

Telecom Italia: Europe's odd man out?

A regular column on the information industries

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It is useful to begin by considering some structural issues. There are four major markets in Europe, as measured in terms of mobile subscribers, of which Italy is the third-largest. Each has a dominant incumbent, although the benefits of early establishment have waned considerably. However, what most obviously distinguishes Deutsche Telekom, Orange and Vodafone from Telecom Italia – hereafter TI – is that the first three have significant international empires whereas the latter does not.

Even 10 years ago TI had substantial overseas assets only in Argentina and Brazil and the former is long gone. In Italy, TIM – TI's mobile subsidiary – has maintained a fairly constant 30 million subscribers but the direction of travel is downwards because the Italian market has seen the appearance of a new entrant, France's Iliad, which is well on its way to 10 million subscribers – acquired almost entirely from the other incumbents in a saturated market.

The situation in Brazil is undergoing change due to the redistribution of the assets of Oi to the other three incumbents in February 2022. Whereas this market provides more than twice as many subscribers as Italy, TI has only a 69.8% stake. In effect, therefore, unlike the other major European incumbents, TI has little fallback when things are going badly in the domestic market.

It is salutary to examine the long-term history of TI's share price as it is a good guide to the company's success/failure. In January 2000, as telecoms valuations generally soared, the share price hit a peak of just over €5. By October 2004, it had fallen to €3, by November 2015 to €1.2 and by July 2017 to €0.87. Significantly, during the one-year period prior to the time of writing in March 2022, the share price had deviated between €0.22 and €0.51, standing on 10 March at €0.26, meaning that TI was valued at a lowly €5.44bn.

But what accounted for this sudden deviation in the share price? The answer, quite simply, is Kohlberg Kravis Roberts (KKR) – a US-based private equity group – which tabled a bid worth €10.8bn in November 2021. This was equivalent to €0.51 per share – up from its previous €0.35. However, TI simply ignored the offer as beneath its dignity not to mention its own valuation of its assets. Unfortunately, the share price subsequently collapsed back to, at worst €0.22, indicating a loss of faith in TI's ability to go it alone.

In March 2022, KKR re-entered the fray with a second takeover bid – only this came in at only €0.40 per share and was subject to acceptance by both the TI board and the Italian government. This could readily be explained by the publication of TI's annual accounts for 2021 and its strategic plan as noted below.

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The response by Moody's ratings agency was to downgrade TI's corporate family rating, the rating of debt instruments issued or guaranteed by TI and TI's probability of default rating to a lowly Ba3 negative. This move was a reflection of TI's poor results in Italy, albeit offset somewhat by a steady performance in Brazil. Compound annual growth was predicted to be flat between 2021 and 2024. Meanwhile, the plan was to explore the separation of TI's wholesale operations from its retail operations. TI argued that the separated entities would be able to increase their strategic focus, obtain some regulatory relief and benefit from an improved allocation of capital.

The markets, as noted, were not enthused, not least because TI had got through four CEOs in six years, indicating an ongoing failure to achieve its plans. According to Moody's, the plus side of the ledger comprised the benefits of incumbency, the operations in Brazil and the focus on cost control, while the negative side comprised the high level of net debt, the strong competitive pressures in Italy, the ongoing decline in earnings, the unsatisfactory cash flow driven by the need for heavy investment and an inappropriate structure.

The need for ongoing heavy investment in the domestic market is predominantly a reflection of the cost of licensing and rolling out a 5G network at a time when the 4G network is finally producing significant revenues. Crucially, in May 2018, the regulator stated that it intended to auction 5G-suitable spectrum in September, comprising 75 MHz in the 700 MHz band, 200 MHz in the 3.6–3.8 GHz band and 1,000 MHz in the 26.5–27.5 GHz band. The 26 GHz band was divided into five licences, each of 200 MHz.

France's Iliad was interested in the 700 MHz band because a new entrant would be guaranteed an allocation of

up to three blocks, each of 5 MHz paired. When the auction opened in September, Iliad duly offered €677 for three blocks. Telecom Italia and Vodafone were limited to a total of two blocks apiece – because they both already held 10 MHz of spectrum in both the 800 MHz and 900 MHz bands – for which they initially each offered an almost identical sum. Fastweb participated in the auction as did Hutchison (bidding as Wind Tre). However, as the only new entrant interested in the 700 MHz band, Iliad was declared the winner of two blocks.

The key results were as follows:

- Telecom Italia won 20 MHz in the 700 MHz band and 80 MHz in the 3.7 MHz band at a cost of €2.4bn.
- Iliad won 20 MHz in the 700 MHz band and 20 MHz in the 3.7 MHz band at a cost of €1.2bn.
- Vodafone won 20 MHz in the 700 MHz band and 80 MHz in the 3.7 MHz band at a cost of €2.4bn.
- Wind Tre won 20 MHz in the 3.7 GHz at a cost of €520m.

The total raised of €6.6 billion (\$7.5 bn), twice what had been expected. Overall, the price per MHz per pop for the 3.7 GHz band worked out at \$0.42 and the most obvious explanation for such a high figure in this band was that the EU had designated it as the priority band for 5G. However, the odd distribution of two 80 MHz carriers and two 20 MHz carriers was a contributory factor as was possibly payment by instalments which Aetha calculated might have pushed up prices by one-third.

The high prices paid in the auction triggered structural changes in the market. In February 2019, Vodafone and TI signed an agreement to share access to their respective networks. In July, they took this a stage further with an agreement to merge their respective tower infrastructure – with Vodafone transferring its masts into Wireless Italiane (Inwit) in exchange for over €2bn in cash and each

operator ending up with a 37.5% stake – and to jointly roll out 5G networks in both urban and rural areas.

In June, Hutchison and Fastweb signed their own network-sharing agreement that also enabled Fastweb to roam across the existing networks of Wind Tre which, in turn, gained access to Fastweb's fibre-optic fixed-wire networks. Meanwhile, in June 2019, Vodafone launched commercially in the main cities. The following month Telecom Italia launched a comparable service with plans branded as "TIM Advance 4.5G, 5G and 5G Top".

In December 2020, fixed-wire broadband providers Fastweb and Linkem launched a joint 5G fixed-wireless access network, branded as "UltraFWA", in three towns in southern Italy, providing a maximum 1 Gbps downlink. Acting on its own behalf, Fastweb launched mobile services in four large cities shortly thereafter. For their part, Iliad and Hutchison also launched within days of Fastweb.

On 1 October 2021, Linkem launched the first 5G Standalone network using the 3.5 GHz band. Its 3.5 GHz network covered 70% of Italy with half capable of supporting Standalone 5G. In January 2022, Linkem subsidiary Linkem Retail agreed to merge with Tiscali to form the country's largest combined provider of FWA.

None of the above can really be said to have improved TI's position in the fixed-wire and mobile markets. Cancelling the dividend has provided some cash to help cover the massive costs of 5G, but there is no prospect of an immediate upturn in TI's fortunes unless the other expedients that form part of TI's forward strategy prove to be a success. These consist firstly of a plan to dispose of TI's stake in Inwit after TI splits into a networks business and services operation including mobile. It has already received tentative offers for its Inwit stake. Secondly, there is the joint venture,

FiberCop, formed in April 2021 with TI holding a 58% stake compared to 37.5% for KKR which partly accounts for its interest in TI – and 5.5% for Fastweb.

Subsequent upon the second (conditional) offer by KKR, the board split down the middle – the five Vivendi directors voted against – Vivendi owns a 23.9% stake in TI while the government, which also

believes the offer is too low, holds 8.7% – whereas the five independent directors voted in favour. As KKR is unlikely to raise its offer, there appears to be a total stalemate. It is true that other European incumbents are also going through a difficult patch as, among other things, they seek to pay for 5G, but the prospects for TI appear to be much worse. Unless the strategy delivers a much

improved financial performance, the TI share price is likely to stay depressed and TI will be set up as an ongoing target for a destabilising takeover.

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