

TELEFONICA BRASIL

1Q23 Review: Ballet between revenue and expenses

LatAm Telecom

Main takeaways:

(i) Net accesses remain flat despite accounts cancelled.; (ii) Mobile ARPU slightly slower; (iii) FTTH accelerating broadband accesses, driving growth in ARPU (+3.7% vs. Genial Est.); (iv) Revenue slightly better than estimated (+1.9% vs. Genial Est.); (v) Strong devices sales help mobile revenue (+9.6% vs. Genial Est.); (vi) Operational digitalization via corporate data and IT further help the fixed part (+13,2% vs. Genial Est.); (vii) COGS dynamics worse than expected (+6.1% vs. Genial Est.); (viii) EBITDA misses estimate by a bit (-4,2% vs. Genial Est.); (ix) Net income down (-25.8% q/q; +11.3% y/y); (x) Slight margin loss (-1.52p.p. vs Genial Est.).

Telefonica Brasil (Vivo) reported its 1Q23 earnings results on May 9th after the market closing. The **EBITDA came slightly below our estimates**, but overall, we saw another solid quarter. Despite **profitability dropped q/q**, the Company **grew double digits y/y**, while Vivo continues to work on upselling its mobile base. On account of fixed services, the strategy is to migrate customers from FTTC to FTTH.

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Company

VIVT3 BZ Equity

Buy

Price: R\$ 40.98 (09-May-2023)

Target Price 12M: R\$ 55.00

1Q23 Anlysis

Net accesses remain flat despite accounts cancelled. With net postpaid accesses of 72k and gross accesses of 82k, a slight increase q/q, Vivo reached a total of 98.0mn accesses (+0.1% q/q) for a total of 58.7mn customers in the quarter. Prepaid accesses declined only -10k, reaching 39.2m accesses in 1Q23.

Mobile ARPU slightly slower. Consolidating mobile ARPU at R\$27.1 in 1Q23 (-0.2% vs. Genial Est.), we saw an increase of +0.7% q/q, driven by the increase seen in postpaid ARPU, which reached R\$49.1 in the quarter. Even though it grew +0.9% q/q, the results came in below our expectations (-2.4% vs. Genial Est.). On the flip side, prepaid ARPU reached R\$12.8 in 1Q23 (-0.8% q/q), in line with estimates.

FTTH accelerating broadband accesses, driving growth in ARPU. FTTH was reported in line with what we expected, up +3.1% q/q, reaching 5.6mn users. To the detriment of this increase, FTTC had a higher-than-expected decline of -11.9% q/q.

Additionally, broadband ARPU was reported above our expectations, reaching the R\$90.0 mark (+3.7% vs. Genial Est.), a +4.1% y/y rise, driven by customer additions to Vivo Total plan, a convergent offer in postpaid mobile broadband and fiber, which accounted for 76% of the rise in FTTC accesses over the last three months.

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

(Thousands)	1Q23			4Q22		1Q22	
	Consolidated	Genial Est.	% C/E	Consolidated	% q/q	Consolidated	% y/y
Fixed Base	14.229	14.303	-0,5%	14.351	-0,8%	14.640	-2,8%
Broadband	6.407	6.409	0,0%	6.372	0,6%	6.228	2,9%
FTTH	5.651	5.647	0,1%	5.482	3,1%	4.838	16,8%
Pay TV	884	916	-3,5%	966	-8,5%	1.067	-17,2%
IPTV	884	896	-1,3%	898	-1,6%	899	-1,7%
Fixed Voice	6.939	6.978	-0,6%	7.013	-1,1%	7.345	-5,5%
Mobile Accesses	98.051	98.051	0,0%	97.979	0,1%	85.302	14,9%
Postpaid	58.755	58.755	0,0%	58.673	0,1%	50.903	15,4%
Prepaid	39.296	39.296	0,0%	39.306	0,0%	34.399	14,2%
Mobile Monthly Churn (%)	2,5%	2,5%	-0,02p.p	2,5%	-0,05p.p	2,6%	-0,13p.p
Mobile ARPU (R\$)	27,1	27,2	-0,2%	26,9	0,7%	26,9	0,9%
Postpaid ex. M2M	47,9	49,1	-2,4%	47,5	0,9%	48,8	-1,9%
Prepaid	12,8	13,0	-1,2%	12,9	-0,8%	12,4	2,9%
Broadband ARPU (R\$)	90,0	86,8	3,7%	86,4	4,1%	85,4	5,4%

Source: Telefonica Brasil, Genial Investimentos

Revenue slightly better than estimated. Vivo had net revenues of R\$12.7bn in 1Q23 (+1.9% vs. Genial Est.), reported slightly above our expectations across all divisions, with a highlight for handset-related segments, and corporate data.

Strong devices sales help mobile revenue. Accordingly, mobile service revenues reached R\$8.8bn (+0.6% vs. Genial Est.), positively influenced by handset sales, adding R\$854mn in 1Q23 (+9.6% vs. Genial Est.). We highlight the good delivery of Vivo's numbers, since our estimates had already counted on a double-digit y/y increase, and even so were surpassed. So, even with a -13.3% q/q deceleration, due to the more favorable seasonal dynamics for retail, typical of 4Qs, we still see a +20.6% y/y increase, with the 5G compatibility of the new cell phones driving new sales, improving the product mix while inflation increases the average ticket.

Regarding plans, we see net revenues in line with expectations both in the (i) Prepaid part, coming in at R\$1.5bn (-1.2% vs. Genial Est.), down -1.5% q/q due to customer migration to a higher plan. Meanwhile, by the same dynamics, the (ii) postpaid plans end, brought revenue to R\$6.4bn (-0.1% vs. Genial Est.), up +1.2% q/q.

Operational digitalization via corporate data and IT further help the fixed part. With FTTH revenue already above our expectations, reaching R\$1.4bn (+2.7% vs. Genial Est.), we also see the dynamics for corporate data and IT further adding to fixed services revenue, reaching the R\$1.0bn mark (+13.2% vs. Genial Est.), up +9.9% q/q and +25.6% y/y, thus taking, along with FTTH, the lead for value generation. The consolidated figure for the fixed services unit came to R\$3.0b (+5.8% vs. Genial Est.), up +6.3% q/q and +13.0% y/y.

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

(R\$ millions)	1Q23			4Q22		1Q22	
	Consolidated	1Q23E Genial Est.	% C/E	Consolidated	% q/q	Consolidated	% y/y
Net Revenue	12.721	12.487	1,9%	12.659	0,5%	11.352	12,1%
Net Core Revenue	11.873	11.652	1,9%	11.771	0,9%	10.285	15,4%
Mobile Revenue	8.819	8.766	0,6%	8.899	-0,9%	7.581	16,3%
Postpaid	6.455	6.459	-0,1%	6.381	1,2%	5.594	15,4%
Prepaid	1.510	1.528	-1,2%	1.533	-1,5%	1.279	18,0%
Handset	854	779	9,6%	985	-13,3%	708	20,6%
Fixed Revenue	3.054	2.886	5,8%	2.872	6,3%	2.704	13,0%
FTTH	1.496	1.457	2,7%	1.397	7,1%	1.272	17,7%
FTTC	89	89	0,2%	101	-12,2%	166	-46,4%
IPTV	375	360	4,3%	362	3,6%	384	-2,3%
Corporate Data and ICT	1.093	965	13,2%	994	9,9%	870	25,6%
Net Non Core Revenue	848	835	1,6%	888	-4,5%	1.067	-20,5%

Source: Telefonica Brasil, Genial Investimentos

COGS dynamics worse than expected. We believe that in order to accelerate its B2B expansion to improve its market position, Vivo's costs and expenses were higher than estimated, marginally worsening its efficiency. It consolidated -R\$7.7bn (+6.1% vs.), driven by an acceleration in operating costs of -R\$5.2bn (+8.0% vs. Genial Est.), rising +9.5% q/q, +11.6% y/y, which was not offset by the -4.0% q/q drop in costs of services and goods, reaching -R\$2.5bn (+2.5% vs. Genial Est.).

Thus, the division of operating costs brought us a negative surprise, reporting higher expenses with **(i)** personnel (+7.4% vs. Genial Est.), with readjustments for employees and new hires to leverage its operations, in **(ii)** commercial and infrastructure (+6.7% vs. Genial Est.), with higher expenses in advertising, technology and the early termination of the transition contract of services with Oi, in **(iii)** PDD (+11.7% vs. Genial Est.), and **(iv)** other operating income/expenses, with lower revenues from the sale of materials and real estate.

EBITDA misses estimate by a bit. If on one side we had a positive surprise in net revenue, driven by handset sales and corporate data, on the other side we had a negative surprise by higher operating costs, which were more relevant and made the reported EBITDA come in below our projections, at R\$4.9bn (-4.2% vs. Genial Est.), falling -5.6% q/q even with a +9.5% y/y growth.

In a falling EBITDA margin, reaching 38.8% in 1Q23, we see a figure -2.46p.p. below our estimates, down -2.5p.p. y/y and -0.89p.p. y/y. That said, we see in the q/q comparison we had a revenue expansion slightly above expected, driven mainly by fixed services. However, Vivo invested more on corporate data and IT, so that the cost of this line also weighed. Looking at the balance between revenue and cost, the additional cost exceeded the incremental revenue and the result, for this dynamic, was not positive.

Although in the short term it is part of the commercial strategy to spend more on B2B to capture revenue, we believe in the company's potential for conversion in the long term, positioning itself better than its peers in the market. When we use the yearly comparison, we see the acquisition of Oi Móvel was able to generate value for Vivo, increasing revenue and EBITDA by almost double digits.

Net income down q/q and up y/y. Reflecting gross debt still at high levels compared to historical averages, financial expenses remain strong, reported at -R\$539mn (+12.5% vs. Genial Est.), slightly above what we expected. In addition, the financial result was worse than expected due to more negative net foreign exchange and monetary variations than our projections, at -R\$242mn (+34.4% vs. Genial Est.).

Thus, we see a net income of R\$835mn (-25.8% q/q; +11.3% y/y), a little below our projections. This was due to a stronger COGS, and even though the revenue also came a little higher, the effect was not compensatory. It is important to say that, in comparison with the consolidated before the acquisition of Oi Móvel, we continue to see improvements compared to a year ago, up +11.3% y/y.

Slight margin loss. As a reflex of costs growing faster than revenue, Vivo's net margin stood at 6.6% (-1.52p.p. vs Genial Est.). The company still loses margin q/q and y/y, showing that despite some operational improvement in the numbers, the commercial expansion strategies still do not bring a satisfactory reflection between revenue acquisition and cost increase. We believe, however, that the telecom market is competitive and, as Vivo is the *market share* leader in the main urban centers of the country, our assessment is that the commercial strategy should generate profitability a little further ahead.

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

(R\$ millions)	1Q23			4Q22		1Q22	
	Consolidated	Genial Est.	% C/E	Consolidated	% q/q	Consolidated	% y/y
Net Revenue	12.721	12.659	0,5%	12.659	0,5%	11.352	12,1%
COGS	(7.778)	(7.425)	4,8%	(7.425)	4,8%	(6.840)	13,7%
EBITDA	4.942	5.234	-5,6%	5.234	-5,6%	4.511	9,5%
EBITDA Margin (%)	38,8%	41,3%	-2,5p.p	41,3%	-2,5p.p	39,7%	-0,89p.p
D&A	(3.260)	(3.263)	-0,1%	(3.263)	-0,1%	(3.074)	6,0%
EBIT	1.682	1.971	-14,7%	1.971	-14,7%	1.437	17,0%
EBIT Margin (%)	13,2%	15,6%	-2,35p.p	15,6%	-2,35p.p	12,7%	0,56p.p
Financial Result	(657)	(604)	8,8%	(604)	8,8%	(524)	25,4%
Net Income	835	1.126	-25,8%	1.126	-25,8%	750	11,3%
Net Margin (%)	6,6%	8,9%	-2,33p.p	8,9%	-2,33p.p	6,6%	-0,04p.p

Source: Telefonica Brasil, Genial Investimentos

Our Take on Telefonica

Despite a slight q/q drop in EBITDA, Telefonica Brasil (Vivo) delivered solid numbers in 1Q23, with positive revenue highlights both on the mobile side, from continued *upsell* of its base and strong handset sales, and on the fixed side, from the acceleration of FTTH connection resulting in higher accesses and ARPUs, as well as corporate data growing in double digits.

With a significant reduction in 1Q23 CAPEX, to R\$1.6bn (-16.3% vs. Genial Est.) down -32.2% q/q, and -10.3% y/y, we see potential operating cash generation (EBITDA - CAPEX) coming in higher than expected, in the total amount of R\$3.2bn during the quarter. We like the positive signal that the CAPEX reduction brought on cash generation, indicating that the *guidance* for up to R\$9bn in 2023 should be maintained.

Thanks to cash generation, the Company managed to reduce its net debt to R\$13.1bn vs. R\$16.8bn in 4Q22 (-22.0% y/y), although gross debt is still a point of attention, standing at R\$18.9bn, indicating that financial expenses should continue to exert an opposing force in the formation of net income until the end of the year, as we commented in our earnings preview report.

Ballet between revenue and expenses. We expect price adjustments to be reflected in better numbers for 2Q23, with offers for new clients corrected in January, while the current base only as of April. On the inorganic side, the end of the contract not to readjust Oi's base for a period of 12 months, should increase ARPU by correcting over lower average ticket clients, demonstrating the capacity of *upsell* that Oi's former base has to generate more revenue inside Vivo.

On the cost side, we see the lines linked to B2B, such as corporate data and IT, putting pressure on margins. We believe that the company must find the right balance between commercial pricing strategy, expansion of new lines of business and *upselling*, so that in the ballet dance between revenue increase and expenses acceleration, profitability appears keeping the overall balance.

Therefore, even with total costs higher than expected for the quarter, we still continue to see its privileged position both in the fiber connection market evolving to 24.4mn homes passed (+1.1mn q/q) and 5.7mn homes connected (+0.2mn q/q), as well as in the mobile operation, maintaining the *upsell* momentum from prepaid to postpaid plans, in addition to its expansion into B2B, with the cloud, cybersecurity and IoT market, giving the **Top Pick** position for the **telecom sector**.

Therefore, trading at an **EV/EBITDA** 23E of **4.6x**, we reiterate our **BUY** recommendation, with a **12M Target Price** of **R\$55.00**, which implies an **upside of +34.21%**.

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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