Equity Research

TIM BRASIL

1Q23 Review: Debt is the free man's prison

LatAm Telecom

Analysts

Igor Guedes
+55 (11) 3206-8286
igor.guedes@genial.com.vc

Iago Souza
+55 (11) 3206-1455
iago.souza@genial.com.vc

Antonio Cozman
+55 (11) 3206-1462
antonio.cozman@genial.com.vc

Renan Rossi
+55 (11) 3206-1457
renan.rossi@genial.com.vc

Company

TIMS3 BZ Equity
Buy

Price: R$ 14.01 (08-May-2023)
Target Price 12M: R$ 16.00

Main takeaways:

(i) Rebalancing of a portion of Oi's base brought in negative mobile numbers, but positive prepaid results; **(ii)** Postpaid ARPU above expected, (+3.8% vs. Genial Est.), but prepaid below (-0.4% vs. Genial Est.); **(iii)** FTTH additions offsets retraction in FTTC; **(iv)** TIM Ultrafibra ARPU misses estimates (-2.6% vs. Genial Est.); **(v)** Revenue better than expected, but with a modest q/q slowdown (+2.1% vs. Genial Est.); **(vi)** Stronger postpaid ARPU affects revenue (+4.7% vs. Genial Est.); **(vii)** TIM Ultrafibra growing in line with expectations (0.9% vs. Genial Est.); **(viii)** Costs and expenses slightly higher than expected, caused by Oi Móvel and the sale of I-Systems (+4.6% vs. Genial Est.); **(ix)** commercialization impacted by the acquisition of Oi (+26.6% y/y); **(x)** Network and Interconnection showing higher than expected growth (+2.9% vs Genial Est.); **(xi)** We observed an increase in other operating expenses, due to a non-recurring event (+102.8% q/q); **(xii)** Revenue above expectations is offset by worse than expected COGS, resulting in EBITDA in-line with projections (-0.2% vs. Genial Est.); **(xiii)** Net income better than projected (+31.3% vs. Genial Est.).

Tim's earnings release **came broadly in line with our expectations**, in a quarter with slight deceleration q/q, with the termination of Oi Móvel's consolidation process and reflecting the business model shift in the fixed services. However, we have seen **FCFE formation being hampered by leverage almost 2x above the historical average**.

We expect the market to have a positive reaction upon the opening of the trading session. However, we warn investors that **despite the good mood with the improved results**, including EBITDA margin gains y/y, something we were criticizing in previous results, **we still see clear barriers to cash flow generation** (CAPEX still at high levels and leverage stagnant at 1.4x Net Debt/EBITDA, despite payments of financial leases amortizations along with new loans amounting R$484mn in a single quarter).

1Q23 Analysis

Rebalancing of a portion of Oi's base brought in negative mobile numbers, but positive prepaid results. Consolidated mobile accesses in 1Q23 are 61.7mn, but we see a -1.2% q/q drop caused by the net removal of -764k users. In addition, we see a prepaid additions dynamic of 413k accesses last quarter, as well as a drop of 1,177kt in postpaid, consequence of a reclassification of acquired users that had been inactive for over 3 months.

Postpaid ARPU above expected, but prepaid below. Given the reclassification of part of Oi's base and significant cuts in the postpaid plan, the intensity of the trend was a little higher than previously expected. The unit's ARPU got to a level above our expectations, reaching R$40.5 in 1Q23 (+3.8% vs. Genial Est.), showing a strong increase of +6.0% q/q. On the flip side, Prepaid ARPU grew at a slightly lower rate than previously projected, hitting R$13.9 in 1Q23 (-0.4% vs. Genial Est.), up +1.7% q/q. Despite only representing a revenue's derivative, a relevant hike in Mobile ARPU, reaching R$27.9 (+2.8% vs. Genial Est.), demonstrates how an efficient cleaning of the customer base can increase the average ticket.

In addition, the monthly mobile *churn* came better than expected, moving faster towards normality, reaching 3.5% (-0.75p.p. vs. Genial Est.), just +0.5p.p. above the historical average. As seen, 4Q22 presented an abnormality due to the large base disconnect that inactivity caused, hitting 7.1% last quarter.

FTTH additions offsets retraction in FTTC. The substitution of FTTC technology for FTTH, as pointed out in our previous report, continued to be observed on 1Q23. The latter reached 592mn accesses, slightly above our expectations (+7.9% q/q), while the former came in at 140mn (-4.8% vs. Genial Est.), down -16.3% q/q. In sum, there was a total of 723mn accesses last quarter, up +2.2% q/q, driven by the net addition of 16mn.

TIM Ultrafibra ARPU misses estimates. FTTH ARPU came in above expectations (+1.4% vs. Genial Est.) while FTTC went in the opposite direction (-4.8% vs. Genial Est.). Even though FTTH ARPU is naturally higher, as it is a newer technology, the slight increase over our expectations was not enough to compensate for the very tepid FTTC numbers. Thus, consolidated ARPU for TIM Ultrafibra came in weaker than projected, at R$92.9 (-2.6% vs. Genial Est.). Contrary to what we thought, ARPU fell -2.2% q/q, which led us to believe TIM is using a more aggressive pricing strategy in Ultrafibra to reach higher volume, growing accesses a little more than expected, but at a lower average ticket.

Revenue better than expected, but with a modest q/q slowdown. TIM reported net revenue slightly above our expectations, at R$5.6bn (+2.1% vs. Genial Est.), caused by a more positive dynamic in mobile services, despite a more negative one in fixed services.

Table 1. Operationals TIM (1Q23 vs. Genial Est.)

(Thousands)	1Q23 Consolidated	1Q23E Genial Est.	% C/E	4Q22 Consolidated	% q/q	1Q22 Consolidated	% y/y
TIM Ultrafibra Costumer Base	**732**	**732**	**0,0%**	**716**	**2,2%**	**689**	**6,2%**
FTTH	592	584	1,4%	549	7,9%	438	35,3%
FTTC	140	147	-4,8%	167	-16,3%	252	-44,4%
Mobile Costumer Base	**61.721**	**61.720**	**0,0%**	**62.485**	**-1,2%**	**52.305**	**18,0%**
Prepaid	35.653	35.653	0,0%	35.240	1,2%	29.089	22,6%
Postpaid	26.067	26.067	0,0%	27.245	-4,3%	23.215	12,3%
Mobile Monthly Churn (%)	3,5%	4,2%	-0,75p.p	7,1%	-3,58p.p	3,1%	0,37p.p
Tim Ultrafibra ARPU (R$)	**92,9**	**95,4**	**-2,6%**	**95,0**	**-2,2%**	**91,4**	**1,6%**
Mobile ARPU (R$)	**27,9**	**27,1**	**2,8%**	**26,9**	**3,9%**	**27,4**	**1,8%**
Prepaid	13,9	14,0	-0,4%	13,7	1,7%	13,2	5,4%
Postpaid	40,5	39,0	3,8%	38,2	6,0%	39,1	3,7%

Soure: TIM, Genial Investimentos

Stronger postpaid ARPU affects revenue. On a better-than-expected postpaid ARPU *driver*, customer-generated revenue ended up at R$4.8bn (+4.7% vs. Genial Est.), but that was partially offset by weaker-than-estimated interconnection, customer platform and other weak revenues, totalizing R$5.1bn (+2.7% vs. Genial Est.).

TIM Ultrafibra growing in line with expectations. Even though revenues for fixed services came in at R$315mn (-1.9% vs. Genial Est.), TIM reported Ultrafibra revenue of R$209mn (+0.9% Genial Est.), a +0.8% q/q growth and +9.1% y/y, with the transition from FTTC to FTTH.

Net product revenue showed a sharp drop of -29.2% q/q, reflex of a more intense slowdown seasonality for retail, typical of the 4Qs. Still, we see an increase on a year-on-year basis, pulled by effects of: **(i)** inflation and **(ii)** a more *premium* line of cellphones, rising +21.3% y/y at R$174mn in 1Q23 (-6.8% vs. Genial Est.).

Table 2. Revenue TIM (1Q23 vs. Genial Est.)

(R$ millions)	1Q23 Consolidated	1Q23E Genial Est.	% C/E	4Q22 Consolidated	% q/q	1Q22 Consolidated	% y/y
Net Revenue	**5.681**	**5.562**	**2,1%**	**5.874**	**-3,3%**	**4.727**	**20,2%**
Mobile Service	**5.192**	**5.054**	**2,7%**	**5.305**	**-2,1%**	**4.286**	**21,1%**
Client Generated	4.821	4.605	4,7%	4.869	-1,0%	3.900	23,6%
Interconnection	110	120	-8,3%	113	-3,0%	112	-1,9%
Costumer Platform	32	53	-39,6%	51	-37,1%	35	-9,7%
Others	229	277	-17,3%	271	-15,6%	239	-4,2%
Fixed Service	**315**	**321**	**-1,9%**	**323**	**-2,6%**	**297**	**6,0%**
TIM Ultrafibra	209	207	0,9%	207	0,8%	192	9,1%
Others	106	114	-7,1%	116	-8,7%	106	0,2%
Products	**174**	**187**	**-6,8%**	**246**	**-29,2%**	**143**	**21,3%**

Soure: TIM, Genial Investimentos

Costs and expenses slightly higher than expected, caused by Oi Móvel and the sale of I-Systems. We expected some pressure in costs, with its focus on the acquisition of Oi Móvel and the sale of I-Systems. TIM reported R$3.1bn (+4.6% vs. Genial Est.) in costs and expenses, an increase of 4.3% q/q and 17.9% y/y, surpassing our expectations due to 3 main cost lines: **(i)** Commercialization; **(ii)** network and interconnection and **(iii)** Other revenues (operating expenses).

Commercialization impacted by the acquisition of Oi. The line was strongly impacted by Oi's acquisition (+4.5% q/q; +26.6% y/y), and came in above our projection (+2.6% vs. Genial Est.) The main reasons were: **(i)** TSA (*Temporary Service Agreement*) and **(ii)** higher infrastructure expenses due to a larger customer base.

Network and Interconnection showing higher than expected growth. We were indeed projecting an acceleration in this line, but the numbers came in even higher (+2.9% vs Genial Est.), a consequence of spending more with VAS content providers ("value added services") and an increase in spending with "roaming" services.

We observed an increase in other operating expenses, due to a non-recurring event. The other expenses line was strongly impacted by a civil contingency related to an old legal case, which led to a strong acceleration (+102.8% q/q; +43.4% y/y), well above our estimates (+17.5 vs. Genial Est.).

Revenue above expectations is offset by worse than expected COGS, resulting in EBITDA in-line with projections. Although our revenue expectation was exceeded by +2.1%, costs came in +4.6% higher, neutralizing the results and, consequently, keeping EBITDA at R$2.6bn in 1Q23 (-0.2% vs. Genial Est.), in line with expectations. With a maintenance seen in the short-term result, we were still able to see growth in comparison with 1Q22, demonstrating the positive effect that the acquisition of Oi Móvel was able to add to its result.

Even so, consolidated EBITDA margin was affected, reaching 46.0% in the quarter (-1p.p. vs. Genial Est.), and dropping -3.91p.p. q/q, and a high of +1.06p.p. y/y.

From financial expenses with slow declines due to leverage still above the historical average, as commented in our earnings preview report, we observed a partially offsetting effect above what we projected in financial revenues (+27.9% vs. Genial Est.). We note that Finance Revenue was driven by positive non-recurring items of R$187mn, mostly, from what we identified, monetary updates of tax credits and deposits, as well as underwriting updates with C6 Bank.

Net income better than projected. Reporting a net income of R$436mn (+31.3% vs. Genial Est.), TIM had a better-than-expected *bottom line*. Still, we believe it was heavily impacted by a non-recurring item within the financial result, as EBITDA was delivered well in line with our estimates.

In addition, net margin came in at 7.7% (+1.71p.p. vs. Genial Est.), though it continues to decline both q/q of -2.37p.p. and y/y of -1.18p.p. Although the non-recurring effect has partially offset the still high financial expense, we pointed out in our preview report that there would be a double-digit pullback in net income q/q, and that the margin would be lower.

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

(R$ millions)	1Q23 Consolidated	1Q23E Genial Est.	% C/E	4Q22 Consolidated	% q/q	1Q22 Consolidated	% y/y
Net Revenue	**5.681**	**5.562**	**2,1%**	**5.874**	**-3,3%**	**4.727**	**20,2%**
COGS	(3.069)	(2.934)	4,6%	(2.944)	4,3%	(2.604)	17,9%
EBITDA	**2.612**	**2.616**	**-0,2%**	**2.930**	**-10,9%**	**2.123**	**23,0%**
EBITDA Margin (%)	46,0%	47,0%	-1,06p.p	49,9%	-3,91p.p	44,9%	1,06p.p
D&A	(1.777)	(1.839)	-3,4%	(1.858)	-4,4%	(1.399)	27,0%
EBIT	**816**	**789**	**3,4%**	**1.072**	**-23,9%**	**724**	**12,7%**
EBIT Margin (%)	14,4%	14,2%	0,17p.p	18,3%	-3,89p.p	15,3%	-0,95p.p
Financial Result	(223)	(344)	-35,1%	(350)	-36,3%	(248)	-10,1%
Net Income	**436**	**332**	**31,3%**	**590**	**-26,1%**	**419**	**4,1%**
Net Margin (%)	7,7%	6,0%	1,71p.p	10,0%	-2,37p.p	8,9%	-1,18p.p

Soure: TIM, Genial Investimentos

Our Take on TIM

In another good quarter, despite a q/q drop in comparisons, TIM demonstrated important y/y growth indicators, including EBITDA margin (we criticized it in the previous results), showing a satisfactory reflection of the capital expenditure for the acquisition of its stake in Oi Móvel.

Inactive clients, who bring more costs, and higher PDA expenses (from clients who were more likely to not pay) both are linked to Oi Móvel's base and hinder EBITDA formation. This quarter, Oi Móvel’s consolidation was completed, and the level of costs began to cool down, increasing revenue and gaining margin y/y.

Even if prices for new clients were readjusted in 1Q23, most of the base (who were already clients), will only undergo the readjustment starting in 2Q23. Therefore, going forward, we expect that the next quarter will be more reflective of the readjustment in the organic customer base. Considering that, as of April, the Company has increased the price from R$3 to R$6 for control plans, with the contract ones from R$15 to R$30 depending on the package. Our assessment is that this should increase the Company's profitability within its own client's base.

On the inorganic side, the main triggers to unlock value within the acquired base are: **(i)** the long-awaited end of the non-adjustment agreement (SAT) with Oi's base, which should boost ARPU for clients that decided not to change packages, and **(ii)** TIM somewhat successfully upselling prepaid plans (with lower average ticket) to postpaid plans (with higher average ticket margin), as we commented in our previous earnings release.

Good operational result, but debt is still a problem. Despite a considerably relevant financial revenue coming from non-recurring effects (+R$187mn), such that the consequence of above average gross leverage wasn’t felt in its integrity on the net income line, we still point out that the Company presents a higher leverage than the historical leverage. TIM finished the quarter with a Net Debt/EBITDA at 1.4x, in line with the previous quarter. That is because, although the Company was able to increase its EBITDA, Net Debt also rose to R$15bn vs. R$13.8bn in 4Q22.

When analyzing the reason for net debt to have increased by +8.7% q/q, we found an effect of marketable securities redemption in the amount of R$1.8bn (~85% of this account’s balance in 4Q22), which offset the R$1.5bn spent over financing activities (basically interest and amortization expenses). Without that, the Company's total cash flow would have been approximately -R$800mn. In other words, TIM would have burned cash in 1Q23, which caused the actual net debt to rise as cash and equivalent has decreased.

Debt is the free man's prison. We expect the financial expense to continue to detract net profit and to weigh on Free Cash Flow to Equity until its eventual deleveraging, projected to cool down throughout this year and return to the historical Net Debt/EBITDA level of 0.7x by the end of 2024.

Looking now only at operating cash flow (FCFF), the company generated R$633mn in cash in 1Q23. Still, we have a lower-than-expected number (2x lower vs. Genial Est.), caused by both (i) a negative effect on working capital and fees at -R$691mn, and (ii) a slightly higher than expected CAPEX, despite showing a decline of -6.3% q/q and -3.0% y/y.

Even though our evaluation of 1Q23 showed a positive operational performance for TIM, the leverage level still seems to be a problem. At ~2x above historical average, the negative effect on cash flow is quite relevant. According to our calculations, the Company would have burned cash this quarter if it had not reallocated 85% of the marketable securities balance it held last quarter. Debt is the free man's prison…

Tim is currently trading at an **EV/EBITDA 23E** of **4.0x** and with an **estimate dividend yield** of **6.0%**. We have observed some short-term triggers linked to the readjustment of its organic and inorganic base, as commented above. **The upward movement in the stock price narrowed down the safety margin**, materializing the effect of our recommendation. **We are satisfied with our assumptions, and do not see potential above the price set in our previous report**. Therefore, we reiterate **our BUY recommendation**, with a **Target Price 12M** of **R$16.00**, (unchanged vs. previous recommendation), an **upside** of **+14.20%**.

Appendix: TIM

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

Income Statement	2023E	2024E	2025E	2026E	2027E	2028E
Net Revenue	**22.575**	**23.036**	**23.674**	**24.397**	**25.199**	**25.984**
(-) COGS	(11.778)	(12.611)	(13.383)	(13.909)	(14.373)	(14.820)
EBITDA	**10.796**	**10.425**	**10.291**	**10.488**	**10.826**	**11.164**
(-) D&A	(7.145)	(6.356)	(5.993)	(5.723)	(5.532)	(5.405)
EBIT	**3.651**	**4.070**	**4.298**	**4.765**	**5.294**	**5.759**
(+/-) Financial Result	(1.232)	(559)	(316)	(98)	103	292
EBT	**2.236**	**2.837**	**3.455**	**4.206**	**4.978**	**5.661**
(-) Taxes	(548)	(776)	(927)	(1.110)	(1.298)	(1.464)
Net Income	**1.688**	**2.061**	**2.528**	**3.096**	**3.680**	**4.197**
Profitability						
Net Margin (%)	7,48%	8,95%	10,68%	12,69%	14,61%	16,15%

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

Cash Flow	2023E	2024E	2025E	2026E	2027E	2028E
Net Revenue	**22.575**	**22.706**	**23.011**	**23.357**	**23.741**	**24.165**
(-) COGS	(11.778)	(11.640)	(11.805)	(11.990)	(12.195)	(12.420)
EBITDA	**10.796**	**11.066**	**11.206**	**11.366**	**11.546**	**11.745**
EBIT	**3.651**	**4.070**	**4.298**	**4.765**	**5.294**	**5.759**
(-) Taxas	(548)	(776)	(927)	(1.110)	(1.298)	(1.464)
(+) D&A	7.145	6.356	5.993	5.723	5.532	5.405
(+/-) Δ WK	12	(199)	151	55	22	19
(-) Capex	(4.063)	(4.147)	(4.261)	(4.391)	(4.536)	(4.677)
FCFF	**6.198**	**5.304**	**5.254**	**5.042**	**5.014**	**5.042**

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	Definition	Coverage
Buy	Expected total return 10% above the company's sector average	**54%**
Neutral	Expected total return between +10% and -10% the company's sector average	**33%**
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Under Review	Company's coverage under review	**10%**

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