



Lloyds Chambers  
1 Portsoken Street  
London E1 8HZ  
Tel: 020 7702 0888 Fax: 020 7702 9452  
www.hermes.co.uk

INVESTMENT NOTE

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## Hermes Sourcecap sees opportunities in evolving telecoms markets

*Consolidation is taking place among European telecoms companies and is forcing a deep-seated unravelling of the market structures set in the wake of the 3G licence auctions around the turn of the millennium. What is emerging will create long-term opportunities for investors, says Chi Chan, Co-Manager of the Hermes Sourcecap Eurozone strategy.*

**Continental consolidation:** In the wake of the costly 3G auctions, European regulators had been focused on keeping prices affordable for the consumer. The lower revenues, however, made mobile operators reluctant to invest in network improvement. As a result, Europe's network speeds and quality lag those in other parts of the world. Regulators are starting to play their part, with the European telcos industry watchdog finally realising that consolidation is necessary to sustain investment in a key sector of the economy. The European Commission has belatedly recognised this and now sees the improvement of networks as a priority. This imperative is driving consolidation, as operators seek the scale and additional revenue to make it economical to invest in the infrastructure – think Orange and T-Mobile joining together in the UK to create EE.

**Better priced:** With consolidation, pricing is rationalised as all operators have scale. Now quality becomes the differentiating factor for customers. Several European countries have already seen mobile consolidation, such as Germany and Norway, and Hermes Sourcecap is particularly well-positioned to take advantage of developments in Italy.

**Less aggressive:** Telecom Italia is the market leader with 35% market share, ahead of Vodafone (31%), Wind (24%) and 3 (10%). Smaller market players tend to price aggressively, and this has indeed been the case: last year saw Wind and 3 seeking to undercut the two dominant players. This year, Wind has already announced a change in focus towards profitability, and a merger between Wind and 3 would be a logical combination that should create three profitable operators. Telecom Italia stands to be a significant beneficiary of the emergence of a stable oligopolistic market.

**Italian opportunity:** Telecom Italia's other division is in wireline that, in line with all domestic incumbents, has seen pressure on top-line growth for many years. Yet there is another opportunity here. Broadband has room to grow substantially in Italy with 23% penetration compared to the average of 30% in Europe. Investment in the network is already included in its capex guidance and this should at the very least slow the top-line decline. The improving Italian economy should provide a further boost to Telecom Italia which has a higher proportion of business customers than its rivals in both divisions.

**Well valued:** Telco stocks have been priced for little growth. Market analysts are still captivated by the post-3G auction world. But this is slipping away. We bought the 'saver' shares, which offer a 20% discount to the ordinary shares but guarantee a higher dividend than the latter. The valuation is comfortable too, with a P/E Ratio of 10.4x 2014 and a free cash flow yield of 13%.

**For further information, please contact:**

**Hermes Fund Managers**

Jeannie Dumas  
+44 (0)20 7680 2152  
[j.dumas@hermes.co.uk](mailto:j.dumas@hermes.co.uk)

Melanie Bradley  
+44 (0)20 7680 2110  
[m.bradley@hermes.co.uk](mailto:m.bradley@hermes.co.uk)

**Notes to Editors:**

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