02**

TI FCF/EV valuation (€bn)	2014e	2015e	2015e
Unlevered FCF	2.61	2.68	2.68
Target FCF/EV (peer average)	7.4%	7.6%	7.6%
Implied EV at target price	35.2	35.3	35.3
Net Debt	(2.6)	(2.7)	(2.7)
Equity	18.9	21.0	22.8
Shares outstanding	22.78	22.78	22.78
Implied share price, ord (€)	**0.86**	**0.96**	**1.04**
Implied share price, saver (€)	**0.73**	**0.82**	**0.88**

Blended Valuation	Valuation (€)	Weighting	Per Share
Ord			
DCF	1.20	50%	€ 0.60
FCF/EV (2014/15/16)	0.91	50%	€ 0.46
Blended Valuation			**€ 1.06**
Saver			
DCF	1.02	50%	€ 0.51
FCF/EV (2014/15/16)	0.78	50%	€ 0.39
Blended Valuation			**€ 0.90**

Source: Company reports, Bernstein analysis and estimates

Looking past the inflection in EBITDA and cash flow in 2015, we think TI could be worth up to €1.70 a share (**Exhibit 45)**.

Exhibit 45

Looking further out we think TI could be worth €1.70 a share

TI DCF valuation (€bn)	
Cost of Equity	11.6%
NPV of 2016-20	**0.48**
2020 FCF	0.15
LT Growth %	1.0%
Cost of Equity	11.6%
NPV Perpetuity today	**0.96**
NPV of 2016-20	0.48
NPV 2020 onwards	0.96
Implied share price, ord (€)	**1.65**
Implied share price, saver (€)	**1.40**

TI FCF/EV valuation (€bn)	2016e	2017e	2018e	Average
Unlevered FCF	3.17	4.17	5.17	
Target FCF/EV (peer average)	7.6%	7.4%	7.4%	
Implied EV at target price	41.6	56.1	69.6	
Net Debt	(2.7)	(2.7)	(2.7)	
Equity	29.3	46.2	62.2	
Shares outstanding	22.78	22.78	22.78	
Implied share price, ord (€)	**1.34**	**2.11**	**2.84**	**1.73**
Implied share price, saver (€)	**1.14**	**1.79**	**2.41**	**1.47**

Blended Valuation	Valuation (€)	Weighting	Per Share
Ord			
DCF	1.65	50%	€ 0.82
FCF/EV (2016/17/18)	1.73	50%	€ 0.86
Blended Valuation			**€ 1.69**
Saver			
DCF	1.40	50%	€ 0.70
FCF/EV (2016/17/18)	1.47	50%	€ 0.73
Blended Valuation			**€ 1.43**

Source: Company reports, Bernstein analysis and estimates

The downside case for TI implies a share price of ~€0.54 (Exhibit 46)**.**

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Exhibit 46

In the downside case for TI we think shares would be worth €0.54

TI DCF valuation (€bn)	
Cost of Equity	16.6%
NPV of 2013-20	**0.39**
2021 FCF	0.07
LT Growth %	0.0%
Cost of Equity	16.6%
NPV Perpetuity today	**0.19**
NPV of 2013-20	0.39
NPV 2020 onwards	0.19
Implied share price, ord (€)	**0.61**
Implied share price, saver (€)	**0.52**

TI FCF/EV valuation (€bn)	2013	2014	2015	Average
Unlevered FCF	3.03	3.03	2.81	
Target FCF/EV (peer average)	7.1%	7.4%	7.6%	
Implied EV at target price	42.7	40.9	36.9	
Net Debt	(5.6)	(5.6)	(5.8)	
Equity	10.2	9.9	6.6	
Shares outstanding	19.43	19.43	19.43	
Implied share price, ord (€)	**0.55**	**0.53**	**0.36**	**0.48**
Implied share price, saver (€)	**0.47**	**0.45**	**0.30**	**0.41**

Blended Valuation	Valuation (€)	Weighting	Per Share
Ord			
DCF	0.61	50%	€ 0.30
FCF/EV (2014/15/16)	0.48	50%	€ 0.24
Blended Valuation			**€ 0.54**
Saver			
DCF	0.52	50%	€ 0.26
FCF/EV (2014/15/16)	0.41	50%	€ 0.20
Blended Valuation			**€ 0.46**

Source: Company reports, Bernstein estimate

Q3 results will be a reminder of why TI needs a new direction

We expect domestic wireless service revenue trends to show a modest sign of improvement, declining at a 'just' 14.7% compared to -17.8% in the last quarter, but this improvement is entirely as a result of a declining MTR headwind, and we do not expect any improvement in the underlying trend. We do expect TI to continue to outperform Vodafone. In wireline, price increases are likely to result in higher line losses, but those higher prices will offset the higher losses meaning little change in revenue trends. As outlined above we think TI's approach to the domestic market needs to change. We don't expect any material change in the momentum of domestic EBITDA shrink – with a forecast decline of -11.8% vs -11.9% in 2Q14. TIM Brasil results will be overshadowed by large currency moves, so underling service revenue growth (SCBe +3.3%) will be translated into revenue shrink in euro terms (SCBe -7.5%).

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Exhibit 47
TI 3Q Preview table

TI Q3 2013 Preview						
€ million	**Actual Q3 2012**	**SCB Estimate Q3 2013**	**SCBe YoY Change (%) Q3 2013**	**YoY change % Q2 2013**	**Variance (%) SCBe vs**	**Forecast Cons. Q3 2013**
Net Revenue	7,268	6,614	-9.0%	-5.9%	-0.6%	6,656
EBITDA	3,001	2,692	-10.3%	-11.2%	-0.9%	2,716
Margin	41.3%	40.7%	-60 bps	-220 bps	-10 bps	40.8%
Net Income (post minorities)	696	164	-76.4%	-378.0%		
Operating FCF	1,898	1,328	-30.1%	-29.5%		
Segmental results € million						
Domestic						
Revenue	4,365	3,926	-10.1%	-10.9%	0.1%	3,923
o/w Wireline	3,136	2,892	-7.8%	-8.0%		
o/w Mobile	1,584	1,362	-14.0%	-17.8%		
o/w Wireless services	1,503	1,281	-14.7%	-18.4%		
EBITDA	2,289	2,018	-11.8%	-11.9%	2.1%	1,977
Margin	52.4%	51.4%	-100 bps	-60 bps	100 bps	50.4%
TIM Brasil						
Revenue	1,862	1,723	-7.5%	1.6%	-0.5%	1,732
Service revenue (BRL)	4,100	4,235	3.3%	2.0%		
EBITDA	490	431	-12.1%	-5.4%	-5.2%	454
Margin	26.3%	25.0%	-130 bps	-180 bps	-120 bps	26.2%
Argentina						
Revenue	981	917	-6.6%	5.5%	-8.4%	1,001
EBITDA	275	266	-3.4%	1.9%	-6.6%	285
Margin	28.0%	29.0%	100 bps	-100 bps	60 bps	28.4%

Source: Company reports, Capital iQ, Bloomberg, Bernstein estimates and analysis

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Disclosure Appendix

Valuation Methodology

We value stocks within the sector based on a short term target FCF/EV yield, which we adjust based on forecast EBITDA growth, and a long term DCF. Our price target is based on a blend of these two methodologies, with the weighting dependent on the current short term versus long term focus of investors

Risks

Telecom stocks are heavily dependent on regulation, and changes to the regulatory environment comprise a significant risk to our investment theses. This may include determinations on regulated pricing for fibre or copper, roaming and MTR charges, spectrum availability and cost, and Competition Commission rulings. Other risks include significant investment in infrastructure, excessive price competition, competition within the telecom value chain, and M&A activity.

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12-Month Rating History as of 10/24/2013

Ticker	Rating Changes			
AMX	U (IC) 04/15/13			
AMXL.MM	U (IC) 04/15/13			
KPN.NA	O (RC) 06/07/13	M (RC) 02/13/13	U (RC) 11/15/12	M (RC) 05/18/12
O2D.GR	O (RC) 09/24/13	M (IC) 11/12/12		
TEF.SM	O (RC) 04/19/13	M (RC) 02/26/13	U (RC) 08/20/12	
TIMP3.BZ	O (RC) 09/20/13	M (RC) 08/22/12		
TIT.IM	O (RC) 08/30/13	M (RC) 02/13/13	O (RC) 05/30/12	
TITR.IM	O (RC) 08/30/13	M (RC) 02/13/13	O (RC) 05/30/12	
TSU	O (RC) 09/20/13	M (RC) 08/22/12		

Rating Guide: O - Outperform, M - Market-Perform, U - Underperform, N - Not Rated

Rating Actions: IC - Initiated Coverage, DC - Dropped Coverage, RC - Rating Change

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