

# Telecom Italia (TIT IM)

**Hold: Crunch time on single fixed NetCo negotiations**

- ◆ Italian press reports on government support for proposal to unify fixed-line network assets of TI and Open Fiber
- ◆ TI would retain control of the network entity but with significant governance restrictions
- ◆ A positive step but the journey remains long and potential value creation depends on unknown crucial points; maintain Hold with unchanged TP of EUR0.40

**Negotiations on single fixed-line network intensify:** According to the Italian press (*IlSole24Ore* and *Il Corriere della Sera*, 27 Aug 2020) the Italian government has agreed upon a framework that could facilitate an agreement between Telecom Italia and state lender CDP (which holds 50% in Open Fiber and 9.9% in TI), with the aim of unifying the fixed network assets of TI and Open Fiber into a single fixed-line network company. The press reports that the plan presented by CDP's CEO Fabrizio Palermo in the morning of 27 August has met the approval of Italian Prime Minister Giuseppe Conte and other key members of the government. According to *IlSole24Ore*, TI would crucially retain control (50.1%) of the resulting entity, but with restrictions on the governance aimed at facilitating regulatory approval: specifically, TI would appoint the CEO but only with CDP's approval and would not be allowed to have a majority of board seats on the single network company.

**Government support makes KKR/FiberCop deal more likely:** As we discuss in [TI: The government steps in](#) (6 August 2020), an eleventh hour intervention from the government convinced TI's Board to postpone its decision on the proposed KKR/FiberCop deal to a board meeting to be held on 31 August 2020. The government support now makes TI's Board approval likely. FiberCop is a newly formed newco that holds TI's secondary network (from the street cabinets to the homes) where TI has presented a binding offer to acquire 37.5% (for EUR1.8bn) and where alternative operator Fastweb has agreed to hold a 4.5% stake (in exchange for its 20% stake in Flash Fiber, the FTTH JV between TI and Fastweb). According to *IlSole24Ore*, CDP may now be given the option to also acquire a stake in FiberCop.

**What to expect for TI's Board meeting on 31 August:** Beyond the approval of the FiberCop deal, the Italian press suggests that the government/CDP may submit to TI's Board a proposed MoU outlining the framework to achieve a single fixed NetCo.

**Devil is in the (unknown) details:** A merger between TI's fixed network assets and Open Fiber with TI retaining control was our preferred of the various scenarios we explored (among others) in [TI: Countdown to checkmate](#) (13 April 2018). Removing the threat of a state-sponsored parallel fibre deployment would be a clear positive for TI. However, the road to a final agreement is still long and the extent of the potential value creation very much depends on a series of unknown crucial details, including competition authority approval, valuation, governance and future regulation of the network entity.

## Disclosures & Disclaimer

This report must be read with the disclosures and the analyst certifications in the Disclosure appendix, and with the Disclaimer, which forms part of it.

Equities  
Diversified  
Telecommunications

Italy



MAINTAIN HOLD

TARGET PRICE (EUR)

**0.40**

PREVIOUS TARGET (EUR)

**0.40**

SHARE PRICE (EUR)

**0.39**

(as of 26 Aug 2020)

UPSIDE/DOWNSIDE

**+3.0%**

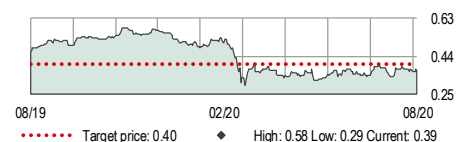
### MARKET DATA

Market cap (EURm)	8,173	Free float	75%
Market cap (USDm)	9,658	BBG	TIT IM
3m ADTV (USDm)	66	RIC	TLIT.MI

### FINANCIALS AND RATIOS (EUR)

Year to	12/2019a	12/2020e	12/2021e	12/2022e
HSBC EPS	0.04	0.03	0.07	0.07
HSBC EPS (prev)	0.04	0.03	0.07	0.07
Change (%)	0.0	0.0	0.0	0.0
Consensus EPS	0.06	0.04	0.04	0.05
PE (x)	8.9	11.1	5.9	5.5
Dividend yield (%)	2.6	2.7	2.8	3.0
EV/EBITDA (x)	4.8	5.5	5.1	5.0
ROE (%)	4.6	3.6	4.9	5.1

### 52-WEEK PRICE (EUR)



Source: Refinitiv IBES, HSBC estimates

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## Financials & valuation: Telecom Italia

**Hold**

### Financial statements

Year to	12/2019a	12/2020e	12/2021e	12/2022e
<b>Profit &amp; loss summary (EURm)</b>				
Revenue	17,974	15,445	15,548	15,577
EBITDA	8,151	6,672	6,907	7,028
Depreciation & amortisation	-4,144	-3,962	-3,809	-3,790
Operating profit/EBIT	3,958	2,703	3,098	3,239
Net interest	-1,080	-964	-861	-761
PBT	2,878	2,175	2,234	2,476
HSBC PBT	1,784	1,184	1,538	1,694
Taxation	-513	-348	-462	-509
Net profit	2,039	1,732	1,677	1,847
HSBC net profit	923	733	981	1,065
<b>Cash flow summary (EURm)</b>				
Cash flow from operations	5,828	5,620	5,352	5,565
Capex	-3,631	-3,726	-2,933	-2,979
Cash flow from investment	-3,255	-1,878	-2,988	-4,717
Dividends	-173	-316	-327	-332
Change in net debt	2,398	-2,786	-1,480	43
FCF equity	2,211	2,296	2,419	2,586
<b>Balance sheet summary (EURm)</b>				
Intangible fixed assets	36,244	34,662	33,975	34,892
Tangible fixed assets	14,011	13,034	12,900	12,910
Current assets	14,108	10,722	12,218	12,179
Cash & others	3,138	4,692	6,172	6,129
Total assets	70,104	66,005	66,642	67,494
Operating liabilities	8,107	6,502	6,638	6,795
Gross debt	34,002	33,569	33,569	33,569
Net debt	27,668	24,882	23,402	23,445
Shareholders' funds	20,280	19,921	20,404	21,045
Invested capital	53,118	47,223	46,282	47,056

### Ratio, growth and per share analysis

Year to	12/2019a	12/2020e	12/2021e	12/2022e
<b>Y-o-y % change</b>				
Revenue	-5.1	-14.1	0.7	0.2
EBITDA	10.1	-18.1	3.5	1.8
Operating profit	605.5	-31.7	14.6	4.5
PBT		-24.4	2.7	10.8
HSBC EPS	-28.8	-20.6	87.5	8.6
<b>Ratios (%)</b>				
Revenue/IC (x)	0.3	0.3	0.3	0.3
ROIC	7.6	6.2	7.2	7.5
ROE	4.6	3.6	4.9	5.1
ROA	4.6	3.9	3.9	4.2
EBITDA margin	45.3	43.2	44.4	45.1
Operating profit margin	22.0	17.5	19.9	20.8
EBITDA/net interest (x)	7.5	6.9	8.0	9.2
Net debt/equity	122.3	117.0	107.4	104.2
Net debt/EBITDA (x)	3.4	3.7	3.4	3.3
CF from operations/net debt	21.1	22.6	22.9	23.7
<b>Per share data (EUR)</b>				
EPS Rep (diluted)	0.10	0.08	0.11	0.12
HSBC EPS (diluted)	0.04	0.03	0.07	0.07
DPS	0.01	0.01	0.01	0.01
Book value	0.96	0.95	1.36	1.40

### Key forecast drivers

Year to	12/2019a	12/2020e	12/2021e	12/2022e
Domestic business	14,019	12,685	12,821	12,695
Brazilian mobile	3,937	2,831	2,761	2,917
Others/Elimination	-41	-35	-35	-35
Group Revenues	17,915	15,482	15,548	15,577

### Valuation data

Year to	12/2019a	12/2020e	12/2021e	12/2022e
EV/sales	2.2	2.4	2.2	2.2
EV/EBITDA	4.8	5.5	5.1	5.0
EV/IC	0.7	0.8	0.8	0.7
PE*	8.9	11.1	5.9	5.5
PB	0.4	0.4	0.3	0.3
FCF yield (%)	27.0	28.1	29.6	31.6
Dividend yield (%)	2.6	2.7	2.8	3.0

\* Based on HSBC EPS (diluted)

### ESG metrics

Environmental Indicators	12/2019a	Governance Indicators	12/2019a
GHG emission intensity*	39.5	No. of board members	15
Energy intensity*	137.5	Average board tenure (years)	1.6
CO <sub>2</sub> reduction policy	Yes	Female board members (%)	40
Social Indicators	12/2019a	Board members independence (%)	73.3
Employee costs as % of revenues	17.1		
Employee turnover (%)	11.2		
Diversity policy	Yes		

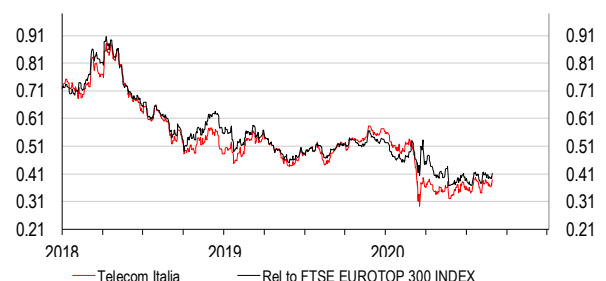
Source: Company data, HSBC

\* GHG intensity and energy intensity are measured in kg and kWh respectively against revenue in USD '000s

### Issuer information

Share price (EUR)	0.39	Free float	75%
Target price (EUR)	0.40	Sector	Diversified Telecoms
RIC (Equity)	TLIT.MI	Country/Region	Italy
Bloomberg (Equity)	TIT IM	Analyst	Luigi Minerva
Market cap (USDm)	9,658	Contact	+44 20 7991 6928

### Price relative



Source: HSBC

Note: Priced at close of 26 Aug 2020

## Possible next steps towards a single fixed-line network

### 1. TI's Board meeting on 31 August likely to approve the KKR/FiberCop deal:

With the blessing of the Italian government, TI's Board may now approve the KKR/FiberCop deal.

The key terms of the binding offer can be summarised as follows:

- ◆ The perimeter of FiberCop would include all of TI's passive secondary network infrastructure, both copper and fibre, from the cabinet to the home (ducts, secondary network, sockets – street cabinets are excluded)
- ◆ TI and Fastweb would contribute the FTTH secondary network (currently part of their co-investment vehicle Flash Fiber) into FiberCop. Flash Fiber connects about 20% of premises with FTTH. Fastweb holds 20% of Flash Fiber, with TI holding the remaining 80%.
- ◆ The shareholding structure of FiberCop would see TI with a controlling stake of 58%, and Fastweb would swap its 20% in Flash Fiber with a 4.5% stake in FiberCop and KKR would acquire 37.5% in FiberCop

The terms of the proposed offer can be summarised as follows:

#### FiberCop: key terms of proposed deal

	FiberCop	Notes
EV	EUR7.7bn	
Debt allocated	EUR3.0bn	TI's intercompany loan
Equity value	EUR4.7bn	
Stake to be acquired by KKR	37.50%	
Potential cash-in for TI	EUR1.8bn	37.5% of the Equity value

Source: Company data

Under the proposed terms, TI would maintain control of FiberCop and consolidate it. It would raise EUR1.8bn from selling a 37.5% stake in the company to KKR: such funds would be used largely to support the future network deployment (aiming to expand FTTH coverage from the current 20% of premises to 56% by 2025, largely an FTTC to FTTH network upgrade).

Additionally, according to *//Sole24Ore*, state lender CDP may now be given the option to also acquire a stake in FiberCop.

### 2. 31 August TI Board meeting: Government/CDP working to finalise framework aiming to submit a proposed MoU to TI's Board

The Italian press (*// Corriere della Sera*, 27 Aug 2020) suggests that the government/CDP may submit to TI's Board a proposed MoU outlining the framework to achieve a single fixed NetCo.

Governance will be key. According to *//Sole24Ore*, TI would crucially retain control (50.1%) of the resulting network entity, but with restrictions on the governance aimed at facilitating approval from the relevant competition authority and sector regulator:

- ◆ TI would appoint the CEO but the appointment would require CDP's approval
- ◆ CDP would appoint the Executive Chairman (who is likely to have significant powers), with the appointment requiring TI's approval
- ◆ A qualified majority would be required on key strategic decisions
- ◆ TI would not be allowed to have a majority of board seats on the single network company.

### 3. From MoU to agreement: potentially a long journey

An agreed framework agreement between government/CDP and TI would be good news and would be a significant step towards finding a solution to TI's fixed-line network ownership and strategy (an issue which, indirectly, affects TI's leverage level), an issue that has cast a shadow on TI's investment case for a decade and a half.

However, investors should be very clear that the journey to an agreement remains long and the extent of the potential value creation very much depends on a series of unknown crucial details, including:

- ◆ **Final perimeter and structure of the company:** FiberCop's perimeter is TI's secondary network (from the street cabinets to the homes). A merger with Open Fiber would involve TI contributing its full fixed network assets, including the primary network. TI may want to pursue partial monetization at the FiberCop level (with KKR potentially buying 37.5%, TI would raise EUR1.8bn), but it will be important to avoid a complex, multi-layered ownership structure. For this reason, FiberCop may eventually be collapsed into the larger new network entity (this may be a reason why, according to *IlSole24Ore*, state lender CDP may now be given the option to also acquire a stake in FiberCop).
- ◆ **Competition authority approval** is by no means a given. The final proposed deal may certainly involve a Phase 2 investigation by the Italian AGCM or by the EC's DG COMPETITION. The critical issue here would be TI's control, which the parties may try to mitigate with a **strong governance framework** to guarantee that the new network entity is run as independently as possible from the TI Group.
- ◆ TI's control may also represent an issue with regards to the **Infratel tenders** to fund the deployment in the more rural areas of the countries (so called Clusters C and D), which were awarded to Open Fiber on the basis (among other factors) of its "wholesale-only operator" status.
- ◆ **Valuation:** while external investors (such as KKR) may play a role in FiberCop, when it comes to the broader new fixed-line network entity there is only – in our view – one possible strategic partner for TI: that is the Italian State through the lender CDP (this is because the fixed-line network infrastructure is considered to be an asset of strategic national interest). Valuation of the assets may not be straightforward: for instance, CDP is a 9.9% shareholder in TI and at the same time may have an interest in seeing a generous valuation of Open Fiber where it holds 50% (with the reluctant seller ENEL, where the Italian Treasury is the larger shareholder, holding the other 50%).
- ◆ **Future regulation of the network entity** will be key to determine the returns. Over the years, the debate around this topic has often mentioned that the new fixed-network entity may benefit from a Regulated Asset Base RAB-style regulation, referring to a methodology used for industries having natural monopoly characteristics and first introduced by the British water regulator Ofwat in 1994. The introduction of RAB in telecoms would be a very complex exercise in our view and, as Professor Jon Stern of City University London notes "the role of the RAB as a commitment device derives from the quality of its implementation plus the predictability and integrity of the process in which it is revised and redefined, rather than from the definition of the RAB per se" (European Networks Law and Regulation Quarterly, 2014). A pre-condition to introduce RAB would be to unify all the available network assets; in this respect, having Fastweb on board (Fastweb has agreed to hold a 4.5% (in exchange for its 20% stake in Flash Fiber, the FTTH JV between TI and Fastweb) is a good starting point.

A merger between TI's fixed network assets and Open Fiber with TI retaining control was our preferred of the various scenarios we explored (among others) in [TI: Countdown to checkmate](#) (13 April 2018). Such a solution would be desirable and would achieve several goals for the various interested parties:

1. Remove the threat of a state-sponsored parallel fibre deployment;
2. Bring the state (via lender CDP) back on board as a significant shareholder in the fixed-line network, ie. the asset considered to be of strategic national interest;
3. Raise funds which could help reduce TI's leverage while unlocking some unexpressed value from the network asset;
4. TI would continue to be the majority shareholder in the merged entity, preserving the link between network and services, protecting the ability to generate sustainable cash flows and drive innovation.

## Valuation and risks

	Valuation	Risks to our view
<b>Telecom Italia</b> <b>TIT IM</b>	Current price: <b>EUR0.39</b> Target price: <b>EUR0.40</b> Up/downside: <b>3%</b>	<b>Upside risks:</b> (1) a (partial) disposal of the fixed-line network at an attractive valuation; (2) a merger with Open Fiber on attractive terms; (3) slow progress from Open Fiber in its parallel fibre access network deployment; and (4) an improvement in the competitive environment in the Italian market. <b>Downside risks:</b> (1) slower-than-expected progress in the 2020-22 cost-cutting programme; (2) more substantial network disintermediation as a result of OF's parallel fibre deployment; and (3) a severe recession causing further loss of business and increase in bad debt.
<b>Hold</b>	We use a DCF methodology to value Telecom Italia's domestic business. We use a WACC of 7.3%, based on a risk-free rate of 2.5% (unchanged), a market risk premium of 4.5% (unchanged), and a levered beta of 2.0 (unchanged). We bring in TI's Brazilian asset, TIM Participações (TIMP3 BZ, BRL14.5, Hold, covered by Christopher Recouso), at the current market price. We use a terminal value growth rate of 0% in view of the macro and competitive pressures. Our EUR0.40 target price implies upside of 3% from current levels, and we retain our Hold rating.	

Priced at 26 August 2020  
 Source: HSBC estimates

# Disclosure appendix

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## Important disclosures

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### From 23rd March 2015 HSBC has assigned ratings on the following basis:

The target price is based on the analyst's assessment of the stock's actual current value, although we expect it to take six to 12 months for the market price to reflect this. When the target price is more than 20% above the current share price, the stock will be classified as a Buy; when it is between 5% and 20% above the current share price, the stock may be classified as a Buy or a Hold; when it is between 5% below and 5% above the current share price, the stock will be classified as a Hold; when it is between 5% and 20% below the current share price, the stock may be classified as a Hold or a Reduce; and when it is more than 20% below the current share price, the stock will be classified as a Reduce.

Our ratings are re-calibrated against these bands at the time of any 'material change' (initiation or resumption of coverage, change in target price or estimates).

Upside/Downside is the percentage difference between the target price and the share price.

### Prior to this date, HSBC's rating structure was applied on the following basis:

For each stock we set a required rate of return calculated from the cost of equity for that stock's domestic or, as appropriate, regional market established by our strategy team. The target price for a stock represented the value the analyst expected the stock to reach over our performance horizon. The performance horizon was 12 months. For a stock to be classified as Overweight, the potential return, which equals the percentage difference between the current share price and the target price, including the forecast dividend yield when indicated, had to exceed the required return by at least 5 percentage points over the succeeding 12 months (or 10 percentage points for a stock classified as Volatile\*). For a stock to be classified as Underweight, the stock was expected to underperform its required return by at least 5 percentage points over the succeeding 12 months (or 10 percentage points for a stock classified as Volatile\*). Stocks between these bands were classified as Neutral.

\*A stock was classified as volatile if its historical volatility had exceeded 40%, if the stock had been listed for less than 12 months (unless it was in an industry or sector where volatility is low) or if the analyst expected significant volatility. However, stocks which we did not consider volatile may in fact also have behaved in such a way. Historical volatility was defined as the past month's average of the daily 365-day moving average volatilities. In order to avoid misleadingly frequent changes in rating, however, volatility had to move 2.5 percentage points past the 40% benchmark in either direction for a stock's status to change.



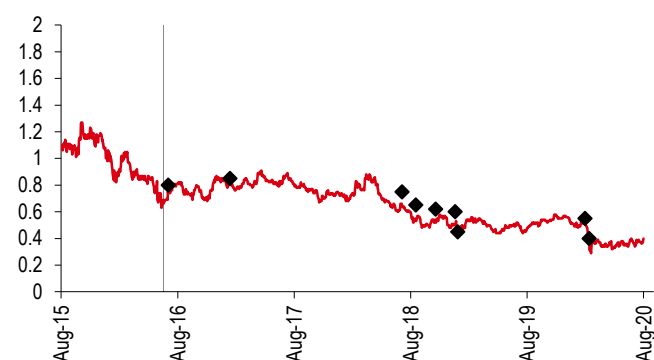
**Rating distribution for long-term investment opportunities**

As of 28 August 2020, the distribution of all independent ratings published by HSBC is as follows:

<b>Buy</b>	55%	( 31% of these provided with Investment Banking Services )
<b>Hold</b>	36%	( 32% of these provided with Investment Banking Services )
<b>Sell</b>	9%	( 25% of these provided with Investment Banking Services )

For the purposes of the distribution above the following mapping structure is used during the transition from the previous to current rating models: under our previous model, Overweight = Buy, Neutral = Hold and Underweight = Sell; under our current model Buy = Buy, Hold = Hold and Reduce = Sell. For rating definitions under both models, please see “Stock ratings and basis for financial analysis” above.

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**Share price and rating changes for long-term investment opportunities**
**Telecom Italia (TLIT.MI) share price performance EUR Vs HSBC rating history**


Source: HSBC

**Rating & target price history**

From	To	Date	Analyst
Buy	Hold	14 Jul 2016	Luigi Minerva
Target price	Value	Date	Analyst
Price 1	.80	28 Jul 2016	Luigi Minerva
Price 2	.85	07 Feb 2017	Luigi Minerva
Price 3	.75	01 Aug 2018	Luigi Minerva
Price 4	.65	13 Sep 2018	Luigi Minerva
Price 5	.62	14 Nov 2018	Luigi Minerva
Price 6	.60	14 Jan 2019	Luigi Minerva
Price 7	.45	22 Jan 2019	Luigi Minerva
Price 8	.55	26 Feb 2020	Luigi Minerva
Price 9	.40	10 Mar 2020	Luigi Minerva

Source: HSBC

To view a list of all the independent fundamental ratings disseminated by HSBC during the preceding 12-month period, please use the following links to access the disclosure page:

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**Disclosure checklist**

Company	Ticker	Recent price	Price date	Disclosure
TELECOM ITALIA	TLIT.MI	.40	27 Aug 2020	4, 5, 6, 7

Source: HSBC

- 1 HSBC has managed or co-managed a public offering of securities for this company within the past 12 months.
- 2 HSBC expects to receive or intends to seek compensation for investment banking services from this company in the next 3 months.
- 3 At the time of publication of this report, HSBC Securities (USA) Inc. is a Market Maker in securities issued by this company.
- 4 As of 31 July 2020, HSBC beneficially owned 1% or more of a class of common equity securities of this company.
- 5 As of 30 June 2020, this company was a client of HSBC or had during the preceding 12 month period been a client of and/or paid compensation to HSBC in respect of investment banking services.
- 6 As of 30 June 2020, this company was a client of HSBC or had during the preceding 12 month period been a client of and/or paid compensation to HSBC in respect of non-investment banking securities-related services.

- 7 As of 30 June 2020, this company was a client of HSBC or had during the preceding 12 month period been a client of and/or paid compensation to HSBC in respect of non-securities services.
- 8 A covering analyst/s has received compensation from this company in the past 12 months.
- 9 A covering analyst/s or a member of his/her household has a financial interest in the securities of this company, as detailed below.
- 10 A covering analyst/s or a member of his/her household is an officer, director or supervisory board member of this company, as detailed below.
- 11 At the time of publication of this report, HSBC is a non-US Market Maker in securities issued by this company and/or in securities in respect of this company
- 12 As of 21 Aug 2020, HSBC beneficially held a net long position of more than 0.5% of this company's total issued share capital, calculated according to the SSR methodology<sup>1</sup>
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#### **Additional disclosures**

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- 2 All market data included in this report are dated as at close 26 August 2020, unless a different date and/or a specific time of day is indicated in the report.
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