



JARDIM BOTÂNICO INVESTIMENTOS

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## INDEX

INVESTMENT CASE – VIVO (TELEFÔNICA BRASIL) .....	3
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**INVESTMENT CASE – VIVO (TELEFÔNICA BRASIL)**

Two events were recently announced in the Brazilian telecom sector that may change the market's competitive environment: (i) the merger between Oi and Portugal Telecom (PT) into a new company, CorpCo, in which PT will be the largest shareholder with up to 39% of total shares; and (ii) the increase in Telefónica Spain's (TEF) stake in Telecom Itália (TIT) – focus of this article. The reason behind these events was the same: to reduce the substantial debt levels of both Oi and TIT.

As investors in Telefônica Brasil (VIVT4, Vivo), we have to analyze the likely impacts, if any, those transactions could have in the sector and in the company, in particular. Having invested in Telesp from 2005 to 2008, we resumed our position in the company in June 2011 – already under its new name Telef Brasil following the acquisition of PT's stake in the business by TEF. Our investment thesis is based on the fact that Telef Brasil presents the best quality service among its peers, leads the mobile market with a share of 29% and generates enough cash flow to make the necessary investments in new technology and still maintain an average dividend yield of 7% p.a..

We consider the Oi-PT merger a limited threat to Telef Brasil. Even taking into account a likely capital increase of R\$ 8 billion, the new company (CorpCo) will remain highly leveraged (3.0x net debt / EBITDA compared to a current level of 3.4x). Therefore, investments in network and service improvement will be hampered as will the company's payout policy. Moreover, CorpCo is only expected to generate positive cash flows by the end of 2015, while the proposed terms of the deal seem to entail an excessive dilution of minority shareholders. As detailed in JBI letter #2 (December 2009), our

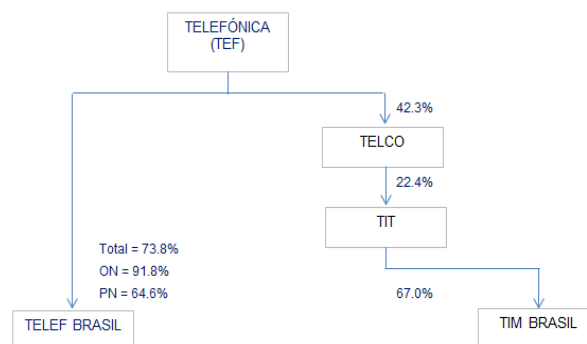
investment process applies a few filters in order to establish which companies will integrate our investment universe. As we always stress, governance criteria are essential during this process and represent a main part of our DNA as a firm. CorpCo complex shareholding structure and the potential misalignment of interests between controlling and minority shareholders make us uncomfortable as investors and the company was therefore excluded from our investment universe.

As for the Telecom Itália deal, we expect it to have a relevant impact on Telefônica Brasil. Being highly leveraged (close to 3.0x EBITDA), TIT was having difficulties to meet its short-term obligations. In order to improve TIT's finances, TEF increased its stake in the holding Telco (owner of 22.4% of TIT's shares) to 66% through a capital increase of EUR 320 million. The deal is due to be implemented in two stages. In the first one, the Spanish group will still not have the majority of voting shares. The second stage started in January 2014 and entitles TEF to raise its shareholding to 70% and convert its stocks into voting shares, reaching approximately 65% of Telco's voting capital. Additionally, TEF was also given the option to buy the totality of Telco's shares. Considering that both TEF and TIT need to reduce their debt ratio, we believe that TEF will try to implement a strategy in which TIT has to alienate some of its assets. The deal was split into different stages to allow for extra time to find an acceptable solution for both Brazilian and Italian regulators. In Brazil, TIT's subsidiary TIM is the second mobile operator with a market share of 27%. Probably, ANATEL (the National Telecommunications Agency) and/ or CADE (the Brazilian antitrust authority) would not allow TEF to own the two biggest mobile

operators in the country, Vivo and TIM, which together represent 56% of the domestic market. From a regulatory point of view, the ideal solution would be to sell TIM to a new entrant to the Brazilian market – AT&T and Vodafone come to mind, but neither has demonstrated any interest so far. In this case, we would have a more competitive environment as the buyer would be well capitalized and could gain a reasonable market share. Another solution would be to change the Brazilian regulation in order to allow TIM to be split in different segments and have the current players – Vivo, Oi, Claro and Nextel – competing for each individual tranche. In this scenario, Telef Brasil could benefit from its lower degree of leverage (0.1x ratio) to acquire certain tranches. Even if we consider this to be a less likely solution, the speculation on the theme gave rise to discussions on whether tag along rights would be triggered. The situation is not clear and is highly dependent on the deal's outcome.

In this sense, it is worth revisiting CVM's Process RJ 2009/1956, established when TEF acquired 42% of Olimpia, a holding company that owned the same 22.4% of TIT's shares. On that occasion, the regulator decided that tag along rights should not be triggered, as there had been no change of control. A member of CVM's Board had also indicated then that the Italian law should prevail, including its 30% threshold for a mandatory bid to be required. Hence, depending on what happens to TIM, the possibility of making use of tag along rights is uncertain and a case-by-case analysis will be necessary. The stock market is already considering these possibilities. TIMP3 was up 3.3% in USD compared to a 12.1% fall of the Ibovespa since the deal was announced until the end of the year.

**Figure 1: TEF stake in the Brazilian market**



Moreover, in the beginning of December, CADE imposed restrictions to the transaction. The agency concluded that even if TEF was initially raising its stake in Telco through the acquisition of non-voting shares, this was not enough to prevent the company from interfering in TIM's activities. Despite the conclusion of the integration process between Telesp and Vivo following PT's exit from the business in 2011 and ANATEL's formal approval, CADE's recent decision may force the Spanish group to either find a new partner to share Telef Brasil's control or sell the stake in TIM it acquired via Telco. According to the press, CADE gave an additional 12 to 18 months for TEF to find a solution. We do not expect the company to opt for sharing Vivo's control. The Brazilian subsidiary is a strategic asset for the group and represents 20% of TEF's income and 45% of its operational earnings. Moreover, TEF's stake in Vivo is valued at R\$ 35Bn, while its shareholding in TIM, already considering the total ownership of Telco's shares, has a value of R\$ 4.6Bn, almost ten times less.

The Spanish group will probably try to revert CADE's decision (they have already indicated they would appeal) and present further data in order to prove that a potential merger could actually benefit the sector (as observed in some Latin American and European countries). In that case, they could make a general bid for all of TIM's outstanding shares in order to consolidate both businesses or sell the integrity or part of their

shareholding in Telco up to a point that the Brazilian government considers reasonable.

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