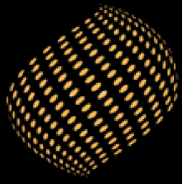

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11/11/2022

Vodafone UK's Merger with Three UK

SORTINOMAGROUP.COM

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Source: Mobile Europe

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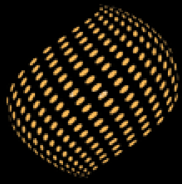

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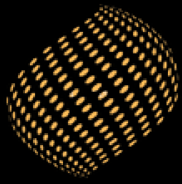

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DEAL INTRODUCTION

DETAILS ABOUT THE DEAL

Vodafone is in advanced talks with CK Hutchison's Three Mobile about merging their businesses in Britain. The proposed deal would see Vodafone owning 51% of the business and Three owning 49% of the business.

Interestingly, this merger will involve no cash considerations. Instead, it is being funded through the allocation of debt.

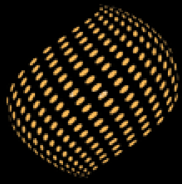
In the main merger scenario, Vodafone would spin off the 51%-owned new entity with debt of 2.5 times earnings, in-line with its own leverage target. The new combined business would support an estimated €6.6 billion of debt, with its implicit equity value being €10.2 billion, valuing Vodafone's 51% stake at €5.2 billion.

With the assumption that both merging parties share synergies equally, Vodafone would be contributing €10.8 billion of the new company's €16.8 billion enterprise value.

Proceeds would be repatriated to shareholders to achieve the value consistent with 51%/49% equity stakes, with Vodafone forecast under this scenario to receive €5.5 billion and Three €1.1 billion, again, with no cash consideration required.

The merger would see Vodafone-Three taking the number one spot in the UK mobile network provider industry in terms of market share (37%). The remaining two network providers are BT and Virgin Media O2 with market shares of 32% and 31% respectfully.

There is still a long road ahead before this merger will be fully solidified, mainly due to regulatory hurdles posed by the Competition and Markets Authority.



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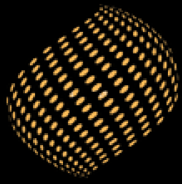
INDUSTRY OVERVIEW: TELECOMMUNICATIONS

According to Bain&Company, this year has seen a slow start to the year for telecommunications M&A activity, with total deal values falling from $88 billion to just $44 billion for the first six months of 2022.

Despite this fall, the technology, media, and telecommunications sector (TMT), according to McKinsey, has continued to outperform other industries, with TMT accounting for 30% of total deal value. The next largest sector was real estate, totalling 13%.

With the macroeconomic headwinds that we've seen so far this year set to continue into Q4, it's expected businesses will place larger significance on synergistic M&A deals.

Source: Microsoft



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HISTORICAL TRENDS

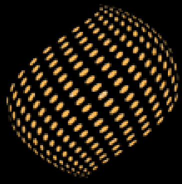
Within the telecommunications industry, it is a common theme that the most successful companies are often the largest. Therefore, there is no surprise that with the potential to become a market leader that this deal has occurred.

Last year saw the telecommunications sector display its resilience, with deal value rising by 48% from a Covid-struck 2020.

More specifically, in-country M&A deals have seen a consistent uptick since 2016 due to a greater emphasis on growth in infrastructure. Last year, in-country deals accounted for 36% of all completed transactions.

There has also been a greater shift to private investments in recent years. This momentum is expected to continue as private telecommunication valuations remain higher than listed valuations.

Source: Data Center Post



VODAFONE OVERVIEW

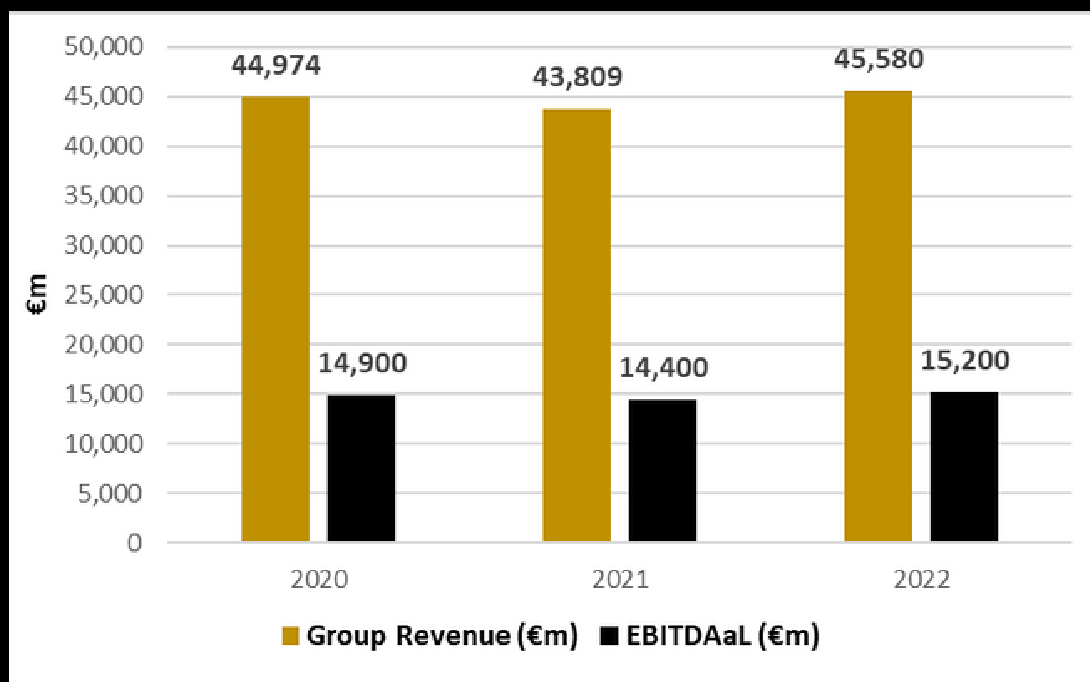
TICKER:VOD

VODAFONE

•Vodafone is a British telecommunications company that was founded in 1984 and is headquarted in Newbury, UK. The business is responsible for the first-ever mobile call on a UK network.

•Vodafone specialises in telecommunication services in Europe and Africa, developing a range of products and services including smartphone and mobile connectivity to fixed broadband and WiFi.

KEY FINANCIALS



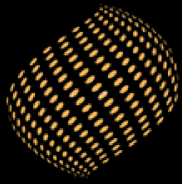
BUSINESS MODEL

Vodafone splits its operations up into three customer segments:

•Europe consumer: Within Europe, Vodafone offers an array of connectivity products and platforms. This includes its mobile services, which allow for users to access calls, texts, and data all through Vodafone's platform. The business also offers its European customers fixed-line services such as broadband and TV.

•African technology leader: Vodafone also has a specialised focus on Sub-Saharan Africa. As a continent with incredibly fast-developing societies, Vodafone is key in the creation and support of digital infrastructure that is permitting businesses and economies to continue to grow. Within Africa, Vodafone operates through local brands such as Vodacom and Safaricom.

•Vodafone Business: Vodafone also offers specialised services to private and public sector customers through its global network. Vodafone Business has more than 10 million organisations utilising its services, with fixed network points of presence in 74 countries. Vodafone Business provides mobile and fixed-line services, as well as cloud and security solutions.



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THREE UK OVERVIEW

THREE UK

Three UK is the fourth-largest mobile network operator in the United Kingdom, with about 9.5 million subscribers as of 2021.

The company launched on 3 March 2003 as the United Kingdom's first commercial 100% 3G network. It provides 3G, 4G and 5G (certain areas) services through its own network infrastructure.

BUSINESS MODEL

Three generates revenue through two different streams:

1. Active contract customer base – revenue generated through customers being in a binding contract for up to two years, in which regular monthly payments are made.

2. Handset sales – revenue generated through up-front sales of mobile phones, in which there is no contract, a straight sale of the device .

Source: JWA Architects

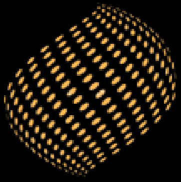
ESG PRACTICES

Environmental - Three are committed to limiting the effect they have on the environment, including:

- **Protecting the environment from harm and limiting the effect that our business operations have on the local and global environment.**
- **Measuring our carbon emissions and setting a carbon reduction strategy to further reduce our carbon emissions.**
- **Regularly reviewing operations and arrangements to identify opportunities to reduce waste streams and promote opportunities to reuse and recycle materials.**
- **Engaging with and encouraging our people, partners and suppliers to reduce their environmental impact.**

Social - Three are empowering communities to get connected, and are committed to making people's lives better:

- **Three-year partnership with Samaritans aims to connect 1 million people to emotional support. The Covid-19 pandemic had a profound impact on the UK population's mental health. Three can use its technology, retail stores and expertise to help more people access emotional support, 24/7, 365 days a year. All through our partnership with Samaritans.**
- **Pledged 1 million GB of data to the UK National Databank to help an estimated 40,000 people get connected.**
- **The Community Fund aims to help the organisations and groups that mean a lot to its people. Each month, employees nominate up to 5 local charities to receive £500 from Three. Since the Fund launched in 2012, Three have donated over £250,000 to organisations nationwide.**



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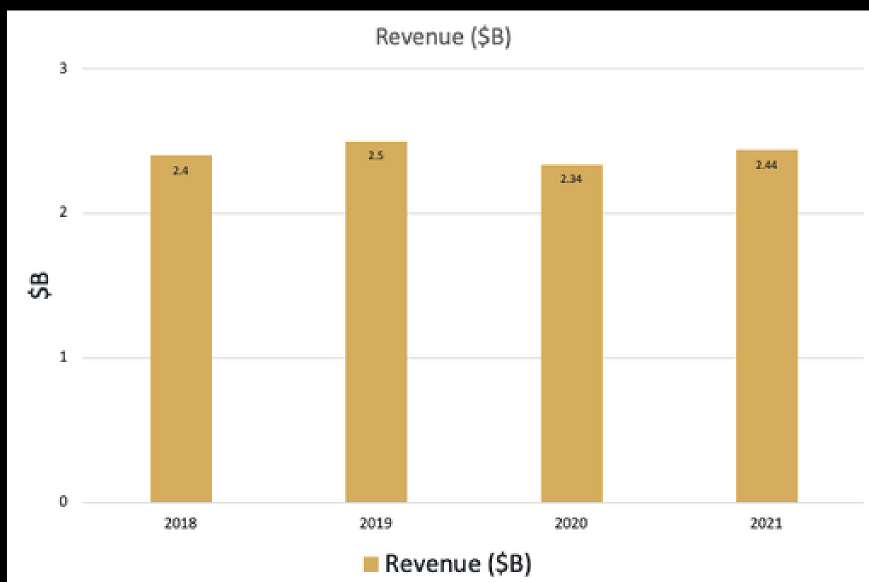
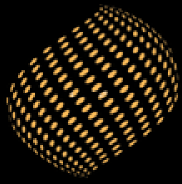
ESG PRACTICES

Governance - From 2022, Three are committed to focusing on 3 key goals:

- **Build an Inclusive Workplace: Through celebrating diverse events, raising awareness and challenging bias. Three have a company-wide zero tolerance policy on discrimination or abuse of any kind.**
- **Achieve Equity in Hiring, Pay and Progression: Three have an active Gender Action plan to try to reduce its gender pay gap. Also committed to increasing our gender balance in leadership roles to 50/50 by 2030. Three are also working towards becoming an accredited space for a disabled workforce.**
- **Be Recognised as a DIB Leader: Three were recognised as Diversity Steering Group of the Year at the FREDIE Awards and have been included on their 100 best places to work list. Three are continuously improving and want to be a great place to work for all employees. Three have also been identified in the Financial Times Diversity Leaders 2023 Special Report.**

KEY FINANCIALS





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DEAL ANALYSIS

STRENGTHS

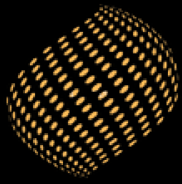
In an industry that requires large-scale capital investment, Kleinman, the owning conglomerate of Three, viewed the firm as having a "sub-scale" level of infrastructure expansion. Combining its operations with Vodafone, broadband and 5G coverage could be expanded and accelerated. With greater scale, using a single network, this can benefit under-served communities and the firm's profitability.

In the last five years Vodafone has lost half its market value but this merger would establish the firm as the UK's largest mobile operator. With both Vodafone and Three struggling to renumerate the cost of investment, due to a lack of scale, a more synergised operation could help raise their earnings on capital. Such synergies could amount to a £2billion saving, according to New Street Research analysts.

WEAKNESSES

There is much debate regarding the competitive impact telecommunication mergers have for consumers. This merger would reduce the number of competitors that own UK infrastructure from four to three, increasing the risk of price hikes. The view of analysts at Jeffries is that the political support this deal could have had post-pandemic is weaker because of the cost-of-living crisis. Annualised inflation in the UK was 8.8% for September; Ofcom nor the Competition and Markets Authority are likely to gamble with an endorsement of a deal that could further increase prices for consumers.

According to New Street analysts in October, the main benefit of this merger would be the combination of the network of radio antennas. Despite this, since 2021, to reduce debt obligations, Vodafone has been attempting a sale of its tower arm unit, Vantage Towers, on the Frankfurt stock exchange of which it owns 82%.



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DEAL ANALYSIS

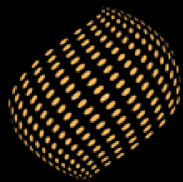
OPPORTUNITIES

The 31bn merger of Virgin Media and O2 in 2021 was the most recent M&A activity in the UK market, providing some insight to what could be expected from Vodafone and Three. By Q3 2021, the firm saw a 38,500 + increase in fixed customer base and a 1% increase in revenue. Innovatively, the new firm has combined its services to create a new product, Volt, sold at a price lower than if they were bought separately; only a year after launch, this service has surpassed one million customers. Evidently, in the UK market, mergers have widened product offerings of Vodafone and Three's competitors. This acquisition has the potential to do the same.

THREATS / REGULATORY CONCERNS

Oddo analysts believe the deal's chance of success is 55%. Although, unlike CK Hutchison's failed attempt to buy Telefonica SA's O2 in 2016, analysts believe this deal to be more likely to go-ahead. This is because of Ofcom (the UK telecoms regulator) views both firm's to be earning below their costs of capital.

Source: The Times



VALUATION ANALYSIS

VODAFONE DCF MODEL

Enterprise Value	105,254
(+) Cash	15,427
(-) Debt	(70,092)
Equity Value	50,589
# of Millions of Shares	29,592
Share Price	1.71

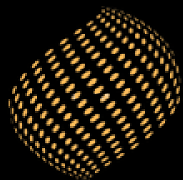
Please click on the table to access full model.

As calculated by the Discounted Cash Flow (DCF) Analysis, Vodafone Group (VOD)'s share price, the stock traded under the London Stock Exchange, was found to be between £0.65 and £1.93. This calculation was obtained through the use of sensitivity analysis, in which three scenarios were calculated in the DCF, a conservative, base and an optimistic one.

5 days prior to the deal becoming public, Vodafone's share price stood at approximately £1.05, within the boundaries obtained through the DCF. According to the base case scenario, the stock was undervalued by 63%, as an implied share price of £1.71 was found.

To build the model, various assumptions were taken into consideration, two crucial ones being the Terminal Growth Rate (2.5%), and the Weighted Average Cost of Capital (WACC) (6.6%). Therefore, it must be noted that the valuation obtained from the model was affected by these assumptions.

Additionally, an analyst consensus of projections for key financials for Vodafone was used to cross reference research findings, which can result in a more accurate model.



VALUATION ANALYSIS

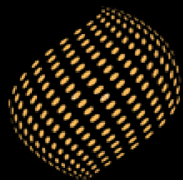
THREE UK DCF MODEL

Terminal Value	26,866,260,778
PV of Terminal Value	22,809,486,135
Enterprise Value	25,151,071,712
(+) Cash	57,984,000
(-) Debt	722,516
Equity Value	25,208,333,196
	(£)

<u>Please click on the table to access full model.</u>

As calculated by the Discounted Cash Flow (DCF) Analysis, Three UK currently has a maximum valuation of around £25bn. Since the company is not public, finding publicly available data was challenging. Therefore, the valuation above was derived through using the past two years' data to forecast the future cash flows, and also by eliminating the impact of change in net working capital. Therefore, the current enterprise value is slightly lower than the figure shown above, however, the valuation still signifies the magnitude of this merger since Vodafone has the possibility to merge with a company with over £20bn enterprise value, offering the company many benefits as discussed in this report.

To build the model, various assumptions were taken into consideration to be able to obtain the Terminal Growth Rate (2.10%), and the Weighted Average Cost of Capital (WACC) (3.33%). Therefore, it must be noted that the valuation obtained from the model was affected by these assumptions.



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VALUATION ANALYSIS

VODAFONE CCA MODEL

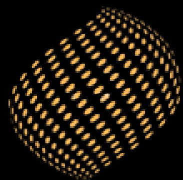
Telecommunications Co.	Low	High
Selected EBITDA Multiple:	3.5x	18.9x
Implied Enterprise Value	71,175	386,991
Net Debt	(47,143)	(47,143)
Implied Equity Value	24,032	339,848
Equity Value per share	**0.81**	**11.48**
Overvalued or - Undervalued %	1211%	-7%

Please click on the table to access full model.

Based on the comparable company analysis (CCA), Vodafone's valuation multiples appear to be higher than the mean of the comparable group of companies. Out of the 4 comparable companies, there were a wide range of telecommunication companies in terms of equity value and EV/EBITDA multiples. All comparable companies appeared to have positive EV/EBITDA valuation multiples.

As a result of the multiples, the low and high EBITDA multiples were chosen to be (3.5x) and (18.9x), giving the implied enterprise values of $71,175m and $386,991m, respectively. At the end of the valuation, the implied share price was found to be at least $0.81 and at most $11.48. It must be noted that the discrepancy is caused by companies due to the firms of lower EV and revenue figures.

However, due to the similarity between Vodafone and AT&T in terms of financial multiples and their operating nature, the high multiple was chosen, yielding a 7% undervaluation of Vodafone's current stock price as of 11 November 2022.



VALUATION ANALYSIS

MERGER MODEL

PBT	6,621.38
Less:Income Tax	1,655.34
Net income	4,966.03
Outstanding Diluted shares of combined company	29,592
EPS of combined company	0.1678
EPS of acquirer standalone	0.0706
Accretive/Dilutive	Accretive
Accretive/Dilutive	0.0973
Accretive/Dilutive (%)	138%

Please click on the table to access full model.

Based on the merger model and the accretion/dilution analysis shown above, a potential Vodafone and Three UK merger deal would be accretive, having the possibility of increasing the EPS of the acquirer by 138%. This analysis suggests that Vodafone's interest in merging with Three UK is highly justifiable, and has the potential to bring in significant financial benefits for the company.

CONCLUSION

IMPACT ON THE CLOSE COMPETITORS

This deal has clear potential to increase the innovation and operational synergies of Vodafone and Three's competitors, as demonstrated by recent M&A activity. Although, the long-term impact for consumers is uncertain.

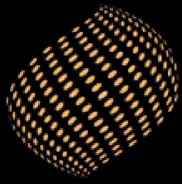
Until Virgin Media and O2 merged in 2021, BT was the only infrastructure-converged operator in the UK. As already discussed, recent M&A activity expanded the product offerings and capabilities of key players in the telecoms industry.

Announced in 2022, seven years after the merger took place, BT and EE have undergone a full brand convergence. EE will now be the flagship consumer brand, synergising the firm's internal operations and market positioning.

Until now, there had been a significant brand mismatch and a slow integration, and lack of competitive pressure. As a result of the Virgin O2 merger, BT-EE are facing increased product and market competition, incentivising the firm to become simplified.

When operating under one brand, BT-EE will benefit from operational cost-savings and consumers will benefit from a coherent communication strategy. These efficiencies are a product of the pressure applied by competitors, demonstrating that an integrated retail model, as opposed to a cross-selling approach, is more effective.

Therefore, with a greater number of competitors becoming infrastructurally converged, offering a greater range of products under a single brand, pressure will be put on others to merge. The proposed deal between Vodafone and Three, highlights this perceived need for M&A.



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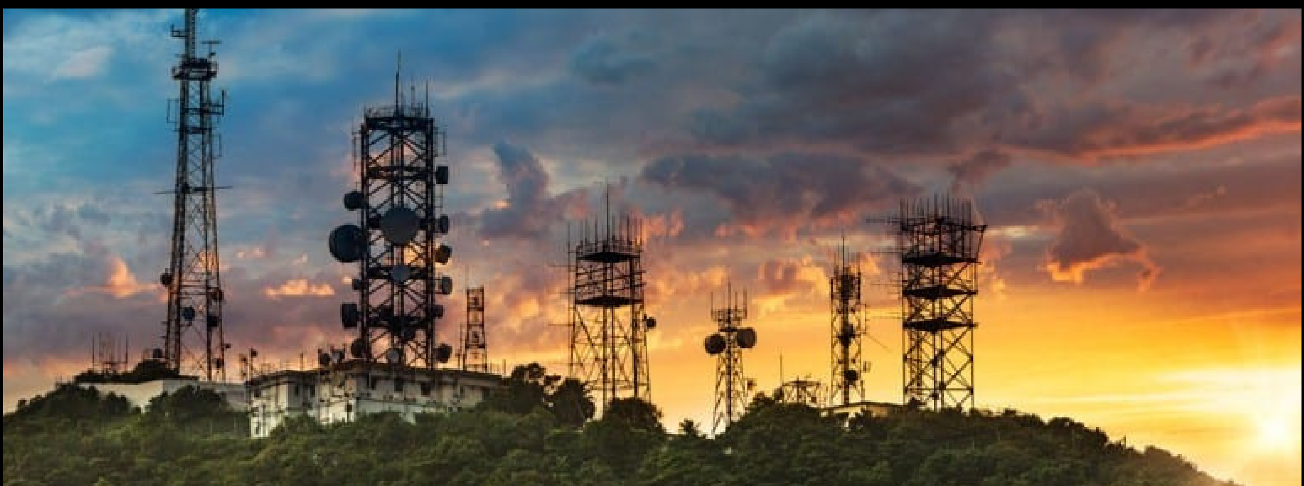
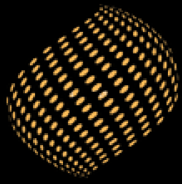
IMPACT ON THE INDUSTRY

Despite the short-term increase in competitive pressure, this may not benefit consumers in the long run. As a result of this merger the number of telecom firms that own network infrastructure will continue to shrink with product offerings becoming increasingly similar. If completed, this deal would make the UK telecoms market, by definition, monopolised with each firm representing more than 25% market share: Virgin Media O2 (32%), BT – EE (32%), Vodafone - Three (36%). With a small set of indistinguishable competitors, the industry runs the risk of becoming less competitive, with less scope to distinguish themselves. The impact this could have on consumer prices and customer experience is significant.

Ultimately, this deal will likely deliver positive results for the industry in the short-to-medium term. With mergers in this market becoming more common, as seen in the UK, the competitive potential may be limited in the long-term. If granted, the outcome would perhaps settle the debate.



Source: Telecoms.com



GLOSSARY

Accretive: **Accretive in finance refers to the positive change in value after a transaction.**

Equity Value: **Total value of a publicly traded company's outstanding common shares owned by the stockholders.**

EV/EBITDA: ***Enterprise Value 'Multiple', gives insight into the value of companies against their cash earnings less their non-cash expenses.***

Premium: ***increased amount paid per share in comparison to the share price at the time of the M&A transaction, often presented as a percentage.***

Sensitivity Analysis: ***The analysis of how a change in assumptions (inputs) can impact the output of a financial model.***

Terminal Growth Rate: ***A growth rate that a company is expected to grow at forever based on the market and industry conditions.***

Valuation Multiples: ***Financial tool providing one metric as a ratio of another; often used to compare similar companies.***

WACC: ***Cost of capital used to represent a firm's after-tax costs from all resources.***