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Dutch telecoms regulatory proposals: Watershed moment for European telecoms?

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We were worried that it might happen, but never thought it actually could.

Earlier this morning, the Dutch regulatory body ACM released a rather terse four-page draft version of its market analysis decision on the fixed wholesale access market. ACM has concluded that KPN and VodafoneZiggo have collective Significant Market Power (SMP) and that *both* need to be regulated – effectively declaring joint dominance.

This regulatory intervention is unquestionably onerous. The envisaged framework would impose on KPN and Vodafone the obligation to provide competing access seekers (T-Mobile NL, Tele2, etc.) with access to their networks. The price would be set by KPN and VodafoneZiggo separately engaging in direct negotiations with the providers, with ACM intervening only if a negotiated agreement cannot be reached. This would involve the imposition of a tariff cap. ACM's findings and proposals can be viewed as evidence of abject regulatory failure. Failure to institute retail- and infrastructure-based competition in the broadband market. If unchecked, these proposals would likely imply that the Dutch market remains a symmetrically regulated market for the foreseeable future with few means to reverse the interventions, once implemented.

This is a significant event, potentially a watershed moment for the sector in Europe. Until now, the consensus view was that cable assets would only be regulated in exceptional circumstances (e.g. Telenet in the northern half of Belgium). The view was supported by the European Commission's proposals for a fundamental overhaul of the regulatory code in Europe with the objective of stimulating infrastructure-based competition and ultimately deregulation. ACM's proposals today constitute a material divergence from these proposals, which are going through legislative due process in Brussels.

The EU Commission is very likely to reject ACM's proposals. The EU will review ACM's proposals. We see a reasonably high probability that it will reject ACM's draft submission as it runs counter to the aims of EU regulatory philosophy as described above. If approved, the proposals would set an unhelpful precedent. For those markets where three competing infrastructures have not yet emerged, national regulators may also be keen to impose joint dominance regulation. With the Electronic Communications Code still draft, we would be very surprised if the EU were to allow divergence from it even before it comes into force.

And what if it were to go through? We would expect fixed infrastructure access market share distribution away from KPN and to cable. Take Belgium, where the cable operator Telenet is also regulated. The market share of cable within the country has been stable at just over 50% indicating a natural share threshold under a regulated framework (**Exhibit 1**). In the Netherlands, cable already has a high share at 44%. Under a joint dominance scenario, 10% of KPN's fixed line base churning to VodafoneZiggo could be realistic. We would expect this to manifest in a ROIC-WACC spread for KPN c. 30bps lower than would be the case without cable regulation. Not disastrous by any means, but certainly unhelpful.

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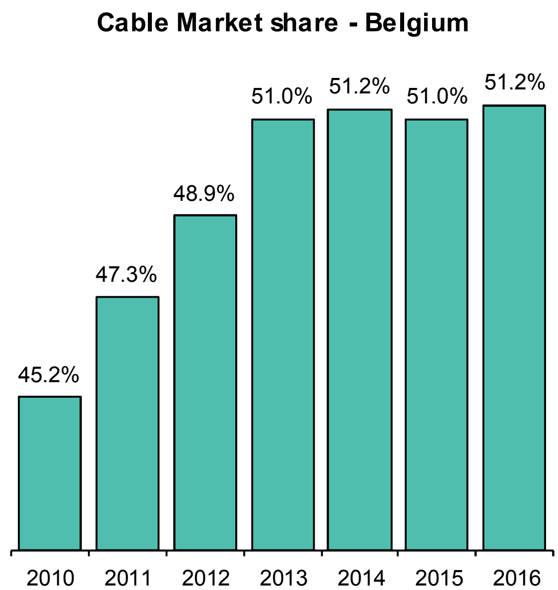
EXHIBIT 1: **In Belgium, the market share of cable in a regulated environment has flattened out at c. 51%**



Source: BIPT, Bernstein analysis.

INVESTMENT IMPLICATIONS

We rate KPN market-perform, with a PT of EUR2.50.

We rate Liberty Global market-perform, with a PT of USD 35.40

We rate Vodafone outperform, with a PT of GBp270.

We rate Deutsche Telekom market-perform, with a PT of EUR16.25.

DISCLOSURE APPENDIX

TICKER TABLE

Ticker	Rating		26 Feb 2018 Closing Price	Target Price	TTM Rel. Perf.		EPS Adjusted 2016A	EPS Adjusted 2017E	EPS Adjusted 2018E	EV/EBITDA 2016A	EV/EBITDA 2017E	EV/EBITDA 2018E
KPN.NA	M	EUR	2.64	2.50	(8.2)%	EUR	0.07	0.10	0.15	7.15	7.18	7.18
LBTYA	M	USD	32.28	35.40	(30.8)%	USD	2.17	(0.37)	1.25	9.84	9.45	8.59
VOD.LN	O	GBp	205.55	270.00	(4.7)%	EUR	0.06	0.11	0.11	6.87	6.48	6.34
DTE.GR	M	EUR	13.53	16.25	(24.8)%	EUR	0.89	0.95	1.09	5.84	5.49	5.35
MSDLE15			1,584.39				87.87	99.42	108.36	18.03	15.94	14.62
SPX			2,779.60				116.42	129.97	154.91	23.88	21.39	17.94

O - Outperform, M - Market-Perform, U - Underperform, N – Not Rated

VOD.LN base year is 2017;.

VALUATION METHODOLOGY

European Telecommunications & Cable

We value our companies based upon a blended view originating from their 12-24 month EBITDA, OpCF and FCFE/F growth prospects (FY+1 vs. FY) and a deserved valuation premium or discount on EV/EBITDA and EV/OpCF multiples and FCF yields to sector averages. We normalize EBITDA to include the negative impact of restructuring charges, when recurring in nature. We normalize our OpCF and FCFE/F estimates for an implicit recurring cost of spectrum licenses broadly in line with forecasted spectrum amortization expenses. When computing FCFE yields, we adjust the market cap for the value of deferred tax assets, if our cash taxes are lower than accounting taxes due to the benefit of these assets. We also add back the equity value attributable to minority interests to the market cap when using fully consolidated FCFE across all subsidiaries.

We test our derived target prices against our longer-term fundamental valuation of our covered companies based upon Bernstein's three-stage discounted cash flow (DCF) methodology. We discount free-cash flows to the firm (FCFF) using a company-specific weighted average cost of capital (WACC). We use the capital asset pricing model (CAPM) method to estimate the weighted average cost of capital (WACC) for our companies. Our cost of equity estimates are based upon a risk free rate for each company derived by weighting the risk free rates of the countries our companies operate in by their contribution to overall company EBITDA. Similarly, we use a derived equity risk premium by weighting the equity risk premia for each operating country by its contribution to total company EBITDA. We adjust the risk premium for the levered beta for each company based upon a sector-level regression beta vs. the MSCI Europe. For the cost of debt, we use the most recently reported effective cost of senior debt of our companies.

Koninklijke KPN NV

We value KPN at 15x 2019E EV/OpCF, a discount to the sector given lower EBITDA growth prospects.

Liberty Global PLC

We use an EV multiple on 2018 BERNe EBITDA to value Liberty Global Group. This EV/EBITDA multiple is derived using a blend of 1) our short-to-mid-term fair value multiple based on 2018 BERNe EBITDA growth expectations (75% weightage) and 2) a long-term intrinsic DCF-based valuation multiple (25% weightage). Our price target is derived by applying this target multiple to 2018 BERNe EBITDA and adjusting it for Net Debt and Other Assets and Liabilities. We do not include the value of LiLAC tracking shares in our valuation.

Vodafone Group PLC

At current valuations of 6.6x BERNe '18/19 EBITDA, Vodafone is trading on par with sector valuations in Europe despite its stronger growth prospects. Our 12-month target price of GBp 270 implies a 7.7x BERNe EBITDA,17x normalized OpFCF in FY18/19 and 5.5% equity FCF yield.

Deutsche Telekom AG

We value DT with a SOTP, using market multiples for TMUS (EV/Operating Cash Flow) and the three listed European subsidiaries (EV/EBITDA). We then estimate EV/EBITDA multiples for the other segments based on relevant comps. This provides us with a price target based on 2019 earnings of €16.25. In our view, the stock will unlikely re-rate in the medium term without a key catalyst.

RISKS

European Telecommunications & Cable

We highlight five key areas of risks to the valuation of the sector in general and our coverage in particular below: macro-economic risk and the resulting impact on the behaviour of consumer and businesses; competitive risk originating from market structure imbalances and potentially impacting price realization; regulatory risks impacting market structure and directly impacting sector revenues, profitability and free cash flow; technology risk impacting capital expenditure requirements and sector free cash flows; and credit market risks impacting the financing ability and financing costs of the sector.

Sector revenues are linked to the macro-economic health and resulting consumer and business confidence of the countries our companies operate in. The adoption and continued use of telecommunications services and the willingness to remunerate sector constituents appropriately are both subject to prospects of the broader economy. Furthermore, for companies with exposure to geographies outside their country of equity listing, revenues are also exposed to currency exchange rate volatility and risks.

The telecommunications and cable sector in Europe is highly competitive and price realization is subject to the competitive structure in each country market. Heightened competitive intensity originating from asymmetries in market share and/or the asset structure of sector constituents can result in price deflation and with it an erosion of sector profitability and cash flows.

The telecommunications sector in Europe is subject to industry regulation enshrined in the telecommunications laws at the European and country level aimed at ensuring competition and good outcomes for consumer and businesses. Regulatory intervention can result in an increase in competitive intensity by facilitating the introduction of new sector entrants. It can also result in the heightening of competition by a mandated reduction in prices of price-controlled wholesale or upstream products and in the decline in revenues, profitability and cash flows of sector constituents subject to these price controls. However unlikely, regulatory intervention can also result in the forced disappropriation of assets of sector constituents to the detriment of current shareholders.

Technological innovations and the need for capital expenditure to deploy technological advances are a key characteristic of the telecommunications sector. A heightened need for capital expenditure in the face of technological changes and the inability to adequately monetize these investments can result in a reduction in sector cash flows and in the intrinsic value of sector constituents.

Sector constituents rely on debt capital markets to fulfil their financing needs. An increase in credit yields and yield spreads vs. risk-free investments is likely to limit the sector's ability to raise capital and result in an increase in financing expenses, thereby impacting sector profitability and cash flows. This risk is more protracted for those companies in our coverage which have sub-investment grade credit ratings and are hence exposed to the potentially greater risks originating from higher-yield debt capital markets.

Koninklijke KPN NV

The key upside risks to our price target for KPN are:

+ A more rapid recovery in the Business segment through an improvement in fixed access line losses in the SME segment
+ A slower erosion of legacy network and IT solutions revenues in the Large Enterprise & Corporate segments
+ More aggressive and frequent increases in triple- and quadruple-play bundle pricing applicable to the Consumer subscriber base
+ In-market mobile M&A with T-Mobile NL and Tele2 being the most likely candidates

The key downside risks are:

+ Continued and heightened promotional activity by VodafoneZiggo for both Consumer broadband and triple-play subscribers
+ Greater regulatory and anti-trust scrutiny of KPN's consumer price increases, should these be mirrored by VodafoneZiggo
+ Longer-term, the emergence of a third fibre infrastructure through passive facilities remedies (duct access) as outlined by the EU Commission

Liberty Global PLC

The key upside risks to our price target for Liberty Global are:

- Broadband net adds outperformance vs. our estimates
- Two back-to-back price increases in Germany and the UK at 11-12% aggregate broadband churn
- Merger of Virgin Media and Unitymedia with Vodafone

The key downside risks are:

- Acquisition of O2 UK, as "poison pill" for broader VOD deal
- Broadband net adds underperformance vs. our expectations
- Tightening in the high-yield market

Vodafone Group PLC

The key downside risks are:

- Erosion of mobile pricing across the European footprint, especially in the core markets of Germany, Italy and Spain. In Germany, the Drillisch and UnitedInternet merger is positive in the longer term but could result in market share losses in the value-oriented postpay segment.
- Disruptive market entry by Iliad in Italy, resulting in a repricing event similar to 2013 with 11-12% revenue downside, that flows through to EBITDA in its entirety.
- The company is guiding to positive FX development related to South Africa. If the political climate worsens, this could result in a reversal of the recent recovery in the EUR/ZAR exchange rate.
- A merger between Liberty Global and another mobile operator in the UK and/or Germany could weigh on sentiment, as the long-term prospects for an integrated play in Europe would be diminished.

Deutsche Telekom AG

The key upside risks to our price target for Deutsche Telekom are:

- Accelerated EBITDA growth in Europe incl. the impact of restructuring charges
- Divestiture/spin-off of mobile-only assets (NL, AT, PL, CZ) at valuation premia vs. implicit valuation in a sum-of-the-parts view on the Group
- Carve-out/merger of T-Systems with BT Global Services
- Sale or merger of T-Mobile USA

The key downside risks are:

- Commitment to a FTTP rollout in Germany at scale and CAPEX level above current market consensus
- Acquisition of Unitymedia by Vodafone (mid-term impact)
- Ex-ante/cost-based regulation of VDSL Layer2/Layer 3 bitstream access products in Germany

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  Market-Perform: Stock will perform in line with the market index to within +/-15 pp in the year ahead.

  Underperform: Stock will trail the performance of the market index by more than 15 pp in the year ahead.

  Not Rated: The stock Rating, Target Price and/or estimates (if any) have been suspended temporarily.
- As of 02/26/2018, Bernstein's ratings were distributed as follows: Outperform - 48.3% (0.0% banking clients) ; Market-Perform - 39.6% (0.0% banking clients); Underperform - 12.1% (0.0% banking clients); Not Rated - 0.0% (0.0% banking clients). The numbers in parentheses represent the percentage of companies in each category to whom Bernstein provided investment banking services within the last twelve (12) months.

12-Month Rating History as of 02/26/2018

Ticker	Rating Changes	
DTE.GR	M (IC) 05/23/16	
KPN.NA	M (RC) 03/29/17	U (IC) 05/23/16
LBTYA	M (IC) 05/23/16	
VOD.LN	O (RC) 05/30/17	M (IC) 05/23/16

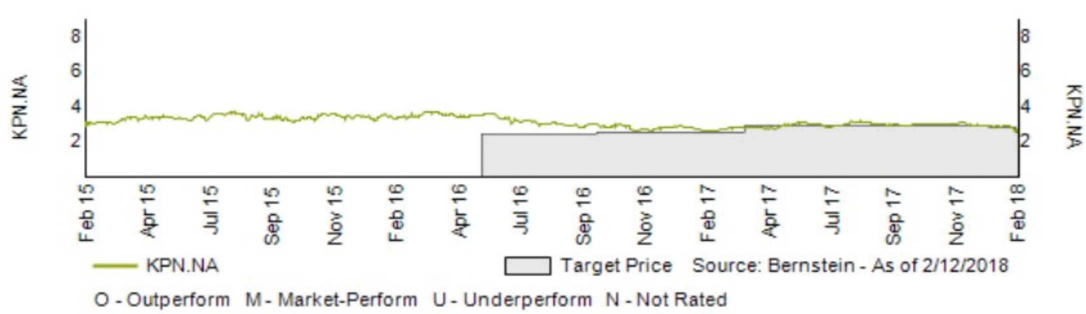
Rating Guide: O - Outperform, M - Market-Perform, U - Underperform, N - Not Rated

Rating Actions: IC - Initiated Coverage, DC - Dropped Coverage, RC - Rating Change

KPN.NA / Koninklijke KPN NV

Date	Rating	Target(EUR)
05/23/16	U(IC)	2.40
10/05/16	U	2.45
03/29/17	M	2.85
01/09/18	M	2.80
02/09/18	M	2.50

IC - Initiated Coverage



LBTYA / Liberty Global PLC

Date	Rating	Target(USD)
05/23/16	M(IC)	34.00
07/19/16	M	30.00
01/09/17	M	32.60
01/09/18	M	35.40

IC - Initiated Coverage

VOD.LN / Vodafone Group PLC

Date	Rating	Target(GBp)
05/23/16	M(IC)	245.00
10/19/16	M	255.00
05/30/17	O	265.00
01/09/18	O	270.00

IC - Initiated Coverage

DTE.GR / Deutsche Telekom AG

Date	Rating	Target(EUR)
05/23/16	M(IC)	15.90
01/09/17	M	16.45
11/14/17	M	16.25

IC - Initiated Coverage

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