

# Telefónica Deutschland: The Transformation of European Telecoms

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**E-PLUS GRUPPE**



## Transaction at a Glance

- Largest German mobile phone carrier
- Combined estimated revenue share of 35%
- Potential cost reductions worth over €5 billion

In-market consolidation is only the first step in a broader transformation of the European telecom landscape

Telefónica Deutschland Holdings AG (TDH, Ticker: 02D:GR) is a unique way to participate in the dramatic transformation process under way in European telecoms. The “in-market” consolidation and incipient convergence processes in the European wireless telecom industry bode well for a sector where stiff competition encouraged by nearsighted regulations had been eroding revenues, profit, and investment. Unlike the vast majority of wireless telecom companies, TDH is extremely well capitalized and has consistently generated strong free cash flows despite its significant network investment requirements. Additionally, it operates in the German market, which benefits from relatively favorable fundamentals. And all of this while selling at an inexpensive price.

TDH is the German arm of Spain’s Telefónica. TDH is an integrated telecommunication services provider based in Munich, Germany. It is currently the third-largest mobile phone carrier in Germany, but is bound to become the country’s largest mobile phone carrier, with a revenue share of ~35% as its €8.1 billion bid for KPN’s German subsidiary E-Plus was approved in early July 2014. This merger puts TDH on equal footing with the two largest mobile carriers in Germany, Deutsche Telecom and Vodafone, each with around a third of the market.

Structural changes in the European regulatory environment, such as the European Commission’s (EC) approval of mergers in Austria and Ireland, and more recently the TDH and E-plus deal in Germany, indicate a departure from a historical norm of regulatory resistance to allowing less than four wireless carriers within a given country. The combination of TDH and E-plus represents the largest European wireless merger to date and has a very high probability of generating significant cost savings and synergies. The merger is estimated to bring cost reductions worth over €5 billion in present value terms, an enormous figure in the context of TDH’s current €7 billion market cap. The potential costs savings and synergies are significant.

The recent rally in TDH’s stock price reflects the market’s increasing confidence that the merger would be approved and in the shareholder value creation likely to result from it. But “in-market” consolidation of the industry is only the first step in what is a broader transformation of the European telecommunications landscape. As has been the case in many global telecommunications markets, convergence often accompanies consolidation. A recent spate of acquisitions of fixed-line telecom businesses in Europe has highlighted the attractiveness and logic of a convergence transaction, i.e., combining fixed-line assets with wireless assets. In such transactions the operator can offer (and more importantly charge for) a suite of three or four services to each of its customers. These types of service packages, referred to as triple or quad plays, offer the prospect of much higher returns to the service providers, enormous savings in marketing expenses, as well as the adoption of the lower “churn rates” associated with fixed-line services.

The ability to offer a converged service offering can again fundamentally change the economic model for the service provider in highly beneficial ways. Thus, it is reasonable to expect that the resource conversion paths for TDH may not end with the E-plus merger. Following the completion of its merger with E-Plus, expected in Q3 2014, TDH will have the largest wireless subscriber base in Germany but very little in the way of a credible television or internet offering. Conversely, TDH’s two competitors, Deutsche Telecom and Vodafone, which recently purchased Kabel Deutschland, have assets in place to provide a strong multi-service offering. Hence, a business combination with

one of two fixed-line companies operating in Germany, both of which are currently offering wireless via a network sharing agreement with TDH, would provide TDH with the synergistic benefits of a convergence transaction and simultaneously offer a step-change improvement in its competitive position.

It is noteworthy that TDH begins this process as among the best capitalized wireless companies in Europe. The merger will not weigh down its balance sheet as TDH is combining with an unleveraged E-Plus. In addition, its parent company, Telefónica S.A., which has been trying to deleverage for the last few years, is willing to fund its portion of the TDH rights offering that will finance the E-Plus merger. The determination to keep TDH extremely well-capitalized is auspicious for its ability to execute on any future transactions.

As it stands today, TDH is generating a recurrent annual free cash flow of close to €700 million while in the process of rolling out a 4G network. The German market is a relatively reasonable operating environment for telecom companies. Low smartphone penetration and “churn rates”, high rate of pre-paid mobile customers (implying an important upselling opportunity), addition of subscribers at twice the rate of the European Union average, and a potentially less competitive pricing environment as a result of the TDH merger are some of the features that make the German market particularly attractive. In addition, TDH has considerable tax assets which enable the company to distribute a dividend yield of approximately 8%, notwithstanding the reinvestment requirements that define the industry.

In spite of the elusive nature of economic recovery in Europe, transformations in the European economy have forged some appealing investment opportunities. Third Avenue’s International Value strategy is capitalizing on the transformation process within European wireless communications through a position in TDH. Reforms in the regulatory environment for European telecom companies are breathing fresh air into a sector that has struggled as a result of too much competition and near-sighted government meddling. The consolidation and convergence processes present an investment opportunity as companies can improve the economics of their business through cost reduction as opposed to price increases, which is why these transactions are increasingly acceptable to regulatory bodies that are determined to ensure affordable service to citizens. TDH is among the most appealing telecom companies in Europe from a balance sheet, business and valuation perspective as well as from a geographic standpoint. Thus, owning TDH is an optimal way to participate in the transformation of European telecoms.

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