

TELEFONICA BRASIL

1Q23 Preview: And now, where does the growth should come from?

LatAm Telecom

Main takeaways:

(i) Mobile accesses with net adds q/q, even with disconnections; **(ii)** FTTH on the rise (+3.0% q/q), but offset by drops in FTTC (-14.3% q/q) and DTH (-5.2% q/q Genial Est.); **(iii)** Mobile ARPU in an upward trend (+0.8% q/q Genial Est.); **(iv)** We expect a slight retraction in revenue q/q (-1.4% Genial Est.); **(v)** No news on costs, flat q/q; **(vi)** Marginal drop in EBITDA (-1.5% q/q); **(vii)** Net income should also feel slowdown q/q (-10.4% Genial Est.).

Telefonica Brasil (Vivo) will release its results on May 9th, after market close. We expect the Company to continue with a solid operation but showing **some signs of revenue and net income deceleration q/q**. We should still find effects of the exclusion movement in the inactive part of Oi's base, which despite slightly changing the dynamics of ARPU should not cause major changes in the formation of revenue on a quarterly basis. We see year-on-year comparisons being driven both organically and inorganically.

In this report **we discuss in what way we think Vivo should continue to delivery growth going forward.**

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Company

VIVT3 BZ Equity

Buy

Price: R\$ 41.40 (05-May-2023)

Target Price 12M: R\$ 55.00

1Q23 Preview

Mobile accesses with net adds q/q, even with disconnections. Based on the numbers already released by Anatel, we can see that mobile accesses had a slight net adds during the quarter, more concentrated in the postpaid plan, which reached 58.7mn in 1Q23 (+0.1% q/q) from the net adds of 82k clients. Meanwhile, prepaid accesses reached 39.2mn, which represents net accesses with a retraction of -10k during the quarter, driven by the continued disconnection of Oi Móvel customers who had not recharged in the last three months.

Therefore, mobile accesses reached 98.0mn in 1Q23, with a slight increase of +0.1% q/q and a more significant increase of +14.9% y/y, reflecting the additions brought by the recent M&A. Our expectation is for churn to remain at contained levels, near the historic low, as we project 2.5% Genial Est. in 1Q23, flat q/q and y/y.

FTTH on the rise, but offset by drops in FTTC and DTH. We estimate that for 1Q23, fixed accesses should come in similar levels to 4Q22, with a slight drop in the consolidated, mainly due to the end of the DTH offer, a type of Pay TV that we already believed was losing market share. Thus, we expect a total of 14.3mn Genial Est. in fixed accesses (-0.3% q/q).

For broadband, we see that the data reported by Anatel brings a q/q rise, which we expect, as usual, to be made up of FTTH additions more than offsetting FTTC losses. With 5.6mn Genial Est. for FTTH, we expect a +3.0% q/q rise, followed by a more relevant +16.7% y/y increase, showing growth and value generation in the line. Other broadband accesses, on the other hand, are expected to post a decline of -14.3% q/q.

Accelerating the trend seen in recent quarters, in which IPTV maintained its resilience in accesses while peripherals, mainly composed of DTH (Direct-to-Home), showed a sharper drop, we expect 1Q23 to report a more significant decrease, given the Company's choice to stop offering the service. We expect Pay-TV accesses at 916mn Genial Est., down -5.2% q/q, and -14.2% y/y.

Mobile ARPU in an upward trend. Being a derivative of total revenue, we believe that some trends will be observed in 1Q23, such as: **(i)** the effect of disconnections from inactive bases with lower average ticket, and **(ii)** the readjustment in the offers, with +12% in the control plan, +11% in postpaid, and +3% in the family plan. Considering these two points, our projection is for a soft ARPU increase, reaching R\$27.2 in 1Q23 Genial Est. (+0.8% q/q; +1.1% y/y), leading by postpaid ARPU ex. M2M of +3.4%, reaching R\$49.1 Genial Est., mainly due to the non-renewal of some M2M contracts during the quarter.

Moreover, prepaid ARPU should show a more contained increase, reaching R\$13.0 Genial Est. (+0.4% q/q/ +4.2% y/y), since the consolidation of the market after Oi's liquidity crisis. On the fixed services side, we estimate broadband ARPU basically flat, reaching R\$86.8mn Genial Est., caused by the continuous switch from FTTH to FTTC, with the entrance of a more expensive average ticket plan and the exit of a cheaper one, which in volumes create a compensatory effect on ARPU.

Table 1. Operationals Telefonica Vivo (1Q23 Genial Est.)

(Thousands)	1Q23E	4Q22	% q/q	1Q22	% y/y
	Genial Est.	Consolidated		Consolidated	
Fixed Base	14.303	14.351	-0,3%	14.640	-2,3%
Broadband	6.409	6.372	0,6%	6.228	2,9%
FTTH	5.647	5.482	3,0%	4.838	16,7%
Pay TV	916	966	-5,2%	1.067	-14,2%
IPTV	896	898	-0,3%	899	-0,4%
Fixed Voice	6.978	7.013	-0,5%	7.345	-5,0%
Mobile Accesses	98.051	97.979	0,1%	85.302	14,9%
Postpaid	58.755	58.673	0,1%	50.903	15,4%
Prepaid	39.296	39.306	0,0%	34.399	14,2%
Mobile Monthly Churn	2,5%	2,5%	-0,03p.p	2,6%	-0,11p.p
Mobile ARPU (R\$)	27,2	26,9	0,8%	26,9	1,1%
Postpaid ex. M2M	49,1	47,5	3,4%	48,8	0,5%
Prepaid	13,0	12,9	0,4%	12,4	4,2%
Broadband ARPU (R\$)	86,8	86,4	0,4%	85,4	1,7%

Soure: Telefonica Brasil, Genial Investimentos

We expect a slight retraction in revenue q/q. We project for 1Q23 a net revenue of R\$12.4bn Genial Est. (-1.4% q/q), with only a slight retraction, remaining at a level close to that seen in the last quarter. While non-core revenues should continue to decline, the dynamics within the core activities should be different between mobile and fixed, as we expect mobile core revenues of R\$8.7bn Genial Est., on a mild deceleration of -1.5% q/q, and fixed core revenues of R\$2.8bn Genial Est., an equally mild increase of +0.5% q/q.

In the short term, we believe in the transition movement between prepaid and postpaid plans, the so-called Upsell, which should remove part of the revenue from one side and add to the other, adding a higher ARPU. Nevertheless, we expect some level of revenue loss q/q in handset sales, given the positive retail seasonality typical of 4Qs. Even though 1Q23 numbers should not be as strong as last quarter, we believe Vivo is managing to maintain a good pace of sales, benefiting from inflation in prices and premium products. Therefore, reaching R\$779mn Genial Est. (-20.9% q/q; +10.0% q/q). Likewise, we expect that even with the end of the DTH (Direct-to-Home) TV offering, which brought in about R\$200mn in revenue per year, and the continued loss of revenue from FTTC, those two should be more than offset by an increase in FTTH, of which we expect R\$1.4bn Genial Est.

Table 2. Revenue Telefonica Vivo (1Q23 Genial Est.)

(R\$ millions)	1Q23E	4Q22	% q/q	1Q22	% y/y
	Genial Est.	Consolidated		Consolidated	
Net Revenue	12.487	12.659	-1,4%	11.352	10,0%
Net Core Revenue	11.652	11.771	-1,0%	10.285	13,3%
Mobile Revenue	8.766	8.899	-1,5%	7.581	15,6%
Postpaid	6.459	6.381	1,2%	5.594	15,5%
Prepaid	1.528	1.533	-0,3%	1.279	19,4%
Handset	779	985	-20,9%	708	10,0%
Fixed Revenue	2.886	2.872	0,5%	2.704	6,8%
FTTH	1.457	1.397	4,3%	1.272	14,6%
FTTC	89	101	-12,4%	166	-46,6%
IPTV	360	362	-0,7%	384	-6,2%
Corporate Data and ICT	965	994	-2,9%	870	10,9%
Net Non Core Revenue	835	888	-6,0%	1.067	-21,7%

Soure: Telefonica Brasil, Genial Investimentos

No news on costs. We expect Vivo's COGS to be -R\$7.4bn Genial Est., flat vs. 4Q22 (-0.1% q/q), with the part related to costs of goods and services falling a bit sharper, as handset and devices sales should slow (-6.3% q/q Genial Est.), while operating costs should come in at a high of +1.4% q/q Genial Est., causing a neutral effect on consolidated costs.

Marginal drop in EBITDA. With a minimal drop in net revenues, while costs should remain similar, we expect EBITDA in 1Q23 to drop slightly, reaching R\$5.0bn Genial Est. Therefore, we project an EBITDA margin of 40.6% as an expectation, falling q/q but rising y/y.

When we compare the EBITDA line on a nominal basis, we see that the acquisition of part of Oi Móvel's base managed to generate value, even though it brought more **(i)** costs and **(ii)** inactive users than initially expected. Therefore, we project a +12.3% y/y increase, a double-digit growth driven both organically and inorganically.

Leverage should still continue to penalize the financial result, given the ratio of accelerated y/y financial expenses caused by still high gross debt; however, with a slight slowdown from last quarter, in which we expect -R\$556mn Genial Est. vs -R\$604mn in 4Q22.

Net income should also feel slowdown q/q. At a projection of R\$1.0bn Genial Est. for Vivo's net income in 1Q23, we expect to see a drop of -10.4% q/q, reflecting a slight deceleration in revenues but still relevant costs, as well as an estimate of slightly lower tax benefits.

In addition, our calculations point to a net margin of 8.1% Genial Est. Despite this, we still project a y/y margin upside, demonstrating that the **(i)** recent acquisition, along with **(ii)** the upsell work on its mobile base, and **(iii)** the increase in homes passed with FTTH connection on the fixed base.

Table 3. Income Statement Telefonica Vivo (1Q23 vs. Genial Est.)

(R\$ millions)	1Q23E		% q/q	1Q22	
	Genial Est.	Consolidated		Consolidated	% y/y
Net Revenue	12.487	12.659	-1,4%	11.352	10,0%
COGS	(7.329)	(7.425)	-1,3%	(6.840)	7,1%
EBITDA	5.158	5.234	-1,5%	4.511	14,3%
EBITDA Margin (%)	41,3%	41,3%	-0,04p.p	39,7%	1,56p.p
D&A	(3.226)	(3.263)		(3.074)	
EBIT	1.932	1.971	-2,0%	1.437	34,4%
EBIT Margin (%)	15,5%	15,6%	-0,1p.p	12,7%	2,81p.p
Financial Result	(557)	(604)	-7,8%	(524)	6,3%
Net Income	1.009	1.126	-10,4%	750	34,6%
Net Margin (%)	8,1%	8,9%	-0,81p.p	6,6%	1,48p.p

Source: Telefonica Brasil, Genial Investimentos

Our Take on Telefonica

Despite a slight loss in EBITDA and net margin q/q, we expect another quarter that we consider solid for Telefonica Brasil (Vivo), marked by new disconnections of customers acquired from Oi who have been inactive for more than three months, which should continue to bring a cleaner ARPU without resulting in a loss of top line.

Going forward, from the 2Q23 result onwards, after a year has passed in relation to consolidation, we will be able to see better how the price readjustment movement for Oi's base should take place, with a direct reflection in a higher value generation for investors in the short term, since the non-adjustment agreement ended in April. On the organic side, the readjustments that took place in 1Q23, with +11% in the postpaid plan, +12% in control, and 3% in family, should already have some effect, while the current base should be corrected for 2Q23.

With mobile churn close to Vivo's historical lows, and the constant fixed growth via **(i)** FTTH increase in detriment of FTTC, and by **(ii)** CAPEX for new homes passed by increasing the number of connections, we see a good strategic positioning by the Company, in some competitive advantages that should be reflected in better results going forward.

Now, where does the growth should come from? Disregarding the y/y effect of the acquisition of Oi Móvel's customer base and looking ahead, we believe that the Company will continue to deliver growth in both the mobile and fixed businesses, but at a more modest pace. In **(i)** mobile, we believe that growth should come organically, with the upsell of its customer base, since the acceleration of postpaid revenue is higher than prepaid. As for **(ii)** the fixed services, we were able to analyze that the technology upgrade, with the change from FTTH to FTTC, and the good positioning of its neutral network, which is ahead of its competitor TIM, and already had more than 23mn homes passed at the end of 4Q22, should continue to support net revenue, with more clients in higher value-added plans.

Why do we prefer Telefonica over TIM? Although both companies are leveraged at levels higher than the historical average and this continues to pose small barriers to higher net income formation, we observe Telefonica (Vivo) is less leveraged than TIM (0.3x vs. 0.9x Net Debt/EBITDA 23E), in such a way that we believe Vivo will have an easier return towards the historical average, which we project to happen by the end of 2023, while TIM should still suffer until 2024. This is easily seen by the net margin, of which Vivo should exceed TIM's performance (9.85% vs. 7.5% 23E). Considering this aspect, we see with good eyes the company's guidance for CAPEX in 2023 of R\$9bn, already showing a deceleration (~-7.0% y/y), as decreases in CAPEX result in direct increases in cash flow (FCFF) generated. Meanwhile, TIM should present even higher CAPEX levels, in our view.

Summarizing, being **(i)** the market share leader, having **(ii)** higher upsell potential, being **(iii)** less leveraged than TIM and **(iv)** having higher cash flow generation capacity in the short term than the competitor, we continue to see Telefonica (Vivo) as **our Top Pick** for the **Telecom sector**. Trading at an **EV/EBITDA 23E** of **4.6x**, with a projected **dividend yield** of **6.2%**, we reiterate our **BUY recommendation**, with a **Target Price 12M** of **R\$55.00**, implying an upside of **+33.37%**.

Appendix: Telefonica Brasil

Figure 1. Telefonica Vivo – Income Statement in R\$ Millions (Genial Est. 2023-2028)

Income Statement	2023E	2024E	2025E	2026E	2027E	2028E
Net Revenue	47.320	48.718	50.191	51.666	53.331	55.165
(-) COGS	(29.371)	(29.902)	(30.898)	(31.760)	(32.800)	(33.897)
EBITDA	21.330	22.299	22.880	23.600	24.337	25.188
(-) D&A	(12.494)	(11.795)	(11.505)	(11.297)	(11.189)	(11.167)
EBIT	8.836	10.504	11.375	12.303	13.148	14.021
(+/-) Financial Result	(1.926)	(1.308)	(1.243)	(1.288)	(1.334)	(1.388)
EBT	6.910	9.196	10.132	11.015	11.814	12.634
(-) Taxes	(2.248)	(2.058)	(2.376)	(2.676)	(2.948)	(3.426)
Net Income	4.663	7.138	7.756	8.339	8.866	9.207
Profitability						
Net Margin (%)	9,85%	14,65%	15,45%	16,14%	16,62%	16,69%

Figure 2. Telefonica Vivo – Cash Flow in R\$ Million (Genial Est. 2023-2028)

Cash Flow	2023E	2024E	2025E	2026E	2027E	2028E
Net Revenue	47.320	48.718	50.191	51.666	53.331	55.165
(-) COGS	(29.371)	(29.902)	(30.898)	(31.760)	(32.800)	(33.897)
EBITDA	21.330	22.299	22.880	23.600	24.337	25.188
EBIT	8.836	10.504	11.375	12.303	13.148	14.021
(-) Taxes	(2.248)	(2.058)	(2.376)	(2.676)	(2.948)	(3.426)
(+) D&A	12.494	11.795	11.505	11.297	11.189	11.167
(+/-) Δ WK	(891)	(165)	(73)	(105)	(101)	(121)
(-) Capex	(9.025)	(9.187)	(9.411)	(9.688)	(10.285)	(10.635)
FCFF	9.166	10.888	11.020	11.131	11.003	11.006

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