SORTINO
M&A GROUP

KKR's Acquisition of TIM's NetCo for €22bn

ALTERNATIVE INVESTMENTS

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Deal Introduction

DETAILS ABOUT THE DEAL

On October 16th, 2023, US Private Equity firm KKR submitted a binding-offer to acquire Telecom Italia’s fixed-line telephone and internet network (NetCo). Although the initial amount offered was not disclosed, TIM's board recently greenlit a €22bn bid from KKR.

TIM’s landline network reaches approximately 89% of Italian’s household. The company has been attempting to disinvest its grid assets since 2021 due to mounting debt and rising interest payments, which amounted to €1.3bn in the first three quarters of 2023. The company’s poor financial performance has led credit agencies to downgrade the credit rating to junk status in Q42022

The announcement of the bid acceptance has sparked strong opposition from TIM's largest shareholder, French media conglomerate Vivendi, which holds a 23.75% stake and more than 17% of TIM's voting rights. Vivendi has been vocal about its disagreement with the deal, particularly the board's decision to accept the offer without seeking a vote.

TIM engaged with advisors Goldman Sachs, Mediobanca, and Vitale & Co, along with legal counsel from Gatti Pavesi Bianchi Ludovici. KKR received advisory services from Citi, Morgan Stanley, and JPMorgan. TIM's independent directors were supported by Lion Tree and Studio Carbonetti.

REASONS FOR M&A

TIM is heavily leveraged, with an outstanding net debt of nearly €26bn before adjusting for leases, equivalent to 4.4x expected EBITDA for 2023. The proposed transaction aims to reduce net debt to more sustainable levels, estimated to be roughly 2.0x EBITDA that ServiceCo activities are projected to generate. TIM's Board believes that the deal will allow to cut debt by 46.2%, moving its figure from €26bn to €14bn. Partnering with KKR, well-renowned for their expertise in LBO deals, is an advantageous move for the company, as it is probable that they will guide the company back on the path to success. This is reinforced by the fact that underperformance of TIM is not attributable to the fundamental services it provides or the telecommunications sector.

This investment in TIM offers KKR the opportunity to capitalize on the growing demand for telecommunication services, particularly in a major European market. TIM's robust infrastructure, strong consumer base, and established brand make it an appealing investment opportunity. Moreover, the stable cash flows of TIM present an attractive prospect for an investment firm seeking steady returns. Given the current scenario, KKR could potentially replicate its success with The Beatrice Company in the case of TIM.

Additionally, the Italian government has signed a memorandum of understanding (MoU) with KKR, allowing the government to acquire as much as a 20% stake in TIM's NetCo following the acquisition. This move grants the Italian government the ability to maintain strategic oversight of the phone network, aligning with increased scrutiny of foreign investments, particularly in one of the country's most critical infrastructures.

Industry Overview

On a global level, the telecommunications industry is a provider of vital services to billions of consumers and businesses.

Global data consumption over telecom networks is driven largely by video traffic, which has a forecasted three-fold growth, from 3.4m petabytes (PB) in 2022 to 9.7m PB in 2027.

As a mature, utility-based industry, it is facing a fundamental strategic challenge: the increasing commoditization of connectivity and data services, which leaves providers with little pricing power. Using revenues from internet access are expected to have a CAGR of only 4% through to 2027. Simultaneously, another area of concern concerns the heavy investments telecommunications companies will have to make in infrastructure in the ongoing transition to 5G.

Looking at the Italian telecom market, despite high demand and an expanding consumer base, annual turnover has followed a declining trend from 2011 onwards, with a projected -0.6% CAGR through 2027. Importantly, the telecom industry will be the beneficiary of a subsidy project: “Italia 1 GIGA”, aimed to improve fixed broadband, 5G, and satellite connectivity throughout the country, with an expected budget of €3.8bn.

The Italian telecom market is rather consolidated: TIM is by far the largest player, reaching 89% of the country’s households. In 2022, market size was around €22bn.

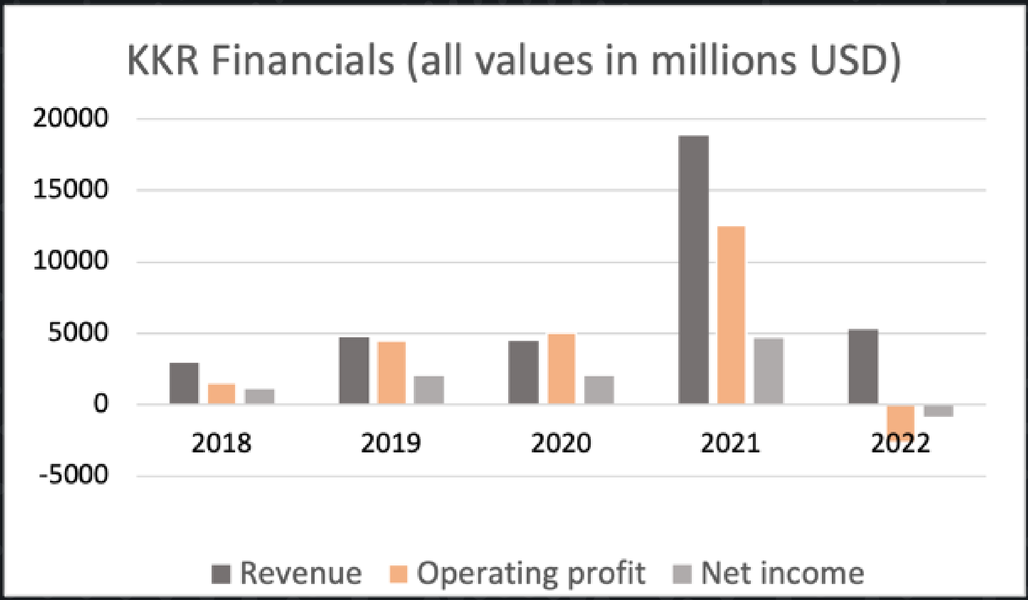
Acquirer Overview

KKR

KKR is a global investment firm primarily engaged in private equity, asset management, and financial services. Founded in 1976 and headquartered in New York, the world-renowned investment firm generates revenue through a variety business segments and activities that can be broken up into the following:

- **Private Equity:** Firm acquires controlling or significant minority stakes in companies from around 20 different industries. Revenue is thus generated through dividends, capital gains, and management fees.
- **Asset Management:** Firm manages investment funds on behalf of institutional investors such as Pension funds, sovereign wealth funds, and endowment funds. Revenue generated from fund management and performance fees.
- **Public Markets:** Firm invests in publicly traded companies and debt securities where revenue is generated through capital gains, dividends and trading activities.
- **Real Assets:** KKR invests in real estate, infrastructure and energy where revenue is generated through rental income, asset appreciation, and management fees.
- **Strategic Partnerships and Capital Markets:** Firm engages in strategic partnerships, co-investments, and capital markets activities. Revenue may be derived from fees related to structuring transactions, advisory services, and facilitating capital market activities.

KEY FINANCIALS



As with many private equity firms, the high interest rate environment has slowed the frequency of acquisitions, hence reflecting the negative operating cash flow and lower ROE than previous years. The Short % of float ratio is only at 0.99%, suggesting that few investors are betting against KKR's future growth. EPS has fallen to $2.74 in 2023 from around $9 throughout 2022 due to decrease in revenues caused by the tighter lending environment.

ROE (TTM): 5.60%

ROI (as of 30.09.23): 1.24%

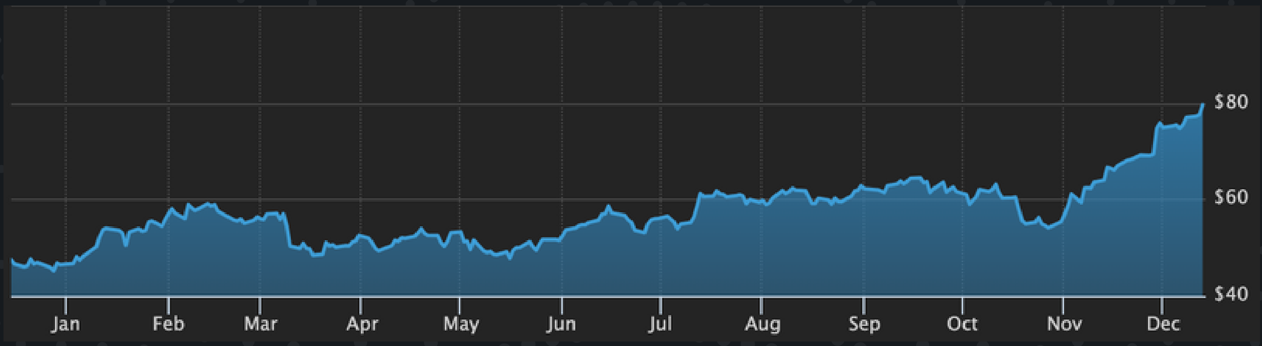
Operating Profit Margin (TTM): 55.56%

Net Profit Margin (3Q 2023): 16.41%

Revenue (Q3 2023 YTD): €10,069,481bn

EPS: $2.74

MARKETS DATA



NYSE: KKR & Co Inc = $77.43 (as of 11.12.2023)

52-week share price change = 32.02%

Despite the bleak outlook for private equity dealmaking, KKR's shares have rallied over the past year, suggesting investor confidence in the stability and resilience of KKR.

However, with the full effect of higher interest rates only slowly fading into effect now, the share price movement might reverse as dealmaking slows and revenues for KKR fall.

The firm managed by two CEOs, Joseph Bae & Scott Nuttall, has a client AUM of $519 million and a market cap of $60.66 billion. The top investments of KKR are USI Inc, PetVet Care Centers LLC, Heartland Dental LLC and Exact Holding B.V.

Target Overview

TIM S.p.A is a telecommunications company with HQ Rome, which provides fixed telephony and digital subscriber line data services (internet services). It was created in 1994 by the mergers of several state telecom companies consisting of Telespazio, Italcable, SIP, IRITEL and SIRM to become the 6th largest telecom company by sales and worth around $100 billion, with over 120,000 employees.

TIM Group also has operations in South America where its TIM Brazilian subsidiary is a major player with over 72.6m customers and is a leader in 4G services. The company also operates in other foreign markets through subsidiaries in Greece and Turkey.

In 1999, at the peak of the telecom bubble, TIM was bought by Roberto Colaninno & Co for a consideration of €65bn in Europe's largest hostile takeover. The payment structure included 50% debt, whose burden resulted in having a long-lasting effect and left the company unable to manoeuvre properly when its industry rivals consolidated after the bubble burst in 2000.

In the ensuing decades, Telecom Italia's sales have declined to €16bn while its net debt increased to €26bn, now with over 40,000 employees. As a result, it's essentially being forced to sell its major asset the fixed-line network business as interest rate rises have increased its interest expense significantly. By reducing its debt load It can therefore restructure and streamline its operations at focus on its internet service business.

LBO Analysis

LBO MODEL - ENTRY AND EXIT ASSUMPTIONS

Entry Valuation	
Entry EBITDA	3,104
EBITDA Multiple	6.06x
Entry EV	18,800
EV/Revenue 2022A	2.13x
EV/Revenue 2023E	2.12x
EV/EBITDA 2022A	6.20x
EV/EBITDA 2023E	6.06x

Exit Assumptions	
Exit Date	2028
Exit Multiple	7.00x
Exit Fees	130

Based on historical financial results, the entry multiple for the LBO model was **6.06x**. Exit multiple for 2028 assumed to be **7.00x**, with €130m in exit fees.

CAPITALIZATION TABLE

	Pre-trx	Post-trx	
		% prefs	% ords
One Equity	89.70%	0.00%	0.00%
New Sponsor	0.00%	70.00%	9.00%
Management	0.50%	0.00%	1.00%
Sweet Equity	0.00%	0.00%	0.00%
Italian Government	9.80%	10.00%	10.00%
Total	100.00%	80.00%	20.00%

Pre-transaction ownership of TIM's NetCo split with a participation of 9.80% by the Italian Government.

Post-transaction Newco displays 79% ownership attributable to KKR, with a 20% participation from the Italian Government

FINANCIAL FORECAST

	Actuals			Forecast	Operating Case				
EURmm	2020A	2021A	2022A	2023FC	2024P	2025P	2026P	2027P	2028P
P&L									
Revenue	8,864	8,544	8,821	8,883	8,982	9,223	9,454	9,746	10,016
% revenue growth		(3.6%)	3.2%	0.7%	1.1%	2.7%	2.5%	3.1%	2.8%
Service Revenue	8,779	8,607	8,276	8,097	8,287	8,601	9,144	9,981	10,921
% service revenue growth		(2.0%)	(3.8%)	(2.2%)	2.3%	3.8%	6.3%	9.1%	9.4%
EBITDA	3,783	2,828	3,031	3,104	3,258	3,198	3,315	3,434	3,537
% EBITDA margin	42.68%	33.10%	34.36%	34.95%	36.27%	34.67%	35.06%	35.24%	35.31%
EBIT	1,181	(1,967)	341	417	513	536	759	883	1,017
% EBIT margin	13.3%	(23.0%)	3.9%	4.7%	5.7%	5.8%	8.0%	9.1%	10.2%
PRETAX INCOME	817	(2,608)	(331)	(517)	205	327	384	440	711
NET INCOME	(4,302)	(4,852)	(1,494)	(670)	(1,118)	(316)	465	524	561

Revenue growth for the model employed rises to a peak of 3.1% in FY2027P and establishes itself at 2.8% in the terminal year. EBITDA margin standing at 35.31% on FY2028P, implying a EV of €24,756bn.

CASH SWEEP

	Actuals			Forecast	Operating Case				
	2020A	2021A	2022A	2023FC	2024P	2025P	2026P	2027P	2028P
Unlevered Free Cash Flow									
(+) BoP Cash	1,817	794	(344)	855	1,036	1,064	1,090	1,124	1,155
(-) Min Cash	10	10	10	10	10	10	10	10	10
Cash Available for Debt Service	1,807	784	(354)	845	1,026	1,054	1,080	1,114	1,145
(-) Interest (assumed i=5,2%)	257	244	279	22	27	28	39	46	53
Cash Available for Mandatory Amortization	1,551	540	(633)	824	999	1,026	1,041	1,068	1,092
(-) Mandatory Amortization	-	-	-	-	-	-	-	-	-
Cash Available for Dividends	1,551	540	(633)	824	999	1,026	1,041	1,068	1,092
(-) Dividends	-	-	-	-	-	-	-	-	-
Excess Cash	1,551	540	(633)	824	999	1,026	1,041	1,068	1,092
(+) Min Cash	10	10	10	10	10	10	10	10	10
Cash EoP	1,561	550	(623)	834	1,009	1,036	1,051	1,078	1,102
Cash BoP	1,817	794	(344)	855	1,036	1,064	1,090	1,124	1,155
Net Change in Cash	257	244	279	22	27	28	39	46	53
Cash EoP	1,561	550	(623)	834	1,009	1,036	1,051	1,078	1,102

Use of cash for principal repayment amortized considering estimated minimum cash requirement for operational purposes

RETURNS ANALYSIS

Return Analysis	2023A	2024A	2025A	2026A	2027A	2028A
Equity Contribution	(6,232)	-	-	-	-	-
Dividends	-	-	-	-	-	-
Preference Shares	-	-	-	-	-	-
Ordinary Shares	-	-	-	-	-	-
Total Cash Flows	(6,232)	-	-	-	-	24,756

IRR	**31.77%**
MOIC	**3.97x**

Equity contribution for acquisition amounted to €6,232bn. Exit EV of €24,756bn highlights an IRR of 31.77% and a MOIC of 3.97x.

Deal Analysis

STRENGTHS

- For TIM, this acquisition can provide the necessary cash flow to reduce the high Net Debt amount on the balance sheet and sustain future operations. The deal could allow the Italian company to improve its current debt rating and access cheaper funding in the future.
- KKR has a positive track record investing in companies operating in the telecom industry, resulting in higher credibility of deal.
- For KKR, the deal offers an opportunity to expand its portfolio and network by investing in a company with substantial infrastructure and recognition. The telecom sector provides relatively secure cash flows.

OPPORTUNITIES

- TIM’s strong network and established market position represents an opportunity to have access to a broad customer base in a rapidly growing market, which could result in higher profitability in the future.
- Opportunity to operate in the domestic market with fewer regulatory constraints due to improved Net Debt to EBITDA ratio, allowing for higher operational flexibility.
- Potential synergies with other telecom companies in KKR’s portfolio could influence bargaining power of TIM.

WEAKNESSES

- Complex regulatory environment in the telecom sector in Italy, with the Italian government placing multiple constraints and pursuing a minority stake in the company.

- TIM's high debt levels need to be carefully addressed to pursue operational efficiency. Failing to do so might compromise future growth and financial performance.

THREATS

- Rising technologies might lead to increased competition and lower capabilities to exploit the pre-existing infrastructure of Tim. Disruptive technologies are frequent in the telecom sector, and Tim's broad network might not be flexible enough to adapt to new changes.

- Regulatory scrutiny of the acquisition due to new-formed network of companies in KKR's portfolio which provides pricing influence from the PE fund.

- KKR's investments track record displays a high-risk approach. An excessively short-sighted approach could compromise performance in the longer term.

GLOSSARY

Enterprise Value: EV is the entire value of a firm equal to its equity value, plus net debt, plus any minority interest. It is the value of the firm's operating activities

Cash Sweep: the mandatory use of excess free cash flows to pay down outstanding debt rather than distribute it to shareholders or reinvest it in the business

IRR: *Internal Rate of Return*, the discount rate that makes the net present value (NPV) of a project zero

MOIC: *Multiple on Invest Capital*, a metric used to describe the value or performance of an investment relative to its initial cost

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