TIM NetCo spin-off: A Risky Bet in a Turbulent Environment

When dealing with TIM (Telecom Italia), it seems that the Net-Co spin-off is an easy catalyst for setting in motion a repetitive pattern of interaction between the Italian Government, Telecom Italia executive team and the lead-shareholders.

With the news and rumors spreading during the past month of February, we count 10 different attempts that ended up with no material impact, over a period of 13 years (2006-19). Governments change, and more likely so in Italy than in any other G-20 country (5 PM in about 6 and half years), new executive teams are appointed with an alarming frequency (4 Ceos in the past 4 years: Patuano, Cattaneo, Genish, Gubitosi), and the new lead-shareholders tend to start exactly where the previous ones have failed, engaging in a tortuous and, up to now, fruitless process aiming at spinning-off the fixed network, with the overarching goal of building-up one single national broadband infrastructure.

It has become a recurrent pattern at Telecom Italia for newly appointed executive teams and new, emergent lead-investors to ignite a few sparks of life into an already stagnant equity story, by saying that "this time will be different." It is quite likely, on the contrary, that history will tend to repeat itself.

This research note is based only on publicly available information and it represents the result of the analysis of each and every single document, news article, digital information and corporate statements covering a period of 13 years, to detect the hidden patterns affecting Telecom Italia share value.

In our view, the NetCo spin-off is taking shape in an already turbulent environment, marked by an ever-growing set of uncertainties that contribute to make this specific case a risky bet, with marginal material impact.
The risk profile is higher due to a number of country and industry-specific drivers that investors should be advised to incorporate in their analysis.
The case for a fixed-network spin-off is not taking place in a vacuum, but in a country, Italy, that is exposed to a more wide-spread political turbulence, likely to pick-up momentum after the European elections at the end of May, and with emerging signs of a deteriorating economic environment and declining consumers and investors' confidence. Financial markets are already trading at a discount Italian equity stocks with respect to their European peers and the mounting level of sovereign debt is a key source of concerns across investment circles across Europe.
The NetCo spin-off should be treated with extra care given that it is likely to take place in an already toxic environment and because of its impact on the overall competitiveness of TIM vis a vis its peers: moreover, bond-holders should expect a correction, at the end of the process. Telecom stocks represent a significantly volatile and mature asset-class in the eyes of investors, with a trivial upside potential, in terms of market capitalization. Thus, given the infrastructural nature of the NetCo spin-off, Telecom Italia executive team should aim at edging off the risk profile of this transformational transaction. There are two, key areas of concerns that should be addressed: (1) what it is likely yield, vis a vis a comparison with 10-year Italian Treasury bonds and how many chances the new entity has to earn back its cost of capital (ROCE).
It has to be noticed that the Net-Co spin-off is a process that it is likely to require a period of 18 to 24 months and the new national broadband infrastructure will be likely to generate a positive return after five years: thus, in the best possible scenario, equity and bond-holders will have to wait about 7 years, before they will be able to find out if the process has unlocked shareholders value.

Lessons Learned: the case of NBN in Australia

To start, our research work we have focused on a simple question: how many historical cases of NetCo separation, followed-up by the rollout of a national broadband infrastructure, have proven to be successful? The answer leaves little or no doubt: there are just a few and they have proven to be an uncertain path to unlocking shareholders value. There is poor empirical evidence that one single, national broadband infrastructure can reward shareholders and taxpayers' money.
There have been, so far, just a negligible number of cases

related to the build-up of a single, national-broadband infrastructure, similar to what could be expected on the basis of the publicly available information regarding the TIM/Open Fiber combination, and the empirical evidence regarding the overall outcome should be a source of concerns for TIM shareholders and the Italian Government, as well.
The case of the national broadband infrastructure (NBN) in Australia should sound as a warning signal for investors: S&P argues that, while NBN will achieve its two key policy objectives of bridging the digital divide between metropolitan and regional areas and breaking up Telstra's fixed-line monopoly, it will impose "an enormous cost to taxpayers, subscribers and incumbent telecommunications providers".
The rollout of the national broadband infrastructure (NBN) in Australia has become a key lesson in how not to pursue a similar plan due to:

- political interference
- poor technology choices
- inadequate delivery.

Instead of catapulting Australia to the top of the ranks as the most connected continent on the planet, the reality turns out to be quite different and it provides a grim picture:

- take-up rates are below expectations
- speeds are not close to what was anticipated
- prices tend to be higher than expected
- customer-satisfaction has been consistently low.

The NetCo spin-off: a risky bet in a turbulent environment

To address the material impact of NetCo spin-off, we have been working on modeling the telecom industry as a set of interdependent networks.
We looked, then, at measuring the impact of 6 areas of risks, with the overall conviction that the chief goal of Telecom Italia executive team should be the one to reduce the overall perception of risks in the eyes of investors. The 6 areas, identified below, are instrumental to provide a correction to the estimates of the material impact of such a transformational deal:

- Structural Risks
- Technology Risks
- Regulatory Risks
- Political Risks
- Governance Risks
- Financial Risks.

The attempt of setting in motion the spin-off of TIM fixed-network has been part of the agenda of Elliott Management since its entry in the TIM saga, about one year ago, and it has resonated with the Italian Government: the convergence of TIM fixed network and Open Fiber (ENEL) into one single national broadband infrastructure has been considered instrumental by Elliott Management to ramp up the de-leveraging TIM balance sheet and to regain Investment Grade status, while the Government, led by the Five Star Movement and the Lega, is keen to seize the opportunity to regain control of the national broadband infrastructure. It is a powerful political message that supports the narrative of the emergent populist wave emerging across the country and it will be the leitmotif of the political debate shaping the campaign towards the European elections (May 2019).
While these goals seem to be mutually compatible, the financial and the structural risks related to the combination out-weight the potential, material impact of this transaction.
TIM is a risky investment in a turbulent environment: the newly appointed executive team is facing a daunting challenge, with few margins for mistakes. Investors should be worried about the execution risk of a network combination that has few comparable cases across the telecom industry and presents historical low success rates.
If you are running a telecom operator like TIM, facing headwinds in terms of competitive pressures and a perception of spreading country risk in the eyes of international investors, you should focus on gaining back control of your investment agenda, by narrowing down the managerial focus to opportunities you can quickly grab, in order to win back the confidence of the investors' community.
For investors already worried about the risk profile of TIM in a volatile and turbulent environment, betting on the material impact of the NetCo spin-off looks more like venturing out into untested waters than bringing back execution discipline into an already shaky context, with little or no guidance on how the newly appointed management team could succeed in overturning the challenges that hampered the rollout of NBN in Australia.
After all, it looks like that TIM has lost investors confidence

over the last 5 years, due to a less than impeccable delivery on execution and a convoluted governance: moreover, if political interference has been an issue in Australia, it seems unlikely that Italy will end up being substantially different. The network separation and combination with Open Fiber represents a risky bet, with marginal material impact, in an already turbulent environment.
Unlocking shareholders value, through network separation is likely to take time, possibly no less than 18 to 24 months: thus, if we expect with some degree of benevolence, that the process will start after the Annual Shareholders Meeting scheduled on Friday, March 29th, it will be likely that shareholders will see the end of the process by mid 2021. The next two years are likely to be an ice-age for the telco industry as whole, given the expectations of more consolidation taking place across the European telecom markets and the emergence of pure IoT players.

The NetCo Spin-off: Enabling Conditions

Given the uncertainty regarding the alternative scenarios that will eventually take place in 2019 across the European telco markets, investors should take a cautionary approach and they should expect to see in place a number of conditions precedent as a key requirement to unlocking shareholders value:

- a stable government
- a strong, seasoned management team, with a proven track-record within the telco industry, capable to win back investors' confidence
- a cohesive core group of shareholders, capable to support the management team during a long negotiating process with the government
- a clear governance, capable to inspire confidence across the investors' community
- a favorable regulatory context at both the country level as well as at the EU Commission
- an overall perception of reduced country-risk, given that it represents an infrastructural investment
- a favorable attitude by foreign investors towards the network spin-off, given that the size of investment will require access to international financial markets
- a stable technology/industry market space, which is not due to change anytime, soon, due to emergence of potential digital disruptions that will be likely to jeopardize the terminal value of the NetCo spin-off.

At Kaufmann & Partners we focus our research on taming the wide array of unstructured and semantic data to extract financial signals, to identify undetected patterns and to select out how different scenarios will be playing out in terms of financial impact and shareholders value. This is why we started out collecting all the publicly available data and information regarding the 10 different attempts to set in motion the network separation at TIM, since 2006 (September 2006, April 2007, February 2009, June 2009, June 2013, February 2015, April 2016, July 2017, March 2018, February 2019). We then focused on the last six and half years, and the five Ceos (Franco Bernabe', Marco Patuano, Flavio Cattaneo, Amos Genish, Luigi Gubitosi) who set in motion an attempt to separate the fixed-network, each and every single time with the aim of deleveraging TIM balance sheet and with the goal of appealing to the four different governments (Letta, Renzi, Gentiloni, Conte) that have been in power, since 2013.
We then analyzed the impact on TIM market capitalization and share value, to find out that after an initial boost that lasted, on average, a little bit less 4.5 weeks, the impact has been negligible and, in some cases, negative.
Each and every single time, the executive team failed to address two key, fundamental issues, that seems to be missing this time, as well:

- Which is the overarching business model and this transaction will affect TIM competitive standing? Does it represent a truly transformational deal or is it just a financial exercise with little material impact and no substantial enhancement TIM competitiveness?
- Which is the governance model? Which party is going to own control and appoint the key managers?

Investors looking at the upside potential in terms of shareholders value should look at the NetCo spin-off as an alternative to buying a 10 year Italian Treasury note, that yields about 3.2%: they should also check the yield that a combination with Open Fiber will be likely to provide, given the CAPEX requirements, and they should be concerned about the level of debt that will offloaded to the new entity in charge of building the national broadband infrastructure, that will end up being equated to a proxy of Italian sovereign debt. Bond-holders should be aware that a correction is likely to take place, and it will be a substantial one, in terms of magnitude.
Even if we take into consideration the most favorable scenario, we can't take away the uncertainty regarding three key factors that have not been, yet, incorporated by financial analysts:

- The emergent wave of concerns regarding the Chinese network gear suppliers, like Huawei, that will impact the ease of financing of future network rollouts
- How likely a NetCo spin-off will win the EU approval, given that the European elections at the end of May 2019 will bring to office to a new set of EU Commissioners
- To what extent the remedies imposed by a newly appointed EU Commission will hamper the financial sustainability of NetCo and how it will reverberate on TIM competitive and financial performance.

Incumbent telcos like Orange, Telefonica, Deutsche Telekom and BT are looking at the implications of a tentative NetCo spin-off and are increasingly worried about a potential "contagion" effect, that will set in motion similar attempts by a number of EU governments.

Conclusions

With a global recession looming at the horizon, negative interest rates, and a change in leadership at the ECB by year end, that is likely not to be as generous in the buying out of toxic debt accumulated by the European leading telecom operators, investors should be concerned about quality of the underlying assets that the likes of NetCo will end up with, in their portfolio.
It seems that the process set in motion by the newly appointed management team will be facing more uncertainties than anticipated, and it will be increasingly challenging to provide a clear, linear path to shareholders value creation. Instead of delivering the execution of a quick and simple way to promote a process of asset disposal to reduce leverage on its balance sheet, TIM will be absorbed in a tedious and tortuous journey, exposed to the uncertainties of the Italian political environment.
Moreover, the lack of clarity about the overall network architecture at a time when the emergent IoT wave (Internet of Things) will redefine the breadth and scope of multiple, overlapping networks, will risk slowing down the innovation process required to adapt to the new telecom landscape likely to emerge within the next two years.
The focus on execution that the newly appointed executive team will have to dedicate to the NetCo spin-off will unfortunately reduce the managerial bandwidth that TIM deserves and badly needs to restore its path to growth, cash flow generation and profitability, after a number of turbulent years that have hampered the chain of command and control that needs to be in place to ignite a disciplined turnaround.
With the telecom stocks likely to split in two different asset classes, with the emergence of a new set players focused on the rollout of IoT networks and with a number of unanticipated digital disruptions looming at the horizon, the attempt of spinning-off the fixed network seems, at minimum, ill-timed. It could be likely that the evolution of telecom networks will go exactly in the opposite direction envisioned by TIM NetCo spin-off, that will eventually materialize within 18-24 months, leaving little or no room for adjustment.
At the present time, there are too many emergent sources of uncertainty, beyond the control of TIM recently appointed executive team, that should make investors concerned about the overall material impact of such a transformational deal, that risks to jeopardize the competitiveness of the group and its chances of regain its Investment Grade status and command and control of its cash flow generation capabilities.
Shareholders and investors should look at how the top executive team is allocating its time and setting priorities: furthermore, they should doubt how quickly an overall consensus could be reached with a government that will be more focused on the progress towards the European elections, instead of working hard to set the policy agenda to improve the country infrastructures. Moreover, without the support and commitment of international financial markets, the NetCo deal will be unlikely to become a catalyst for aggregating the financial resources required to build a national broadband infrastructure, capable to catapult Italy at the forefront of the current digital transformation.