THE ANALYST

Telefónica: A Big One for 2019
SHORT @ €7.60

Telefónica – View All Notes and Models

Analyst: Mark Hiley
T: +44 20 3743 9848
E: mh@theanalyst.co.uk

Recommendation: **Short (Initiation of Coverage)**

Price: **€7.60**	2-Year Price Target: **€5.00**	Forecast Return: **~30%**
3m Average Daily Volume: **$287.5m**	Market Cap: **€40bn**	Ticker: **TEF SM**
Valuation Metric: **FY'20 Free Cash Yield**		

Investment Thesis

- **Funds looking for liquid shorts in Europe should consider the available alpha in Telefónica, which has €40bn market cap, €42bn of debt, additional liabilities, and offers significant downside. The stock scores highly on our Short Screen and is a Schuldschein issuer. Telefónica even had a decent price performance in Q4'18 as a perceived defensive, the stability in Brazil, good performance in Spain, and rumours of activist interest.**
- **Shorting debt-laden European megacaps is akin to buying cheap US tech stocks in 2010; the risk/reward is very attractive at this point in the credit cycle, with optionality on making a lot of money. Telefónica has less than €1bn p.a. left over to reduce the debt burden.**
- **Debt costs may be unsustainable at 3.45%, which represents negative real debt costs, whilst the upside rewards to equity holders are negligible. Telefónica is one of the most levered companies in Europe with a mismatch between cheap, centralised European debt and LatAm cash flows in depreciating currencies. Additional liabilities such as restructuring, pension, spectrum costs, hybrid instruments, and minorities dilute equity upside.**
- **There are worse offenders in Europe (e.g. Telecom Italia), but Telefónica has the favourable characteristics of a great short: no real revenue growth, low cash flow growth, significant debt, a deflationary industry, a huge and complex fixed asset and cost base, and regulatory challenges.**

Debt-laden European large caps were some of the worst-performing stocks in 2018. Specifically, Anheuser Busch InBev, a former market darling, is now drowning in $100bn of debt post SABMiller deal, whilst Bayer, post-Monsanto, faces a dual squeeze from debt and litigation. People will probably still be drinking beer in the long term, but Telefónica is a very capital-intensive business exposed to technology change and obsolescence with no marginal cash costs for the industry, which brings deflationary risks to earnings of a business with negative real cost of debt.

Telefónica is not the worst in large-cap Europe on this thesis of ECB debt-fuelled balance sheets, but it's a good starting place. The ECB has not differentiated between the corporates and there is a raft of other indebted industrials where the equity can potentially have massive downside. Telefónica also scores highly on our Short Screen and flags as a Schuldschein issuer.

As concerns over higher-interest costs may hit equity investors, Telefónica is a levered business that can be de-rated quickly. We find it unbelievable that a company such as Telefónica is financing €42bn of net debt at an average cost of 3.45%. The last re-financing on €1bn notes closed in November 2018 (7-year money at 1.495%). In simple terms, Telefónica is valued like bullet-proof, European government debt, and the real cost of debt is now, in fact, negative. Furthermore, Telefónica earns almost 50% of EBITDA in Brazil and Latin America, meaning the mismatch in cash flows to liabilities is enormous. If we add the UK as a devaluing currency, that's another 10%. Perhaps the company is stronger than the Brazilian government on credit risk, but if it is not, then the cost of debt is wrong (i.e. too low, and this would make the cost of equity higher).

The company itself described the position — in Brazil, it earns €2bn cash from operations, out of €7.5bn for the group (post-capex). Nearly all the group debt is funded in euros and leverage expands as FX devalues. Brazilian credit markets are not liquid enough for the size of Telefónica; the cost of debt would be much higher (Brazil 10-year yield is 9.2%) and it cannot hedge. At 9M'18, currency moves had cut EBITDA by €1.2bn, free cash flow by €330m, but net debt by only €106m. Telefónica actually has net cash in Brazil and no meaningful debt in the UK.

Investors considering exposure to the equity component of Telefónica's capital structure need to bet on the free money era continuing in Europe forever (or at least the rest of their careers) — and even then, the rewards for buying the stock are not significant. The risk/reward on shorting stocks such as this remains very attractive. No revenue growth and debt are key ingredients of good shorts, and Telefónica clearly fits that category. There are much worse offenders in Europe (including Telecom Italia), but we start here.

Telefónica versus 10-Year Yields

The table below shows Telefónica's EBITDA share by region. The key point here is that 48% of EBITDA is in countries with bond yields of 9% (Brazil) to 21% (Argentina). Telefónica should be paying at least 5.8% on the debt, compared to the 3.45% today. That would be pricing the company at parity with the sovereign debt. This is nominal debt; considering inflation, Telefónica has a negative real cost of debt.

Exhibit 1: Telefónica Split of Earnings by Region and 10-year Government Yields Therein

Region	% EBITDA	10-year
Spain	31%	1.5%
UK	10%	1.27%
Germany	11%	0.3%
Brazil	26%	9.2%
Other LatAm	22%	13%
Telefonica Group (synthetic)		**5.8%**

Source: Bloomberg, Company Filings

So What? Equity Is NOT Debt

Investors may say, *So what? This has been the case since 2010*. The company has also fixed 76% of the debt and has an average duration of 9.2 years (at Q3'18). A 100bps move in interest rates hits free cash flow through increased finance costs by €75m in the medium term. We think the market changed in 2018 after a 10-year bull run, and investors need to think seriously about where they stand as equity holders in large capital structures, ranking subordinate to the debt holders. In a company like Telefónica, investors must also live with significant regulatory risks, the pension holders, government licensing, the massive employee base, and local governments and suppliers, who are all competing stakeholders in the business. Like with the large German conglomerates such as ThyssenKrupp, Siemens, and Bayer, it is very difficult an equity holder to get true value out of such sprawling industrial businesses as. Telefónica is a small country in itself.

We discuss Telefónica's real equity free cash flow below, but essentially the headline number of €5bn is deceptive. After headline free cash, Telefónica pays pension costs (guidance of €600-700m), ~€350m of hybrid-equity costs, €2bn equity dividend (based on FY'17 pay out), and €1bn of spectrum costs (forecast FY'19e), leaving, at best, €1bn to de-lever.

From €42bn of headline net debt, it is going to take a long time for equity holders to claim their residual value. Telefónica is not even a cheap stock, aside from the headline EV/EBITDA ratios (6x), which is also deceptive due to the minority holder considerations for Brazil (Telefónica owns 74%), Germany (Telefónica owns 70%), and other potential liabilities we discuss below.

'Cheap' Equity Valuation Is an Illusion

Telefónica's headline equity free cash flow of €5bn could get some naïve analysts somewhat excited. That is a 12% yield — and last year's dividend of €0.4 per share is a 5.2% yield. However, Telefónica now guides on free cash flow pre-spectrum payments, prior to the pre-retirement commitments and prior to the payment of coupon on hybrid equity instruments (€354n in FY'17). On hybrids, the company has conducted some 'liability management' which should bring €60m annual savings on total instruments of €7.5bn.

In the last two years, spectrum payments have been low relative to 2015, but they are set to increase significantly in the coming years. Consensus models €1.35bn and €1.6bn, respectively, for FY'19e and FY'20e. These have averaged €1bn p.a. since 2011.

We consider the hybrid coupons in the equity free cash flow calculation (alternatively, we could capitalise hybrid equity as additional net debt). Pre-retirement cash payments are now guided at €600-700m (€696m in FY'17). These will increase in FY'18 before going back to historic levels. We also consider additional likely cash burden on equity holders of restructuring costs, refinancing costs, litigation & expenses, and unwinding of extended supplier payment terms.

Exhibit 2: Telefónica Only Has €1bn Left Over Each Year to Reduce Debt

Metric (€bn)	FY'15	FY'16	FY'17	FY'18e	FY'19e	FY'20e
OIBDA	***13.2***	***15.1***	***16.2***	***15.9***	***16.2***	***16.5***
Cash from Operations	***13.6***	***13.3***	***13.8***	***13.8***	***14.1***	***14.4***
Net Capex	*-8.9*	*-8.6*	*-8.3*	-8.5	-8.5	-8.5
Minority Dividends	*-0.5*	*-0.5*	*-0.6*	-0.5	-0.5	-0.5
Free Cash Flow (headline, pre-spectrum)	**4.8**	**4.7**	**4.9**	**4.8**	**5.1**	**5.4**
Spectrum payments	*-1.6*	*-0.3*	*-0.4*	-0.7	-1.4	-1.6
Pre-retirement commitments	-0.7	-0.4	-0.7	-0.8	-0.7	-0.7
Hybrid coupons etc.	*-0.3*	*-0.3*	*-0.4*	-0.4	-0.3	-0.3
Suppliers extended credit	*0.0*	*-0.2*	*-0.7*	-0.2	-0.2	-0.2
Adjusted Equity Cash Flow	**2.2**	**3.4**	**2.8**	**2.8**	**2.6**	**2.6**
Equity dividends	*-2.2*	*-2.4*	*-1.9*	-1.9	-1.9	-1.9
Available to delever	**-0.1**	**1.0**	**0.9**	**0.9**	**0.7**	**0.7**

Source: Bloomberg, Company Filings

Here's the rub:

1. Telefónica's real equity free cash yield to de-lever is minimal. After considering spectrum, pension, hybrid instruments, and equity dividends, Telefónica will not reach €1bn per year to reduce debt.
2. Cash yield to equity is approximately below €3bn, or sub-7.5% yield on the equity (post interest payments). It is hard to argue the stock is cheap even on this basis. In fact, most valuation arguments come down to the historical underperformance of the stock, rather than fundamentals. Telefónica, as a group, is unlikely to deliver real earnings growth, and nominal organic growth is running at 2% in FY'18.
3. Without a dividend cut, it will take approximately over 40 years to clear the debt. If we amortise the debt repayments in a straight line over 25 years, there is negative cash flow for equity holders. Of course, Telefónica can carry debt, but that is a useful thought experiment to put the leverage in context. As we have already discussed in this note, Telefónica is by no means the worst offender on Europe on leverage and cash flow.
4. The future of the capital structure is clearly heavily reliant on sustaining the 3.45% average cost of debt and constant refinancing in cheap European markets. Higher underlying debt costs and any losses to the debt holders will likely have negative consequences for the equity valuation.

Additional Liabilities & Assets

Telefónica's EV swells closer to €100bn when you consider additional liabilities. The market cap (€40bn) and net debt (€42bn) do not tell the whole story.

- Telefónica has annual pension commitments of €600-700m, which comes out after net income and after the headline free cash flow (of ~€5bn as discussed above). Capitalising these adds another €6bn to the EV.

- The hybrid loans carried at equity are paying €350m of coupons to quasi-debt holders. Capitalising these adds another piece to the EV. We could add another €3.5bn here.

- Vendor financing has been significant in recent years, with Telefónica getting extended payment terms (extended payables), which is viewed as a positive for the company. As this unwinds, it creates additional headwinds on underlying free cash generation (although this is decreasing). In the cash flow statement and liability notes, we see this factor as shown below.

Exhibit 3: Telefónica's Extended Payment Terms Are a Drag on Cash Flow

In 2016 and 2017 the Group entered into agreements to extend payment terms with various suppliers, and with factoring companies when such payments are discounted. When the new extended payment terms exceed customary payment terms in the industry, trade liabilities are reclassified to other financial liabilities and the deferred payments made are recognized in net cash flow used in financing activities (see Note 20). At December 31, 2017 the corresponding amount pending payment, recognized in "Loans and other payables", was 153 million euros (210 million euros at December 31, 2016). The deferred payments made in relation to this item during the year amounted to 717 million euros (1,758 million euros in 2016).

Source: Telefónica AR 2017

- Spectrum costs are significant. Telefónica will pay €650m this year for UK spectrum, and faces a big sale in Germany next year (consensus of €1bn cost per player). In 2020, spectrum is up for auction in UK (700Mhz), Spain (700Mhz), and possibly in Brazil. That is another €1bn per year out of equity free cash flow. After €1.6bn payments in 2015, Telefónica has benefitted from two relatively benign years. In 2019 and 2020, consensus is at €1.35bn and €1.65bn respectively. Therefore, deleveraging capacity slips well below €1bn p.a.

Exhibit 4: Spectrum Payments Will Increase; the Average Is ~€1bn since 2011

	FY'11	FY'12	FY'13	FY'14	FY'15	FY'16	FY'17	FY'18e	FY'19e	FY'20e	Average
Spectrum Payments (€bn)	-1.3	-0.6	-1.2	-1.3	-1.6	-0.3	-0.4	-0.7	-1.4	-1.6	-1.0

Source: Company Filings, Company Guidance & Analyst Estimates, Completed January 2019

- Mexico is a black spot, burning 'a few hundred million euros' per year of cash. AT&T is in the market (formerly Iusacell) and, according to Telefónica IR, there is rumoured private equity interest in the market. However, Telefónica has <10% revenue share in this market it has been unable to crack due to the strength of the incumbent. Margins are in the teens, with play capex spending at 20% of sales. Mexico is possibly a liability and faces regulatory headwinds.

To switch to a more positive tone, the company does have some unrecognised assets that may be overlooked by the market.

- Tax loss carry-forwards direct on the balance sheet are disclosed at €2.8bn, primarily with €1.5bn in Spain. This offers some tax shelter and could be considered an asset for equity holders. The company claims total DTAs of €7.8bn could be considered in a sum of parts.

- Infrastructure assets including property, data centres, submarine cable, and spectrum may add another few billion euros. For example, Telefónica is decommissioning the copper in Spain by 2024, which leaves over €1bn of book value available for disposal (the company has been booking gains on sales of the 150 out of 6,000 central offices already). The total balance sheet PPE is €34bn, of which €4.4bn are in property assets.

- The company owns the No. 2 IT services company in Spain and has 10m video customers worldwide. This has been viewed as a loss-making business by the street due to content costs but could also be pitched as an asset. In addition, there are stakes in BBVA, China Unicom, and other minorities worth €0.7bn and treasury stock representing 1.3% of the capital.

- In 2017, Telefónica sold a large minority stake in Telxius (towers and submarine infrastructure) to KKR, valuing 100% at €3.7bn.

- Peru and Chile are reported to be on a better trend, and Colombia is a good market in which the company is doing well. These could all be candidates for disposal, but even a sale of the entire 'North Hispamerica' division will not yield more than €1-2bn after considering minorities.

There's Something Missing in the Sum of Parts

Giving a generous €40bn to Spain (€5bn EBITDA and €3.3bn of cash flow in FY'17), €14bn to UK (€1.6bn EBITDA FY'17 and €0.8bn cash flow), and considering Brazil and Germany (ex-minorities) at current share prices still leaves a mismatch between a simplified sum of parts and Telefónica's EV. We assume equity investors would want to be buying the stock at a big discount to a sum of parts. We cannot get up to the current valuation of the company on a sum of parts basis and are missing €10bn — we are debating this balance with the company at the moment. The costs and reallocation of liabilities in breaking up Telefónica would be significant, and although investors may debate our valuation of the large assets, such as Spain, it is not necessarily going to move the dial on the €100bn of EV calculation that needs to be justified. Investors would need upside to buy the stock, and we struggle to find it.

Spectrum payments are not capitalised in our value as they would not be incurred in break-up, but rather need to be won in a future auction. However, it is worth considering the future liabilities of spectrum to stay in the game for Telefónica equity holders.

Exhibit 5: Crude Sum of Parts Relative to EV of Telefónica

Measure	€bn
Market Cap	40.0
Net Debt	42.0
Pension commitments	6.5
Hybrid instruments	7.5
Total EV	**96.0**
Spain	***40.0***
Brazil (74%)	***13.3***
Germany (69%)	***6.6***
UK-O2	***14.0***
Mexico	-1.0
Other LatAM	8.0
Telxius (Towers)	2.2
Spain IT Services Co	2.0
Deferred Tax	3.9
Infrastructure Assets	3.0
Other stakes (BBVA, China Unicom etc.)	0.7
Treasury Shares (1.27% capital stock)	0.5
SOTP	**92.7**

Source: Company Filings, Bloomberg, Company Guidance, Analyst Estimates Completed 2019

Bulls should therefore revert to an asset-based or replacement cost argument. Telefónica has invested €79bn in fixed assets and spectrum since 2012 (€45bn in the last five years). This plays against €40bn of equity value (net book value €27bn) and €34bn of PPE (depreciated value). Telefónica has significant fixed asset backing and could be an asset play for activists in particular. We struggle with this argument considering the fundamentally deflationary nature of telecom services. The incremental cost of volume provision to the client is zero as Telefónica has no incremental cash cost of expanding revenue. This means markets can remain fundamentally competitive despite consolidation. When fibre is rolled out and customers have been won, the only way to grow is to compete again for customers on price and service offer. The fibre network is new and is probably Telefónica's strongest asset (particularly in Spain and Brazil), and should provide the backbone for the next 40 years. However, as we have discussed above, that is how long it would take the company to repay the debt, and the stock is not exactly at a big discount to asset value. We would like to do more analysis on this point.

The company argues that it has gone through the deflation, which is a must when going into convergence (e.g. in Spain). Over the last couple of years, the company has seen revenue growth return via pricing and upselling. For example, the Fusion revenues over the last two years have grown on pricing increases and ARPU has grown above 10%. Telefónica sees revenue growth as an 'enriched data journey' monetising improved networks, video, fibre, content, ultra-HD, and other services to increase customer engagement. Churn falls, ARPU grows, and revenue moves forward (i.e. inflation, not deflation). However, we argue all this improvement has to be supported by offering more and more to the customer in terms of service, data, and products. Telefónica has to keep differentiating the offer to improve pricing power.

A disposal or IPO of O2 in the UK would be a positive headline and potentially clarify a €15bn asset (40% of the market cap). Separately listed, UK debt could be matched to the asset. At the moment, unfortunately GBP is a 'soft' currency which is devaluing against Telefónica's euro debt. With Brexit still the source of most uncertainty in the UK, a listing of O2 would be highly unlikely. Activist focus on LatAm assets might be compelling, but we do not see anything outside of Brazil that would move the dial for the whole company's valuation.

The Bull Case? Not Exciting

Telefónica is disliked by the market, has underperformed for years, and looks 'cheap' on traditional equity measures. The management team has refocused on return on capital, categorising every business into *core*, *develop*, or *dispose* (by country and by type of business). Disposals are likely in LatAm, where Telefónica is very challenged in Mexico and is present in many markets such as Chile, Peru, Colombia, Argentina where either the competitive landscape, scale, or macro environment is a challenge.

Spain and Brazil Are Improving

The Spanish business is a prize asset. In a converged market, Telefónica is No. 1 in fixed and mobile and approaching the end of the fibre roll-out with 80%+ of households covered and wholesaling to the other operators. Spanish margins are 40%, whilst capex/sales has dropped to 13%. The market is competitive, but rational, and has been consolidated. In Brazil, Telefónica is the leader with 40% of contract connections and 25-30% of fixed line. The company may have 40-50% revenue share in Brazil and 80% share of cash flows and profits. EBITDA margins are 37% and growing, but capex is still elevated at 20%. This is a valuable asset with net cash. However, it is in a devaluing currency and supported by potentially unsustainable debt costs in Europe. Brazil is listed and Telefónica's 74% stake is worth €20bn. The company sees the economy improving in 2019 post the election and the possibility for consolidation (Telefónica could not participate, but would benefit).

UK O2 Is a Good Asset

O2 was targeted by Hutchison for €14bn, but the deal was blocked by regulators. This is a good mobile-only operation with good customers, low churn, high APRU, and strong brand positioning. The UK market should converge further over time and there will be buyers for this asset from the fixed space. An IPO has been shelved due to Brexit, but Telefónica wants some currency for the asset, which is also debt-free. The UK business can be €15bn or more, on top of good assets in Spain and Brazil.

Germany Is More Challenged

This market generates €1bn of cash flow. Fibre roll-out is expensive, and Telefónica has a mobile-only asset in a competitive (but rational) market. The Liberty/Vodafone deal is under regulatory scrutiny now, but Telefónica also lost customers loyalty during the integration of the KPN network. ARPU declined and churn increased, but the company claims to be scoring better on network quality now. Germany is listed with €9.4bn market cap, valuing Telefónica's stake at €7bn.

A price of €40-45bn for Spain and €20bn for Brazil supports 60% of the EV of Telefónica today. Both these regions are improving and Spain is doing well. Growing revenue and profits pose a risk for the short case.

Conclusion

We add Telefónica as a liquid, mega-cap Short recommendation with attractive risk/reward. One of our big shorting themes by the end of 2018 was European roll-ups with debt. Telefónica expresses most of our corporate governance concerns in our Short Screen and flags on ECB and Schuldschein debt raisings. It is big and complex, but we are prepared to have a go after doing the work described above.

Setting a price target on such a complex and large set of assets is an art form, so we are interested in the direction of travel given the liquidity in the name. We would suggest investors require more than a 5% yield in the current environment, considering the dividend is stretched and leaves less than €1bn net cash flow to reduce absolute debt levels going forward. EBITDA should nudge forward, which will also contribute to deleveraging.

We take our net free cash flow estimate of €2.6bn for FY'19 and FY'20 and suggest a 10% yield is more appropriate, whilst putting the dividend of €0.40 per share on 8% that would give downside to €26bn of market cap (EV of €86bn); this would begin to offer some value in a break-up scenario. This is about €5 per share, which of course will be heavily dependent on the financing environment in European debt markets.

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