WITG Stock Pitch

I recommend opening a long position in Oi (OIBR), soon to be CorpCo. The impending merger of Portugal Telecom (PT) and Oi into CorpCo as well as the changing landscape of Brazilian Telecom presents an interesting opportunity to invest.

The Merger

The Portugal Telecom and Oi merger was recently approved by Brazil's regulators and is expected to take place in 5-6 months. The agreement stipulates that Oi shareholders will receive 61.9% control of the merged organization with every voting shareholder in Oi will receiving 1.000 voting shares in CorpCo. The merged organization's operations will be roughly divided up into 75% Brazil, 22% Portugal and 3% Africa. The restructured organization will have approximately the same EV/EBITDA as Oi, but will realize a NPV of $5.5 billion, including cost savings of approximately $2.43 billion in present value terms according to the financial Times through pressure on suppliers and consolidation of assets. Factoring in Oi's percentage of the merge organization and noting 1.82 billion outstanding Oi shares, there is a value of $0.82 added per share. Of course, the increase of Oi's exposure to the Portugal market, which it previously had no exposure to, will stunt Oi's growth projections in the near future since the Portuguese economy is still struggling. Discounting this value added by 30% for the sake of uncertainty about the synergies and the risk of Oi defaulting and an additional 20% because of Oi's additional exposure to the weak Portuguese market there is still a net gain of $0.46 per share. This seems to have been baked into Oi's share price subsequent of the merger announcement date.

The other 3.07 billion can be attributed to intangible synergies primarily the managerial prowess of Portugal Telecom adding in the control of Oi rampant costs. These synergies that have been noted by experts have been heavily discounted by the market. The primary argument being that Portugal Telecom, like Oi, suffers from mismanagement as evidenced by the large amounts of debt on its balance sheet. However, this analysis does not normalize for geographic area. When Portugal Telecom is put in perspective with other Portugal telecommunications companies the large tranches of debt are expected due to the recent depression in Portugal. In fact, Portugal Telecom CEO Bava has managed to keep operating costs fairly constant in spite of an aggressive 14% expansion campaign. This cost efficiency will undoubtedly by a huge asset for Oi, which has had a bad reputation for efficient use of funds. This year Bava was appointed CEO of Oi, and he has already implemented notable cost cutting measures such as eliminating Oi's dividend, which caused the stock price to plunge, but it is a huge step towards paying down Oi's debt and increasing internal investment. When Oi starts paying down its debt as CorpCo there will undoubtedly be upwards pressure on the merged companies share value.

The Changing Environment

Investors also underestimate Oi's market position in the Brazilian market. Investors tend to focus on Oi's market share loss in the mobile sector, which is down to 19%. However, Portugal Telecom is a leader in Portugal's mobile sector through its bundling of fixed-line services with pay-TV, internet and mobile services and its military grade software to install and service bundled kits, which is a modified version of the software used by the Israeli military. Telefonica's Vivo, which currently has the largest share (29%). However, pursuing their aggressive expansion policy Telefonica has sacrificed quality of service. The company is among the top five companies with the most service complaints in Brazil and has been ranked the company with the worst public image, and currently has thousands of claims filed against them for non-delivery for services paid for. Telefonica's market share would be unsustainable in the face of strong competition. Furthermore, there are indications that Italia Telecom will shed its subsidiary TIM due to high debt levels, acquisition pressure from Telefonica and the poor economic situation in its home country, Italy. In the event of this happening Brazilian regulators have indicated that they would be concerned about competition. This means that regulators will require TIM be broken up and sold as pieces rather than sold as whole to Telefonica. This presents a unique opportunity for Oi in the form of CorpCo to strengthen its position in the mobile market either through acquisition of a piece of TIM or its own expansion into the vulnerable areas occupied by TIM. At the very least conditions within the mobile sector will become friendly to all telecom companies operating in the Brazilian market.

It should be noted that even though Oi's deficiencies in the mobile market are being highlighted here in the discussion of unrealized value. Oi's other business components are solid. Oi has 28.5% of all broadband internet in Brazil, and controls 43% of landlines in Brazil.

Risks

One source of risk is the Oi-Portgal Telecom merger falling through. However, since the regulatory hurdles have been cleared and both Oi and Portugal Telecom have already taken steps to raise the necessary capital for the merger, this possibility is unlikely.

The main source of risk for OI, after its merger into CorpCo is that both Oi and Portugal Telecom bring large swaths of debt to the table. Nearly, a 3.3x net debt/EBITDA ratio is expected after the merger. The merged company is expected to receive a higher credit rating and more access to debt, as foreshadowed by the cost of protecting Portugal Telecom's debt plunging by 70 basis points after news of the merger came out, which will take pressure of CorpCo in the near future. However, if CorpCo's cost cutting measures are ineffective or the telecom market experience a demand shock the massive amounts of debt will severely decrease CorpCo's ability to operate within the market. Brazilian macroeconomic trends of modest, but steady GDP growth seems to indicate that a demand shockis unlikely.