Creating a brighter future

Webinar:
Structural Separation:
A solution to boost FTTH investments

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Webinar

- 20-25 minutes presentation
- 15-20 minutes Q&A

- Post your questions in the questions box of the webinar system
- Relevant questions that are not answered during the webinar will be answered by email

- The slides will be available for download after the webinar
- The webinar is recorded and can be viewed as video-stream afterwards. The video will be available on the website of the FTTH Council Europe within one week
- Slides and information about the availability will be sent to registered attendees by email

Starting point

- There is still an under-investment problem in the European fixed access sector

- Broadband targets of the EC´s Digital Agenda run the risk of being missed, especially in rural areas

- At the same time, there is growing recognition that these targets are too humble and need adjustments (see, for example, EP 2014/61 Z (3))

The problem defined

- How can the transition from a copper- to a fiber-based access infrastructure be achieved in order to foster growth and employement in the EU?

- What are important constraints to be considered?
    - technology neutrality (towards FTTH/B)
    - regulatory policy (competition policy in partiuclar)
    - stakeholder interests (capital owners, employees etc)
    - effectiveness and efficiency of state aid
    - sustainability

- How could the **design of masterplan** look like?

One avenue to success

- Our approach is based on the analysis of three case studies in Australia, New Zealand and Italy

- We propose to consider the STRUCTURAL SEPARATION of incumbents´ fixed access business, ie the separation of the NetCo and OpCo

- By structural separation we mean the legal, financial and operational separation resulting in full ownership separation and independence

- A spin-off is the default type for such a transaction (see overleaf)

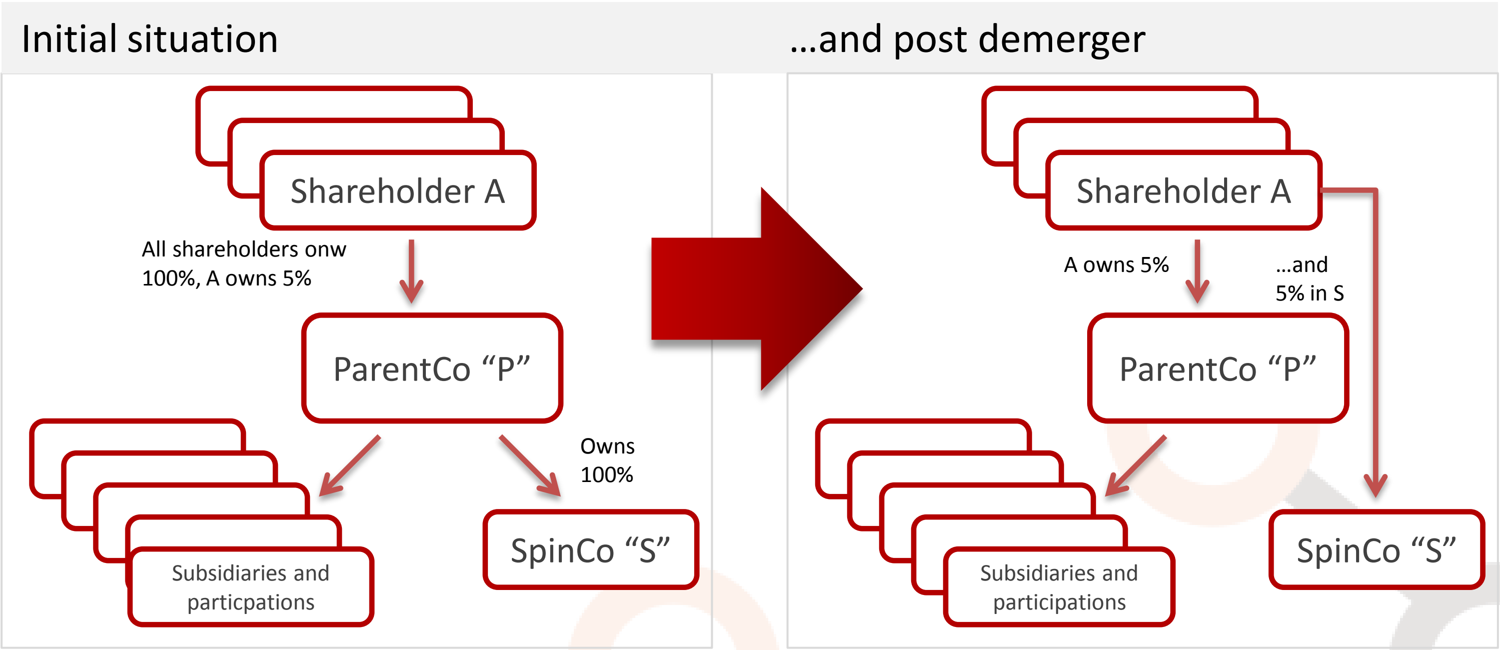
- This must be complemented by a copper-to-fiber migration plan

- Such a solution will only be feasible with the explicit consent and support of board and management

This is where our thought process starts.

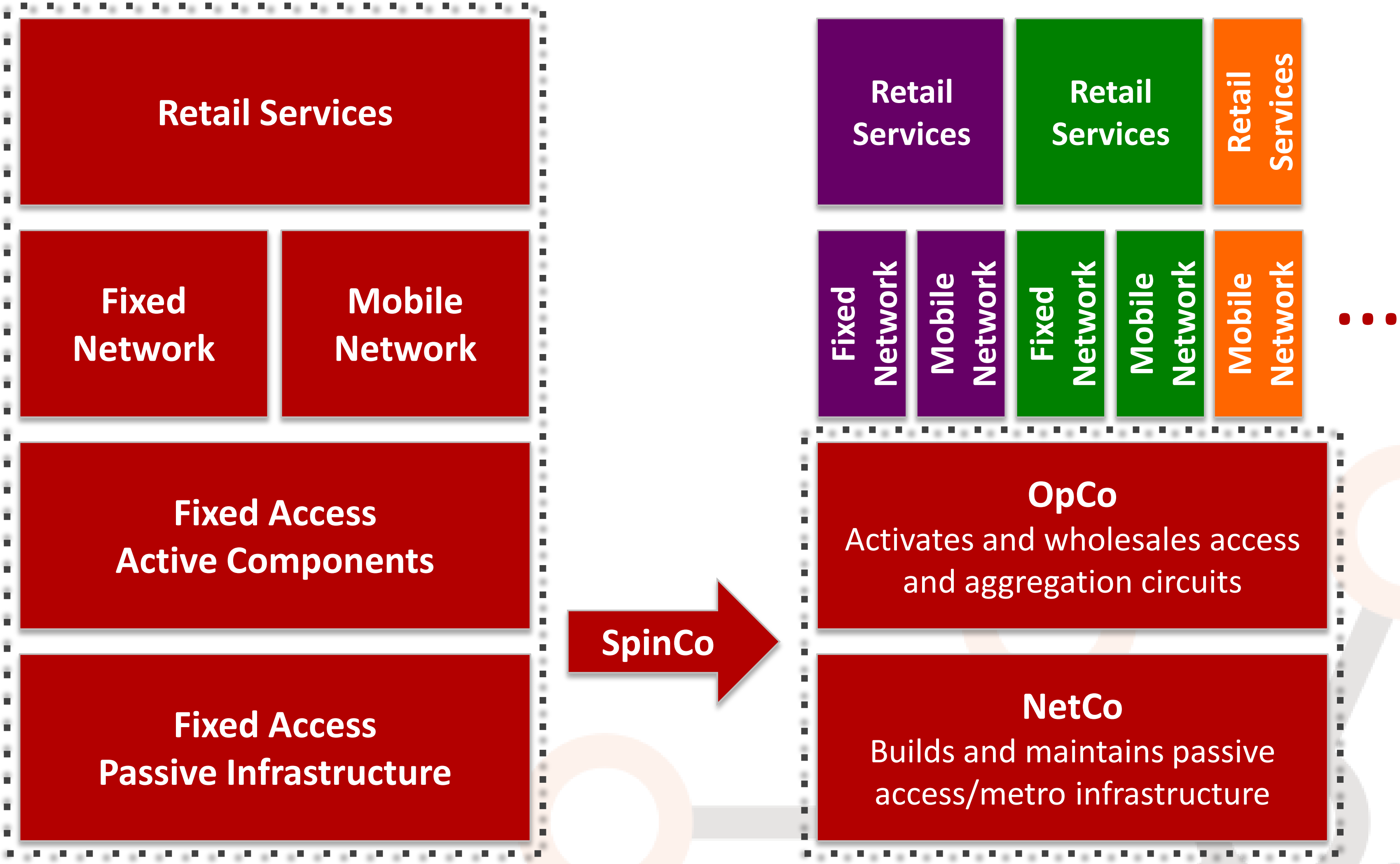
What is a spin-off?

- A spin-off creates an INDEPENDENT company through the pro-rata distribution of new shares
- Thus, shareholders own shares in two companies after the spin-off
- Example: Siemens-Osram



Source: Diffraction Analysis

What is part of the spin-off?



A spin-off looks appealing from a micro and macro perspective

- Shareholder arguments for a value release:
  - conglomerates trade at a discount
  - separation decreases complexity
  - companies become attractive for specific investors
  - last but not least: what´s the value of the *do-nothing* option?

- Macro aspects:
  - creation of an open-access wholesale platform (OpCo)
  - OpCo is a financially stable service company, also for other regional NetCos
  - a solution to many net neutrality related issues
  - a vehicle for a controlled transition to a fully fiber-based infrastructure
  - potential consolidator of regional NetCos (exit option for munis, e.g.)
  - The SpinCo would be a competitor for state aid

- **Q: Why hasn´t this approach been more broadly discussed in public?**

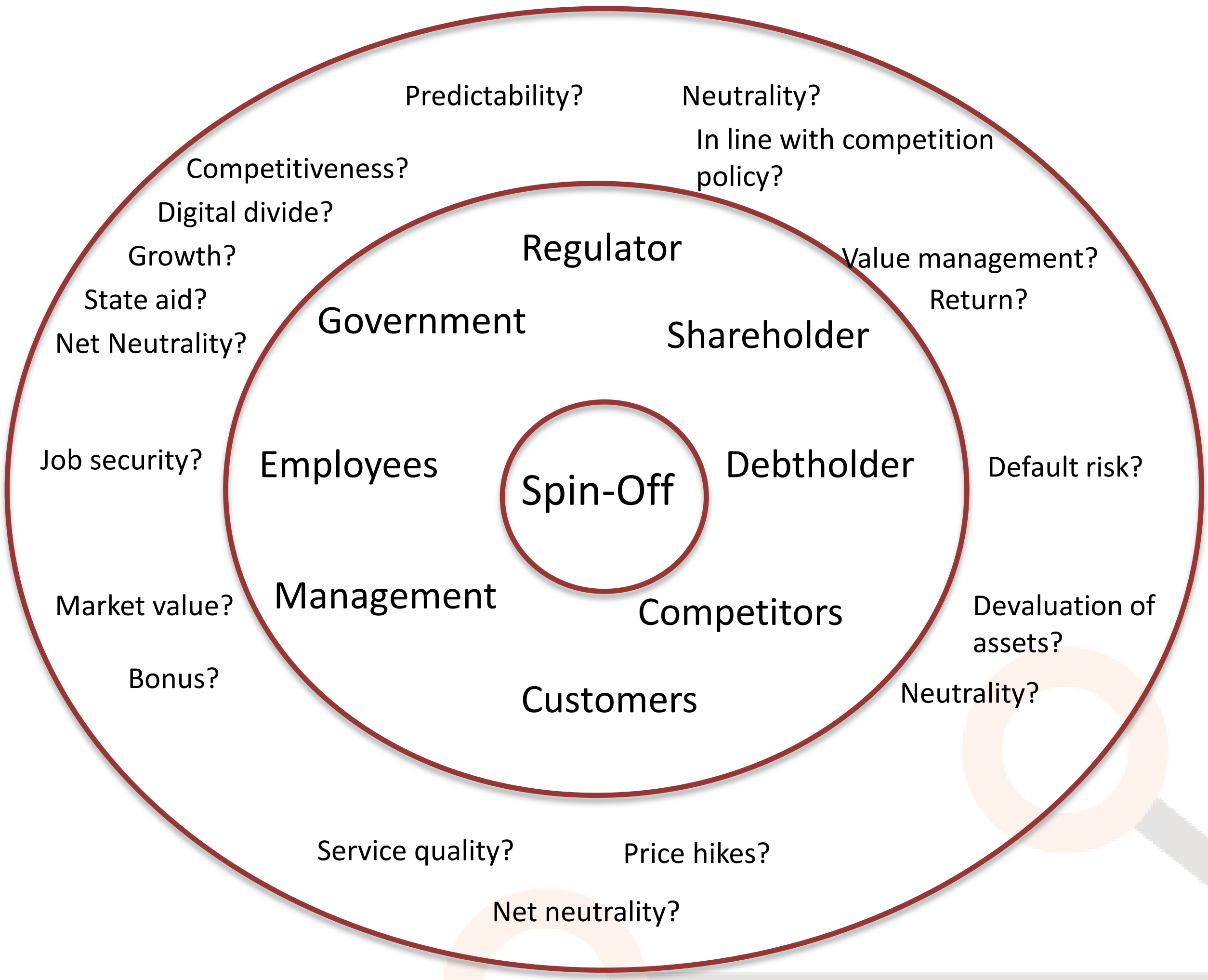
Explanation

Behavioural economics **lead to** proposing Plan B

- Board members are contracted managers, not entrepreneurs
- Information asymmetry exists between managers (so called *Agents*) and providers of capital (*Principals*)
- Managers maximise their own utility, not necessarily shareholder value (Prinicipal-Agent-Theory.) This can be suboptimal for anchor investors such as states, public banks or investment funds
- Managers adopt herd behaviour. Career considerations limit interest in unconventional measures; changes in strategy are avoided as they could be perceived as signs of weakness
- We looked at incentive schemes of larger European incumbents and find that regulated income from largely depreciated copper assets help to secure the bonus -> no incentive for investments

- If the status quo turns into a problem (competition from cable!)
- … and the concept of structural separation is banned from the agenda
- … then mangement needs to present another solution. The Digital Single Market came to the rescue!
- Incumbents promise (but not guarantee) to solve the underinvestment problem in exchange for less competition and less regulation
- Interestingly, incumbents contradict themselves by praising service-led business models but rejecting these models for themselves

Balancing stakeholder interests



Source: Diffraction Analysis

The dynamic dimension

Averting trouble in a post spin-off world

Separation structure

- transparency re employee status and rights
- hygiene factors re inter-company transactions shortly before the spin-off

Market structure

- symmetrical no-compete clauses
- clarification for fixed access segments (NGA, mobile backhaul, smart cities)
- OpCo part must offer services to other NetCos

Ownership structure

- concentration of government onwership in infrastructure
- sale or exchange of shares in the old ParentCo
- Further separation via REITs
- Opportunity of cross-border consolidation of ParentCos

Source: Diffraction Analysis

Acid Test: two critical questions

- 1) Does the SpinCo create enough cash?

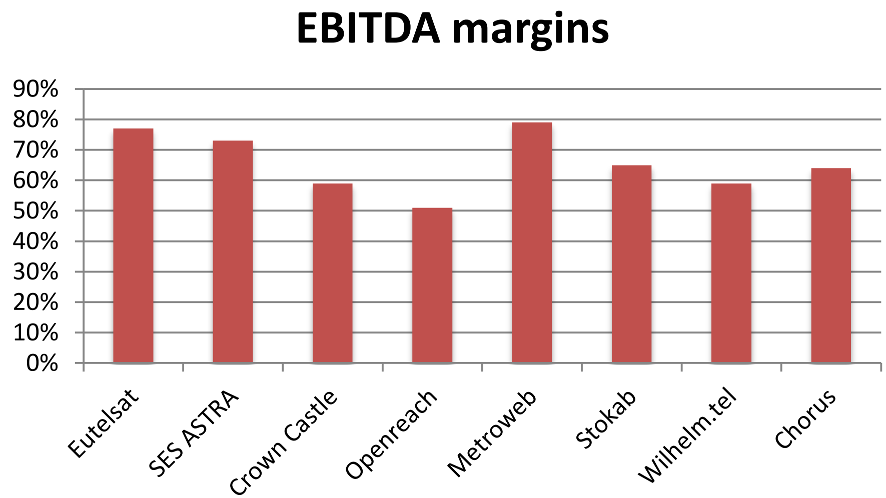
- 2) Is the value release thesis supported?

Testing the hypothesis

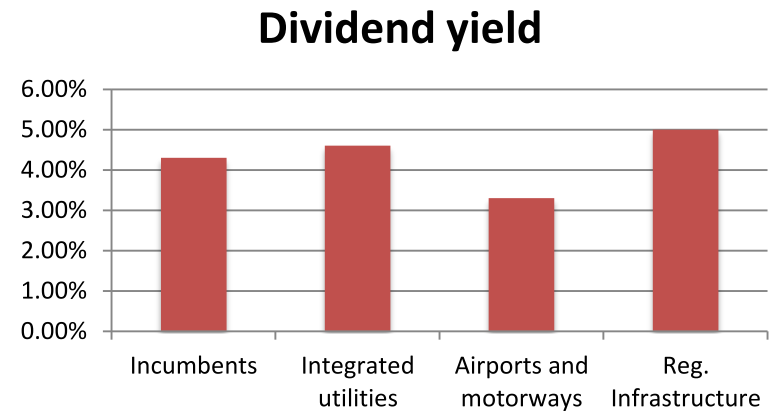
Case study

Note: all stock price data as of Oct 13

Case study (1/7) – Assumptions



Source: Company reports (latest results, except for wilhelm.tel (2011), Chorus(2012))



Source: Company reports

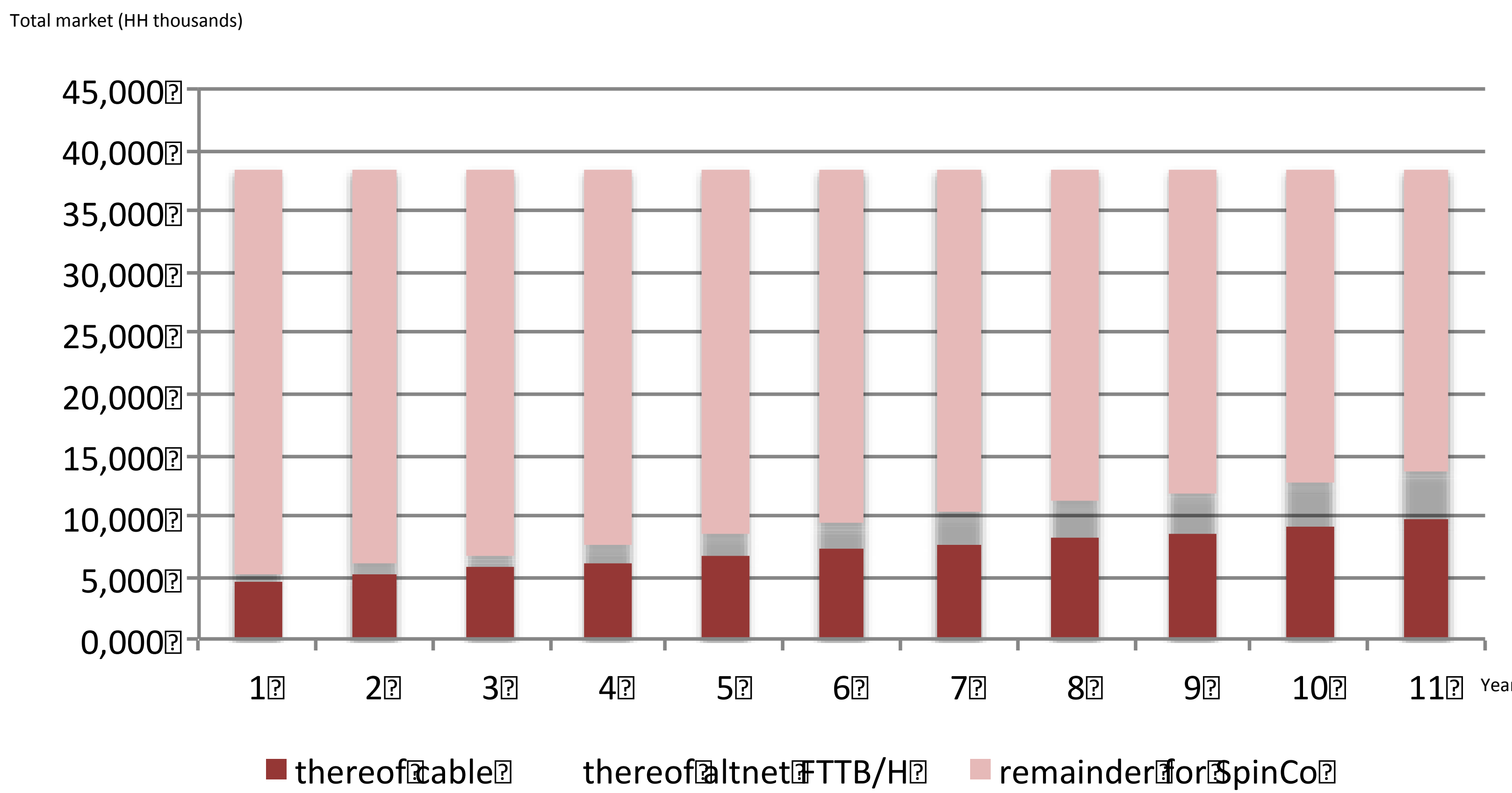
Wholesale pricing

Category	No of lines (m, average 2013)	Revenues (€m)	per line pa (€)	per line per month (€)
ULL	9,3	1220	130,7	10,9
Wholesale	1,9	422	222,5	18,5

Source: DTAG 2013 results

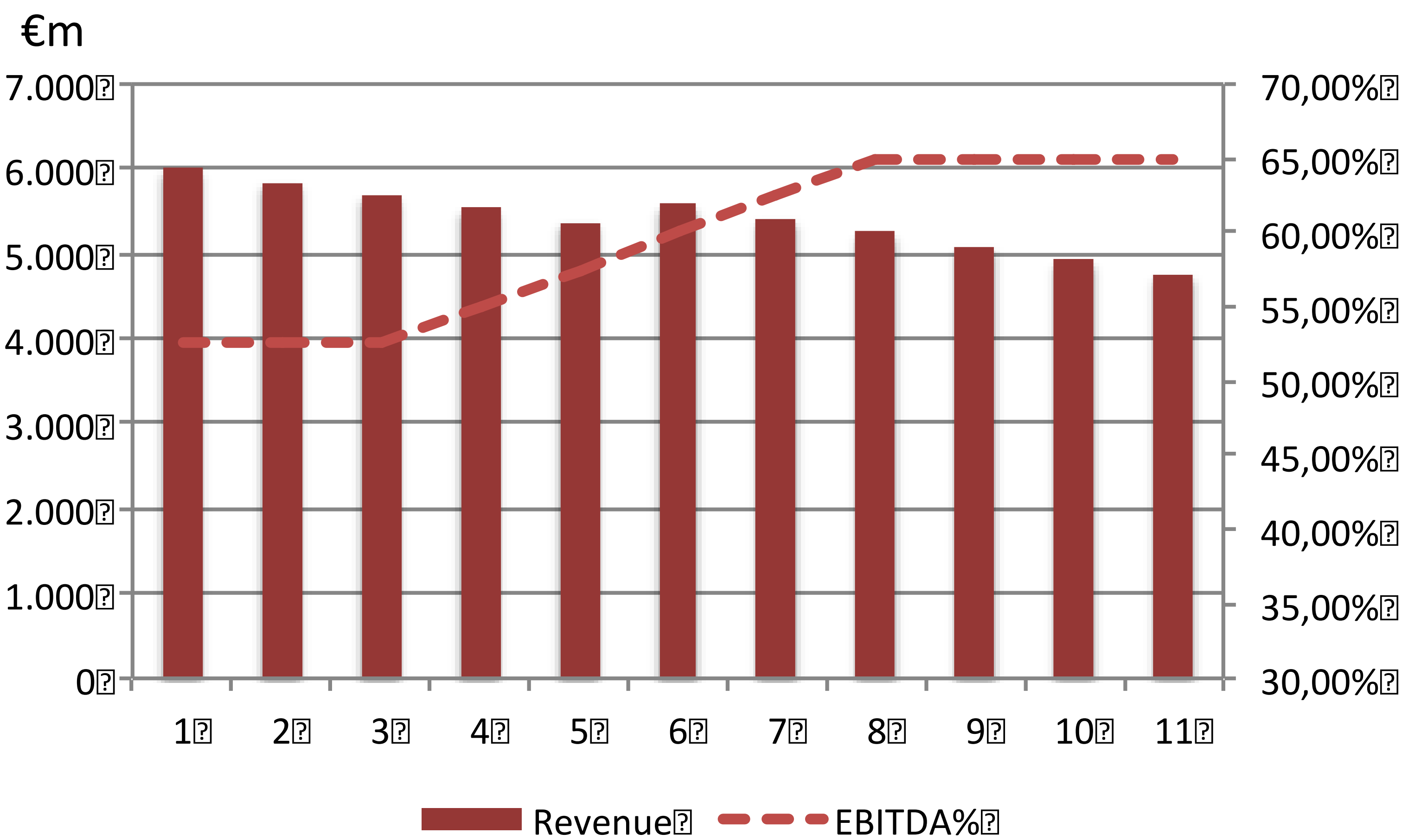
NOTE: This implies a price of ca. €14,7 assuming „DT Retail“ would buy Bitstream only

Case study (2/7) – Base case



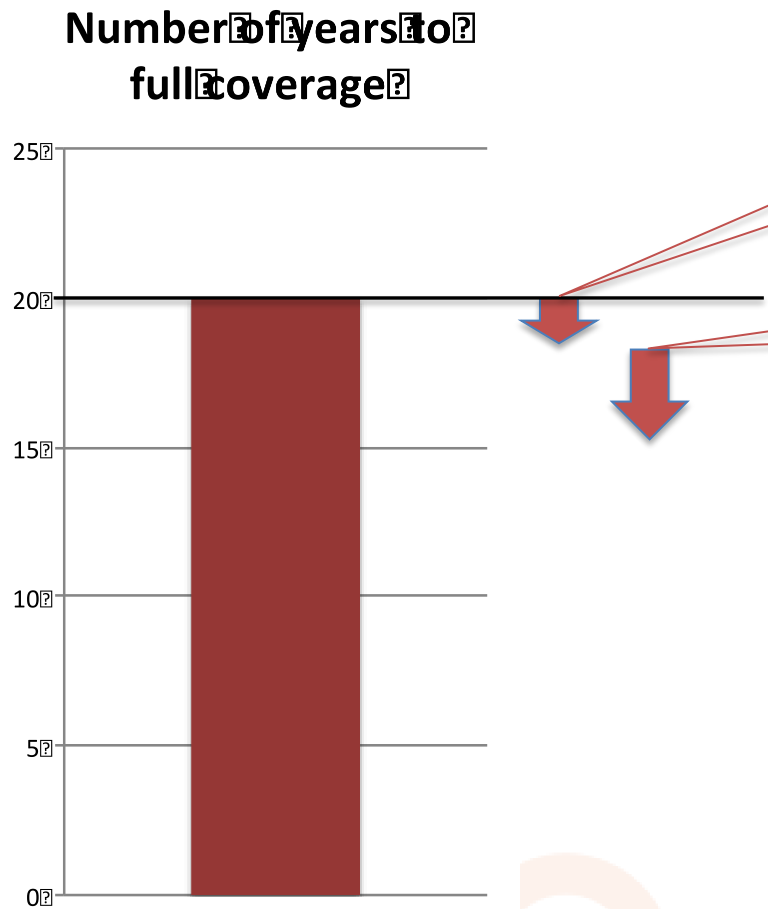
Source: Diffraction Analysis

Case study (3/7) – Base case



Source: Diffraction Analysis

Case study (4/7) – Base case



Higher leverage (50bps equal c. 1 year)

State Aid of €5bn leads to another acceleration by c. 3 years

Answer to question 1:

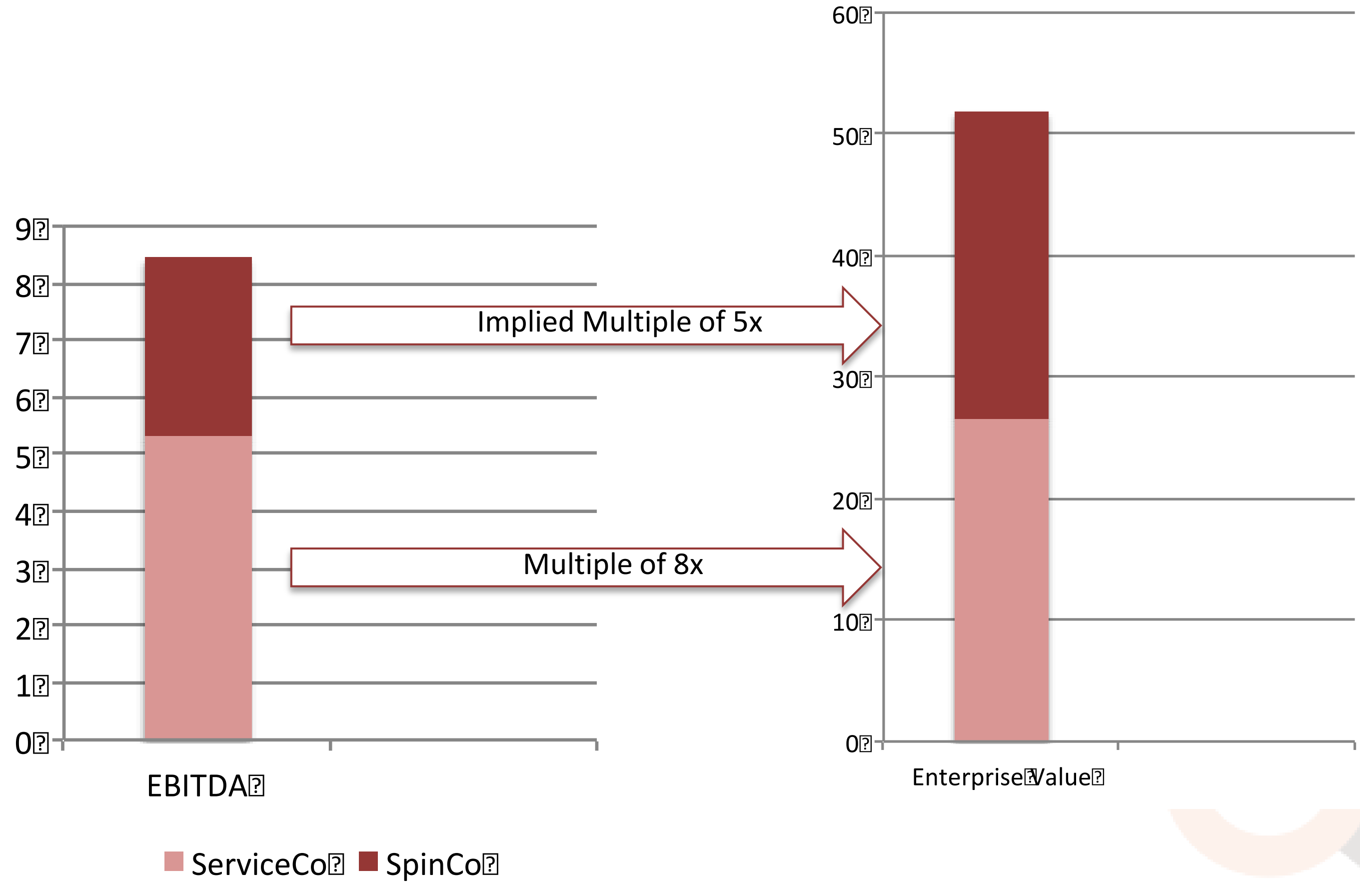
Source: Diffraction Analysis

Note: Average capex per HH connected and activated is €1,125

Case study (5/7) – Valuation Germany

- We take EBITDA estimates for DTAG Germany (2015E)
- And substract the SpinCo´s EBITDA
- We apply a «break-even» multiple to the remainder ...
- And compare this to comparable market multiples

Case study (6/7) – Valuation Germany



Case study (7/7) – Valuation

- Our EBITDA estimate is based on the initial margin profile. But Investors will likely anticipate margin expansion and less market for cable.
- Analysts´ valuation relate to target prices, not the explanation of current prices (targets are ca. 0-10% above DTAG´s current share price)
- The SpinCo multiple of 8x EBITDA looks unambitious (tower companies trade at multiples of 17x EBITDA!)

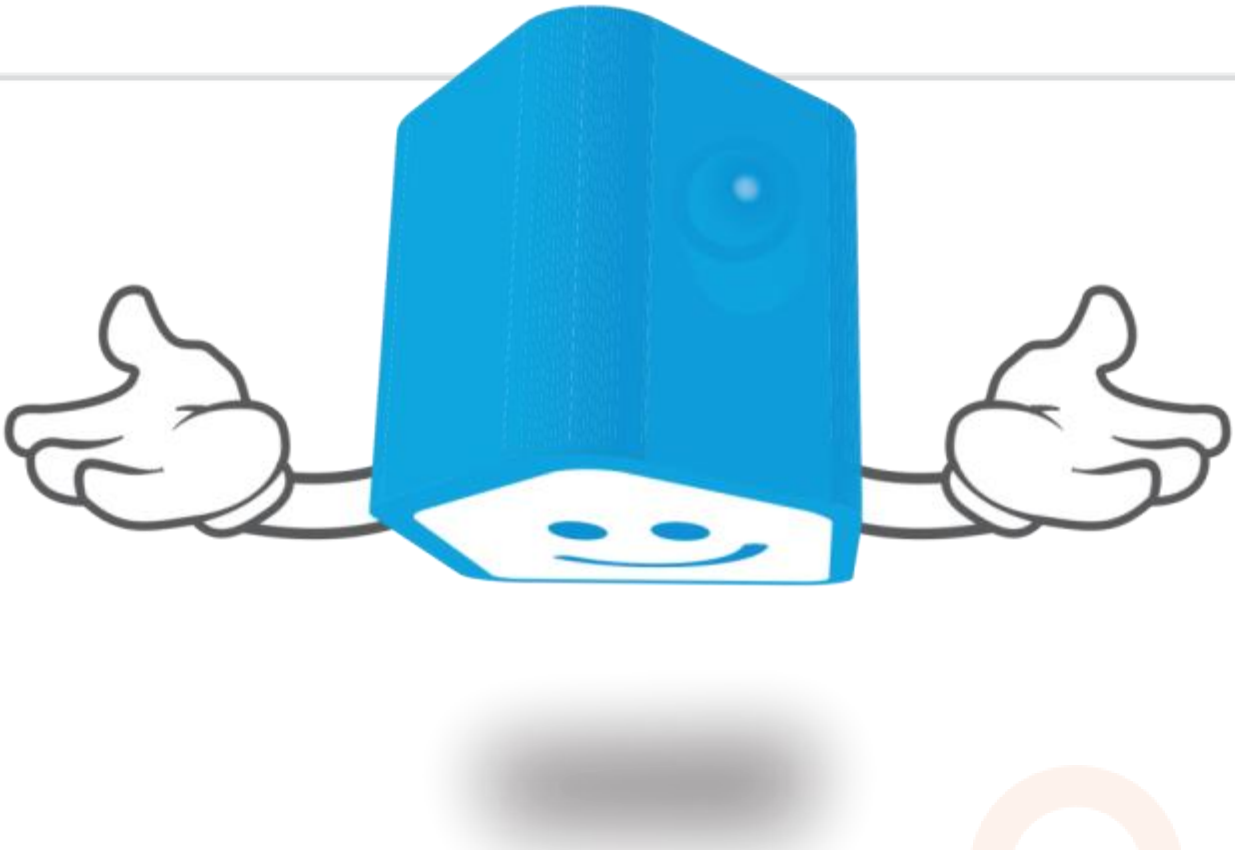
EV/EBITDA (NTM)	Mean	Median	High	Low
Incumbents	5,7	5,7	7,9	4,4
Cable	7,7	7,4	9,7	5,9
Altnets	9,4	8,8	13,7	6,8
Integrated utilities	6,0	5,5	9,7	3,3
Gencos	8,2	7,9	11,4	5,3
Airports & motorways	10,3	8,3	18,0	6,6
Regulated infrastructure	9,3	10,1	13,0	5,6

Source: Financial markets, Diffraction Analysis

Answer to question 2:

Thank you!

Questions?



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