

Telefonica and Telecom Italia

Alert: 'Argentinean Blues'

■ Industry Overview

- **'Blue dollar' moves away from official exchange rate** — The parallel (*el blue*) ARS/\$ exchange rate has started to diverge from the official rate in recent months. As a proxy for the parallel exchange rate, we use the dual listing of TEO and compare the ADR price with that of the Buenos Aires listing. The implied ARS/\$ has moved from ARS4.63/\$ in February to ARS6.64/\$ in August (see Figure 1 on page 2), compared to a ARS4.6/\$ official rate. We see significant forex risk in the coming quarters, which could impact adversely reported trends for TI and TEF as well as the leverage ratios of the two groups.
- **Implications for TEF** — Argentina generates 5.9%/4.4%/4.4% of group revenues/OIBDA/OpFCF on our 2012 estimates but just 3.2% of the EV in our SoP. Should ARS/\$ move closer to the 'blue' rate, it would imply 1/3 downside in €-terms for the Argentinean numbers. Net debt should not be impacted as TEF had a €193m net debt position at the end of 2011, which we expect to turn to a small net cash position by the end of 2012. This follows our report on the potential devaluation of the VEF/\$, after the general election in October (see [Telefonica: Is another VEF devaluation due?](#)).
- **Implications for TI** — The impact would be significant for TI on a reported (consolidated) basis: 12%/9%/9% of 2012E revenues/EBITDA/OpFCF come from Argentina. But the impact would not be material on an underlying basis as Argentina is 2% of value and 4% of net income. TEO had a net cash position of P\$2.3bn in 1H (or c.€380m), which we expect to grow closer to €600m by year-end. Rating agencies do not give TI extra credit for Argentina, due to its low economic stake, but depreciation closer to the 'blue rate' would see a decline in the value of TI's net cash position (by €200, or 1/3). TI has a very tight net debt target of €27.5bn to meet.
- **What to look for** — Sustained weakness in forex could drive c.1.5% downgrades to EPS for each group, but the impact on headline estimates would likely have a disproportionate impact on sentiment, especially given the ambitious deleveraging targets that both companies must deliver. We believe TI may be marginally worse-off due to the direct impact on consolidated net debt and higher impact on headline numbers. But this does not change our relative stance.
- **Reiterate preference for TI** — We have a Buy rating on Telecom Italia with a €1 (€0.85) price target for the ordinary (savings) shares. We have a Neutral rating on TEF with a price target of €9. Telecom Italia savings shares are in our Most Preferred list, paired against Telefonica in our Least Preferred list. We believe that TI offers significant upside, given a current valuation that offsets downside risks due to the sovereign crisis. On the contrary, we believe that TEF offers limited upside in an improved environment and faces similar downside risks despite being better diversified than TI.

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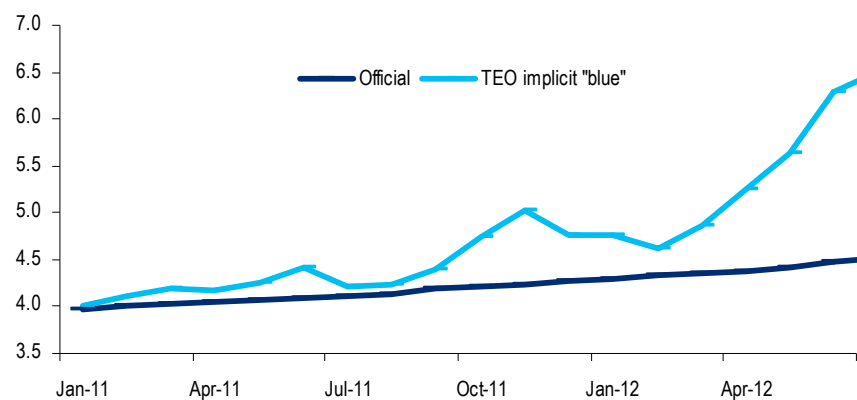
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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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Figure 1. Official exchange rate versus implicit 'Blue' rate using TEO's dual listing



Source: Citi Research

Telefonica SA

(TEF.MC; €8.72; 2)

Valuation

Our valuation of TEF and €9.0 target price are based at a 10% equity discount on our 25-year DCF, which fades the ROCE close to the cost of capital in the longer term. We use a WACC of 9.5% and 1.5% perpetuity growth rate from year 25.

Risks

Downside risks that could impede the share price from reaching our target price include: acquisitions, changes in regulation, macro issues including currency fluctuations. Growth rates in the many different Latin American markets may diverge markedly from our expectations. If the impact of these risk factors is less negative than we anticipate, then the share price might rise above our target price.

Upside risks include a sale of non core assets like China Unicom shares; consolidation of the Spanish mobile market; lower financing costs on improvement in the perception of Spanish sovereign risk.

Telecom Italia SpA

(TLIT.MI; €0.63; 1)

Valuation

Our valuation of TI and €1 target price is based on an 8% discount to our 25-year DCF which fades the ROCE close to the cost of capital in the longer term. We use a WACC of 8.4% and 1.5% perpetuity growth rate from year 25. The perpetual growth in cash flow implied from year four from these assumptions is -0.7%.

Risks

TI has relatively high financial leverage, ownership uncertainty remains through the Telco holding company, and turnaround of its domestic mobile business remains a key risk. If the impact of these risk factors is more or less negative than we currently anticipate, then the share price could fail to reach or exceed our target price.

Telecom Italia SpA(savings shares)

(TLITn.MI; €0.55; 1)

Valuation

Our €0.85 target price for TI saving shares is derived by applying a 15% discount to the current ordinary share €1 target price and rounding to reflect the lack of voting rights, consistent with its recent trading level in the market.

Risks

TI Savings shares have similar risks to the Ordinary shares, namely the risks from the controlling shareholders seeking to transfer value from TI to themselves and risk around the turnaround of its domestic mobile business. If the impact of these risk

factors is more or less negative than we anticipate, then the share price could fail to reach or rise above our target price.

Appendix A-1

Analyst Certification

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IMPORTANT DISCLOSURES

Telefonica SA (TEF.MC)

Ratings and Target Price History

Fundamental Research

Analyst: Georgios Ierodiaconou

Covered since December 10 2010



	Date	Rating	Target Price	Closing Price
1	22-Jan-10	*2M	*18.21	17.74
2	5-Mar-10	2M	*18.01	17.71
3	18-May-10	*1M	*17.23	15.39
4	15-Jun-10	1M	*16.93	15.97
5	3-Aug-10	*2M	*17.23	17.51
6	14-Oct-10	*2L	17.23	19.15

* Indicates change

	Date	Rating	Target Price	Closing Price
7	19-Jan-11	*2M	17.23	17.63
8	21-Apr-11	2M	*16.24	17.33
9	22-Sep-11	2M	*13.29	12.92
10	7-Oct-11	Stock rating system changed		
11	8-Oct-11	*2	13.29	14.71
12	24-Nov-11	2	*12.80	12.66

	Date	Rating	Target Price	Closing Price
13	18-Apr-12	2	*11.32	10.91
14	22-May-12	2	*10.50	9.99
15	1-Jun-12	2	*9.50	9.00
16	26-Jul-12	2	*9.00	8.95

Rating/target price changes above reflect Eastern Standard Time

Telefonica SA (TEF.MC)

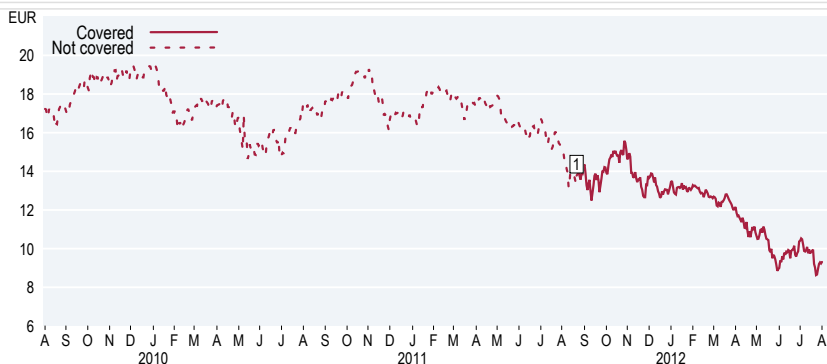
Ratings and Target Price History

Best Ideas Research

Relative Call (3 Month)

Analyst: Georgios Ierodiaconou

Covered since December 10 2010



	Date	Rating	Target Price	Closing Price
1	22-Aug-11	*ADD LP	-	13.78

* Indicates change

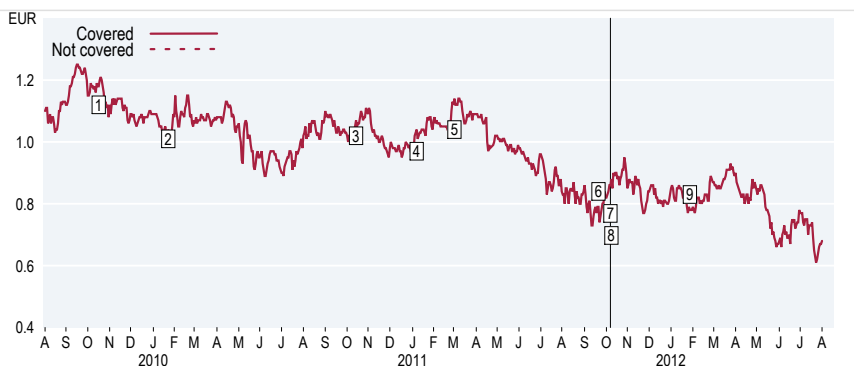
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Telecom Italia SpA (TLIT.MI)

Ratings and Target Price History

Fundamental Research

Analyst: Georgios Ierodiaconou
Covered since December 10 2010



	Date	Rating	Target Price	Closing Price
1	16-Oct-09	1H	*1.40	1.18
2	22-Jan-10	*2H	*1.10	1.04
3	14-Oct-10	*2M	1.10	1.07

* Indicates change

	Date	Rating	Target Price	Closing Price
4	7-Jan-11	*1M	*1.20	1.04
5	2-Mar-11	1M	*1.30	1.14
6	21-Sep-11	1M	*1.20	0.79

	Date	Rating	Target Price	Closing Price
7	7-Oct-11	Stock rating system changed		
8	8-Oct-11	*1	1.20	0.86
9	27-Jan-12	1	*1.00	0.78

Rating/target price changes above reflect Eastern Standard Time

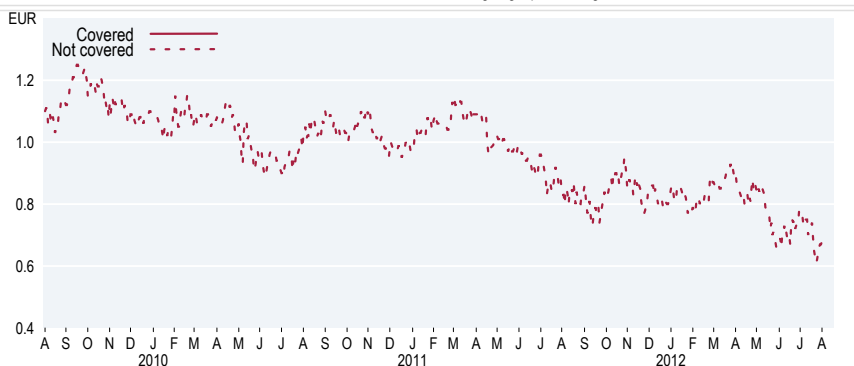
Telecom Italia SpA (TLIT.MI)

Ratings and Target Price History

Best Ideas Research

Relative Call (3 Month)

Analyst: Georgios Ierodiaconou
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* Indicates change

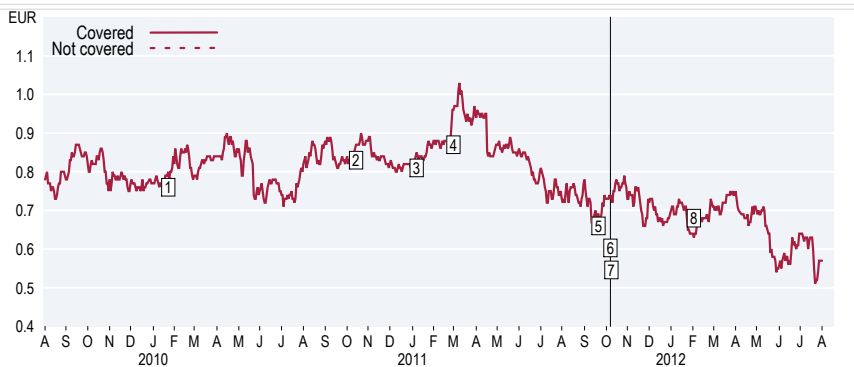
Rating/target price changes above reflect Eastern Standard Time

Telecom Italia SpA(savings shares) (TLITn.MI)

Ratings and Target Price History

Fundamental Research

Analyst: Georgios Ierodiaconou
Covered since December 10 2010



	Date	Rating	Target Price	Closing Price
1	22-Jan-10	*2H	*0.82	0.80
2	14-Oct-10	*2M	*0.88	0.87
3	7-Jan-11	*1M	*1.02	0.85

* Indicates change

	Date	Rating	Target Price	Closing Price
4	1-Mar-11	1M	*1.15	0.96
5	21-Sep-11	1M	*1.05	0.69
6	7-Oct-11	Stock rating system changed		

	Date	Rating	Target Price	Closing Price
7	8-Oct-11	*1	1.05	0.73
8	2-Feb-12	1	*0.85	0.63

Rating/target price changes above reflect Eastern Standard Time

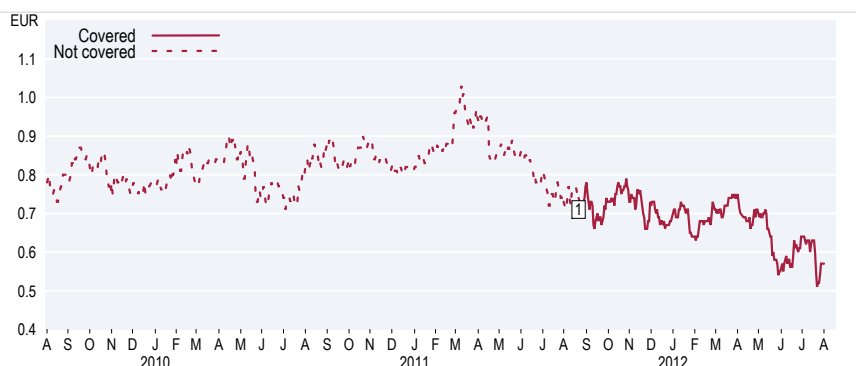
Telecom Italia SpA(savings shares) (TLITn.MI)

Ratings and Target Price History

Best Ideas Research

Relative Call (3 Month)

Analyst: Georgios Ierodiaconou
Covered since December 10 2010



Date	Rating	Target Price	Closing Price
22-Aug-11	*ADD MP	-	0.74

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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Data current as of 30 Jun 2012

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	44%	43%	40%	48%	43%	45%

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