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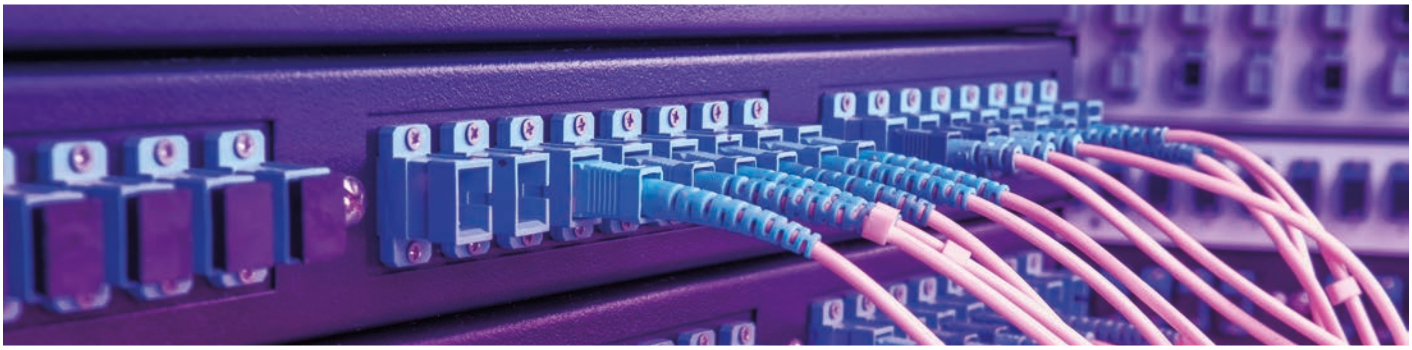
August 2016



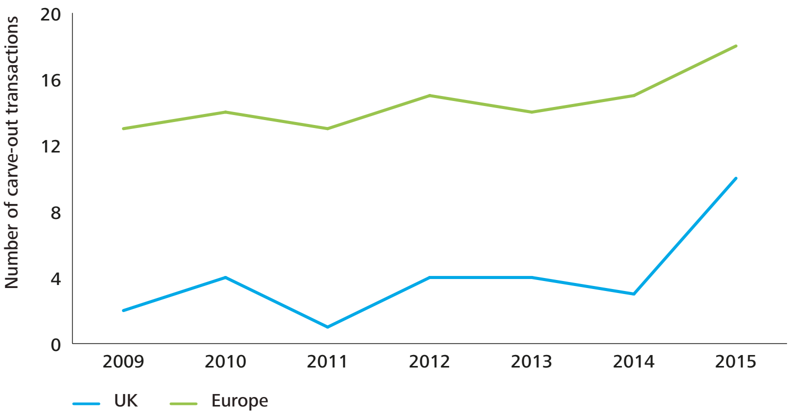
TMT M&A briefing
The rise of telco carve-outs

After a sustained period of consolidation in the telco industry, we are now seeing an increasing number of companies divesting non-core assets as part of broader portfolio rationalisations. In this briefing note, we investigate the reasons for this emerging trend and provide our view on the success factors for a carve-out transaction.

- **Carve-out transactions are becoming part of the changing corporate landscape – this trend is being driven by commercial factors, financial pressures and regulatory requirements.**
- **Telco boardrooms have been executing a range of strategic moves and this trend is likely to be further fuelled by the opportunities and risks created in a post-Brexit environment.**
- **Carve-outs create a range of challenges and in our experience are best addressed through a multi-faceted and multi-disciplinary approach to both maximise value and certainty of sale.**

Telco M&A carve-outs in the UK and Europe

Sales of non-core assets are becoming increasingly prevalent in both markets, as shown below:



Source: Deloitte analysis

Deloitte's telecommunications Advisory Corporate Finance team brings highly relevant and recent experience of carve-out transactions in the sector:

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Portfolio rationalisation is an increasingly hot topic within European telco boardrooms and is driven by a range of factors.

A complex range of deal drivers

The trend towards carve-outs is being fuelled by shareholder and boardroom pressure to focus on core business that is expected to generate the highest returns.

This is being driven by the factors set out below and include commercial, financial and regulatory considerations. These are further explored on the following pages.

Drivers of non-core telco carve-outs

1 "De-convergence" between telcos and IT services?

- From a commercial perspective, simplifying the product offering to focus on core services, may lead to improved win-rates, greater efficiency and better margins.
- Specifically, telco players with IT services divisions are increasingly considering divestments in order to focus on network, voice and data offerings.
- Also, investment cycles may not align, with telcos investing upfront in asset development which is less common in IT services.

2 Merger clearance remedies

- The requirement to divest assets following a merger is becoming an increasingly common competition remedy from European regulators.
- Within the mobile sector, for example, regulators are becoming increasingly active.

3 Capital allocation

- Demands on funding are ever present in the sector, for example to invest in next generation networks. Releasing funds held in non-core assets through M&A may allow re-investment in strategically important assets.
- Further to this, assets are worth different amounts to different investors – this value may be unlocked through a sale.

4 Operating model – Owner vs. operator

- Certain ICT players are increasingly moving towards infrastructure-light models, where ownership of the underlying assets is not an advantage and can actually impede flexibility in delivering customer solutions.
- Selling underlying assets with long term access agreements can offer the advantages of ownership without maintenance and capex liabilities.

5 Management distraction

- Non-core investments may become an expensive distraction for management.
- A key question is whether the investment of management time in a non-core part of the business is justified by the value which might be created.

After a period of convergence between IT services and telecommunications, we are seeing a number of telco players move away from IT services.

1

"De-convergence" between telcos and IT services?

The convergence of telecommunications and technology is well documented and in recent years telcos have expanded their offering into IT services: including data centre; hosting; and managed services.

However, we are seeing an increasing number of corporates review their portfolio and deem IT services to be non-core – a counter trend of "de-convergence".

For example, Colt's sale of its Managed Cloud business, on which Deloitte Corporate Finance advised, allows Colt to focus on its network, voice and data centre offering (see page 8 case study).

Today's M&A environment provides a further incentive for action, as there is a high level of appetite for certain assets and a sale process can be executed with a high degree of certainty.

Sticking to your knitting? – The challenges of developing an IT services business within a telco

Lack of synergies achieved	• IT services divisions are often developed to serve an existing telco customer base. • After this cross-sell, operational synergy between telco and IT services product sets may be difficult to achieve. • Extracting these operational synergies requires a precise skill set within technical staff and a different approach to customer service – creating execution challenges.
Cultural differences	• Telcos are traditionally more focussed on selling the capacity of an asset, whereas IT services businesses are more focussed on selling a skills-based services capability. • IT services businesses may take a more customer-centric approach to developing a customer proposition within a service driven culture. • This difference in frame of reference can significantly influence the likelihood of successful execution.
Improved connectivity and cloud models	• Customers of IT services businesses can increasingly choose "best in class" service providers, as improved connectivity and cloud operating models allow clients to easily select from a wide range of providers. • For example, a client's preferred network provider might not have the most suitable hosting services or data centres.

Regulatory clearances are increasingly requiring divestments as part of the wider consolidation agenda.

2

Merger clearance remedies

Divestment of certain assets as a condition of regulatory clearance for a merger has become increasingly common – alongside the use of MVNOs[1], wholesale access obligations and infrastructure sharing arrangements.

As shown in the table below, remedial action can be significant, even to the point where remedies render the deal unattractive to shareholders, for example Telenor/Telia.

Selected regulatory remedies to achieve clearance

Country	Deal	Remedies to achieve clearance		
		Sale/Spectrum sale	MVNO	Others
	Orange/Jazztel	Sale of FTTH[2] network	–	Access to ADSL[3] and mobile networks
	Altice/PT Portugal	Sale of fixed line operations	–	–
	Telenor/Telia	Sale of overlapping field telecom services; overseas mobile operators; and cable networks	–	Introduce local loop unbundling (LLU)
	Altice/SFR	Sale of mobile assets in overseas territories and B2B business	–	Provide access to cable networks
	Telefonica/E+	Spectrum sale to a new MNO[4]/ MVNO	Sell 30% of network capacity to up to three MVNOs	Extend pre-existing wholesale agreements
	Three/O2	Divest five blocks of spectrum from 2016	Sell 30% of the network capacity to two MVNOs	Offer Eircom an improved network sharing agreement
	ZON/Optimus	–	–	Extend sharing agreement and wholesale fibre access
	Hutchison/Orange	Spectrum sale to a new MNO	Wholesale 30% of the network capacity to MVNOs	Telekom Austria to buy Orange's largest MVNO

Source: Deloitte analysis, European Commission press releases and company releases
Notes: 1. Mobile virtual network operator
2. Fibre to the home
3. Asymmetric digital subscriber line
4. Mobile network operator

Our clients are increasingly focussed on improved capital allocation and are willing to explore operating model changes to achieve this.

Other key drivers

The drivers of improved capital allocation; refined operating models; and removal of management distraction are evidenced by the UK transactions set out below.

We are increasingly seeing these themes in our corporate client base, for example in the SSE data centre business transaction.

Selected UK deals that evidence key carve-out drivers

Example trend	Date	Vendor	Target business	Acquirer	Value (£m)	Commentary
3 Capital allocation	Oct 2014	SSE Enterprise Telecoms	SSE's data centre business	SCC	12	SSE Telecom's sale of its data centre business, advised by Deloitte Corporate Finance, illustrates improved capital allocation and corporate simplification as part of a broader divestment programme.
4 Operating model – Owner vs. operator	Nov 2015	KCOM	KCOM's national Infrastructure assets	CityFibre Infrastructure	90	KCOM's sale of its national network unlocked the value of an "under-utilised asset" and allowed KCOM to move towards a lighter infrastructure model.
5 Management distraction	Mar 2013	Telefonica	Telefonica UK's broadband and fixed-line telephony business	Sky	180	Telefonica's sale of its UK fixed line and broadband business was undertaken to allow management to focus on mobile and 4G services.

Source: Deloitte analysis and company releases

We believe that ongoing strategic moves within the telco sector are likely to lead to further carve-out transactions on a global basis.

Looking forward – Future deals

The European telco landscape is experiencing high levels of M&A activity, with strategic moves being made at multiple levels.

In this environment, non-core sales as part of wider strategic initiatives are likely to continue. Current market discussion supports our assertion; with a number of European and global telcos reviewing their portfolio of assets.

A wider international trend?

- This trend of non-core divestments by telco companies can be seen in other geographies.
- For example, two large US telecommunication businesses have been linked with the sale of their data centre real estate:
  - CenturyLink is undertaking a strategic review of its data centres having previously acquired them as part of Savis. Centurylink CEO, Glen Post, has stated that: *"We expect colocation services to remain part of our service offerings, but we do not believe ownership of the physical data center assets is necessary to effectively deliver those services."*[1]
  - It has been rumoured that Verizon Communication may be considering the sale of its enterprise division, including data centres.[2]

Source: 1. CenturyLink Third Quarter 2015 Results, 4 November, 2015
2. Reuters "Verizon weighing $10 billion sale of enterprise assets – sources", 6 November 2015

Carve-out transactions present a number of challenges to be managed as part of a successful sale process. In this context, preparation of the team, deal structure and business records are critical.

Success factors for a carve-out transaction

Preparation of information	• Preparation is key to running a successful process that minimises value leakage. • Importantly, assembling financial information that accurately captures the business is critical to value maximisation. • Equally important is the collation and review of legal documentation associated with the business.
Dealing with structuring complexities	• There are a range of structuring options which should be carefully considered balancing, the objectives of the vendor and creating an attractive asset for sale. • The mechanism of the transaction, e.g. asset vs. shares, has implications for legal risks and the completion mechanism. • Defining the "sale perimeter" of exactly what is to be sold will impact the attractiveness of the asset, any retained liabilities/stranded costs and the overall complexity of the deal. • Consideration may be given to transitional service agreements ("TSAs") and long term agreements ("LTAs") for the continuation of services between the vendor and acquirer, in order to support the carved out business post sale – this can be a key driver of value for both parties. • Simplifying existing pension arrangements in advance can make a carve-out more attractive. For UK defined benefit pensions, carve-outs can trigger significant "Section 75" exit liabilities, sometimes unintentionally. Risks should be identified early and mitigated.
Presenting the right team	• Management strength and depth will be thoroughly tested through any sale process. • The selection and motivation of a team with the right mix of commercial, operational, financial and legal knowledge is key to success.
Finding the right buyer	• Selection of potential buyers to approach is critical for both maximising both value and certainty of sale. • This requires detailed knowledge of the buyer universe, including both strategic and financial investors. • Key selection criteria include: potential commercial synergies; ability to fund and complete the transaction; and likely regulatory requirements.
Communication	• Considered communication to both staff and customers is often overlooked and is essential to the trading of the business during and after the sale process.

Our telecommunications carve-out team uses a multi-disciplinary approach to prepare for and ultimately deliver a carve-out transaction.

Our approach

We believe that potential carve-out situations require a multi-disciplinary approach.

Our approach is to consider strategic options broadly, including retain, refocus, invest or divest. Considering the commercial, operational and financial impacts of these options allows well informed and confident decision making.

Our multi-disciplinary approach combines lead M&A advisory services with a broad range of Deloitte services to offer our clients a complete carve-out solution. In summary, we offer:

Multi-disciplinary team

- Full breadth of M&A services seamlessly provided, includes Lead M&A advice, Consulting, Transaction Services, Separation and Tax.

Leverage our buyer networks

- Buyer insight and access through our international network and local presence.

First class sale process execution

- Positioning the business for best results and running a competitive, efficient sale process.

Considered deal structuring

- Corporate finance advice on key structuring issues, including transaction basis, sale perimeter and transitional agreements.

Telecommunications sector focus

- Our team offers deep knowledge and recent experience in the telecommunications sector.

Case study – Colt Managed Cloud

- Deloitte acted as sell-side advisor and led a multi-disciplinary Deloitte team to achieve a successful carve-out.
- Deloitte initially assisted Colt in a strategic review and specifically reviewed Colt's Managed Cloud division – which was identified as a non-core asset by the Board.
- The assets of Colt Managed Cloud were packaged and carved-out of the core operations of the Colt group and were sold to Getronics.
- As part of the sale agreement, Colt entered into a long-term strategic partnership for Getronics to provide cloud services to Colt.

Carve-out transactions are increasingly being used by telcos to optimise their portfolio. Careful consideration of strategic options and precise execution are critical to success.

Conclusion

Telco companies are increasingly divesting non-core assets as part of broader portfolio rationalisations.

This is being driven by a range of factors, including de-convergence of telco and IT services, regulatory remedies and improved capital allocation.

Carve-outs create a range of challenges and in our experience are best addressed through a multi-faceted and multi-disciplinary approach.

Our team, as set out below, would welcome a discussion on the topics raised in this briefing.

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