PEMBERTON

SECTORIAL SERIES

TELECOMS

September 2021

Introduction

Telecoms is a fundamental sector in any economy. Telecom infrastructure provides essential services to a highly diversified customer base but has high capex needs. By contrast, Telecom Services companies are asset-light businesses with low capex requirements and strong cashflows. These attributes make Telecom Services an attractive sector for direct lending generally – and for Pemberton. We have made three investments in the sector up to July 2021, deploying €310m of investor capital.

Our recent investments

- **Project Opera:** €50m payment in kind (PIK) loan to support the sponsor's acquisition of a leading provider of infrastructure installations and maintenance services to the telecom industry in France.
- **Project Eureka:** €150m Term Loan B (TLB) to support the sponsor's acquisition of a leading provider of network equipment sourcing and supply chain solutions for the telecom industry in Europe and the US.
- **Project Tiger:** €110m Term Loan B (TLB) and acquisition and capex facility (ACF) to support the sponsor's acquisition of a leading company active in the design, installation and maintenance of Wi-Fi networks for multi-dwelling units in France.

Covid-19 impact

Solid resilience in face of Covid-19: The Telecom Services sector delivered strong financial performance in 2020 and has continued to show solid resilience in the face of the Covid-19 pandemic. Telecom infrastructure is key to any modern economy, and investment has continued during the crisis, albeit at a slower pace.

The impact of the Covid-19 pandemic did delay some work, both in Europe (for example, in France and Spain) and in the US, as technicians were not able to get into households during lockdown – that being the last step in fibre-optic installation. Similarly, some necessary roadworks to install fibre-optic cables have not happened. There have also been short-term (but probably only one-year) postponements of 5G spectrum auctions that were only in part attributable to Covid-19[1].

At the operating level, as in many industries, telecom companies were affected by the wave of sudden lockdowns in Q2 2020. However, the following table shows how resilient these companies have been, both by reference to performance in 2019 but also compared to their budgets. All three Pemberton portfolio companies ended 2020 flat, or up compared with FY 2019 and little different from budget[2]:

Company	FY 2020 rev vs. FY 2019	FY 2020 vs. budget
Eureka	+1%	-5%
Opera	+12%	+6%
Tiger	+10%	-1%

In Q1 2021 revenues continued to rise, with all three companies showing growth on the prior-year figures, and two of the three achieving increases against budget:

Company	Q1 2021 rev vs. Q1 2020	Q1 2021 vs. budget
Eureka	+18%	+15%
Opera	+18%	+16%
Tiger	+8%	-2%

1. The state of digital communications 2021.pdf (etno.eu), page 33
2. Pemberton internal data.

Private debt volumes on the rise: Private equity investment has been resilient in the face of the Covid-19 pandemic. The volume of private debt deals in the wider Telecommunications, Media and Technology ('TMT') sector was stable in 2020, with 50 deals completed in Europe in 2019 and 2020[3]. More recently, 2021 has seen a material uptick in activity, with 35 deals done in the year to 8th June. In both 2019 and 2020 the majority of those deals were LBOs, followed by Growth Capital.

In the narrower Telecoms sector, the number of European private debt deals actually rose in 2020 compared with 2019, although the deal numbers were small: 13 in 2020 compared with 6 in 2019. But as with TMT more broadly, in 2021 activity levels have increased, with 6 private debt deals in the year to 8th June. By country, the UK and France consistently see the most telecoms private debt transaction activity, followed by Germany and Spain.

Beyond Covid-19 – Key investment drivers and themes

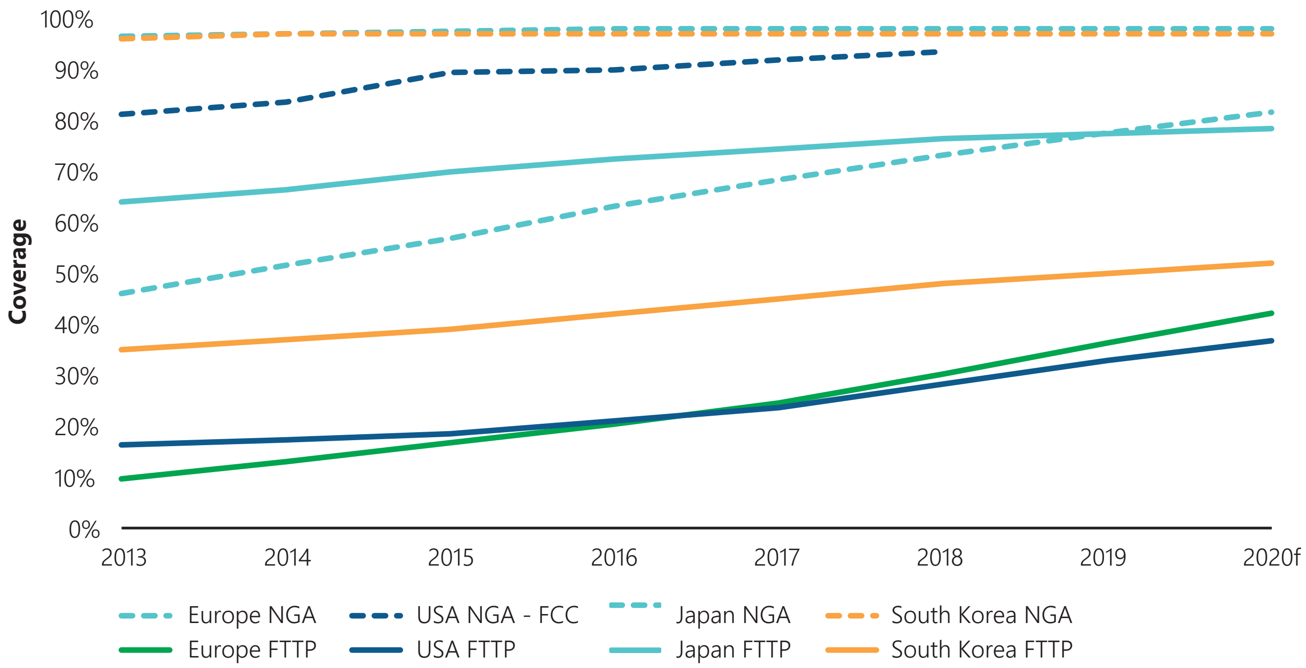
Broadly supportive 12-month outlook: We expect the Telecom Services market to continue to perform well through 2021 and into 2022, as some of the infrastructure work delayed in 2020 is completed.

Overall, 5G investment in Europe accelerated around 2020 and could peak around 2024, which should secure solid revenues for Telecom Services companies for at least the next couple of years. However, the sector needs to contend with the changing geo-political situation and in particular the increased focus on security and the perceived need for 'strategic independence'. This has led several European governments (for example, the UK) to exclude certain vendors (such as China's Huawei) from critical parts of 5G and even some fixed networks. The most likely outcome is that this will not halt the roll-out of 5G, but it will make that process more complicated.

Potential volatility longer term: One of the key risks for the industry is that activity volumes are driven by successive technological waves: 4G, 5G and fibre-optic. So while investment volumes are expected to continue to be strong in the next couple of years (2022 and 2023), they may start falling sharply in certain countries once the peak of fibre-optic deployment is reached.

However, overall Europe still lags both the US and Asia in key network roll-out and digital investment metrics, including 5G, AI and network investment. Figure 1 below shows that several years of continued Telecom Services work will be needed to bridge the gap between Europe's Next Generation Access (NGA) network coverage and Fibre To The Premises (FTTP) coverage versus that of other developed economies.

Figure 1 – Europe lags Asia in FTTP



Source: The state of digital communications 2021.pdf (etno.eu), page 11

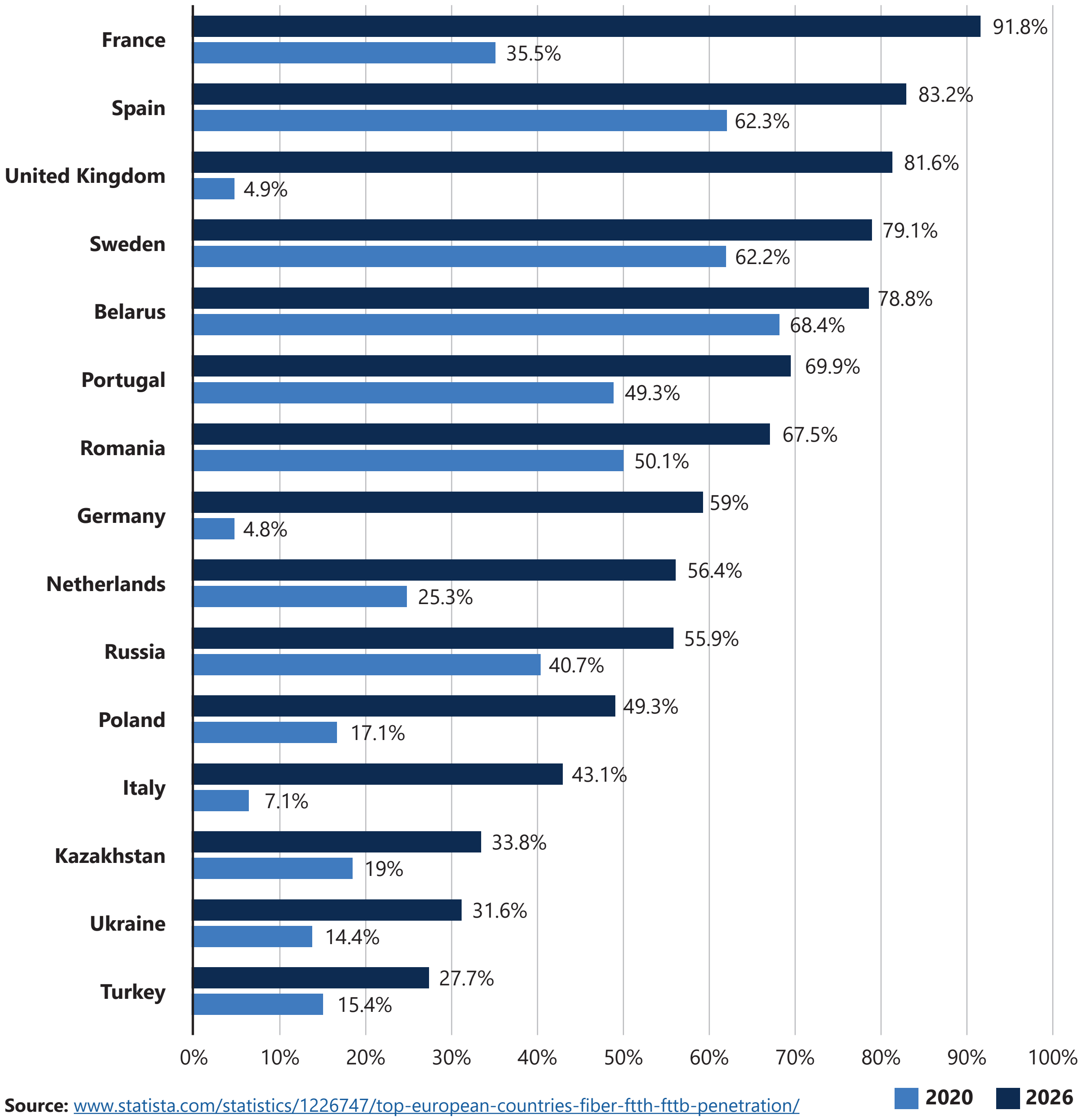
3. Preqin

Within Europe the years of peak investment will vary between countries. For example, the UK currently lags France and Spain, but is forecast to make huge strides by 2026. This can be a real benefit to Telecom Services companies.

"It is important for Telecom Services providers to diversify across multiple countries to reduce the risk of seeing their revenues fall after investment in one country peaks. It is much better to be exposed to multiple countries at different stages of fibre-optic deployment. This is an important credit consideration for us as lenders," said Florent Martel, Director, Credit at Pemberton.

As can be seen in Figure 2 below, France is forecast to have the highest FTTP penetration by 2026, followed by Spain and the UK. In the UK, Germany and Italy the change between penetration levels in 2020 and 2026 is very striking.

Figure 2 – Forecast growth of fibre penetration in Europe to 2026
Leading countries for fibre-to-the-home ('FTTH') and fibre-to-the-building ('FTTB') in Europe in 2020 and 2026



Source: www.statista.com/statistics/1226747/top-european-countries-fiber-ftth-fttb-penetration/

Looking ahead, the EU has set out a plan to achieve "Connectivity for a European Gigabit Society". This envisages faster download speeds and a full roll-out of 5G to all urban areas and major transport corridors[4]. **The German, French and UK governments have all stated gigabit broadband targets for national coverage by 2025.**

4. The state of digital communications 2021.pdf (etno.eu) page 9

Figure 3 – EU targets for 2020 and 2025

Target 2020	Target 2025
European Digital Agenda	**Connectivity for a European Gigabit Society**
Coverage of 30Mbit/s or more for every citizen.	Access to 1Gbit/s for all schools, transport hubs and main providers of public services and digitally intensive enterprises.
Usage of 100Mbit/s or more by 50% of households.	Access to download speeds of at least 100Mbit/s to be upgraded to 1Gbit/s for all European households. Uninterrupted 5G wireless broadband coverage for all urban areas and major roads and railways.

Source: The state of digital communications 2021.pdf (etno.eu), page 9

5G investment requires fibre-optic deployment as a precondition of installation. The number of Fibre To The Home/Building (FTTH/B) subscribers in Europe is expected to more than double in the next six years, to 208 million in 2026, compared to an estimated 86 million in 2021. And according to the forecasts by iDate (presented at the annual FTTH Council Europe conference) the number of homes passed by fibre will grow over the same period to 317 million (from 195 million). Overall, that should translate into a fibre network penetration rate across Europe of approximately two-thirds by 2026, compared to less than half currently[5].

The timeline for rolling out 5G across key European countries varies. In the UK, BT is working to provide near-nationwide 5G coverage by 2028 – currently only 40% of the UK population is covered[6] – while France's Bouygues Telecom expects nationwide coverage by the end of 2021[7]. Meanwhile in Spain, Telefonica closed Q1 2021 with 5G coverage already reaching 80% of the Spanish population[8].

Looking further ahead, the industrial use of 5G technology (Internet of Things or IoT) is likely to be the next milestone in the development of European telecom infrastructure. **Utilities' IoT use increased by 17% in 2020 and is projected to continue to drive growth in the Telco sector[9].**

Telecom Services companies are very much dependent on the roll-out of new technologies because in general they either help the big telcos to deploy or supply them with raw materials, and **incumbent telco network operators have been increasing their use of outsourced service companies.** The telecoms outsourcing market was valued at US$113bn in 2019 and is projected to reach US$154bn by 2027[10].

However, the services companies should benefit from the gradual increase in maintenance needs after deployment, as they provide either maintenance services or materials for repairs. That said, such revenue streams are likely to be lower overall than during the deployment phase, hence the importance of diversification across countries to maximise exposure to each wave of investment.

Consolidation likely to drive M&A: The Telecom Services sector is characterised by high volumes of acquisitions as consolidation continues in what is still a fragmented industry, both for distribution and outsourced services. Of the Pemberton portfolio companies, Opera is now active in several European countries after an impressive series of acquisitions, Tiger is active in the UK, and Eureka has both increased its presence in the US and is present in other European countries.

The EU is far from being a single market for Telecom Services, and following Brexit it is unclear whether the UK will maintain EU competition or data protection principles. European telecoms remain heavily regulated, consolidation is difficult and there is little co-ordination of spectrum policy, making the EU very different from other advanced economies. However, at the national (as opposed to the EU level) individual markets are very concentrated.

"We believe that one of the key risks for a European Telecom Services provider is to be in only one country, and therefore have only a handful of customers or even fewer. This is certainly an issue of concern for credit analysts," said Pemberton's Martel.

Looking ahead, there is expectation that EU rules about M&A might be relaxed, which would lead to further consolidation by the carriers[11]. Another driver for consolidation might be developments in the tower sector, as operators combine their tower assets to create scale and generate cost synergies[12].

5. FTTH Council (fttfcouncil.eu)
6. E&T Magazine (theiet.org)
7. RCR Wireless news (rcrwireless.com)
8. Mobile Europe (mobileeurope.co.uk)
9. Gartner (gartner.com)
10. Telecoms outsourcing market size (stillwatercurrent.com)
11. European tele-consolidation could return for 2021, says Bloomberg | Fibre Systems (fibre-systems.com)
12. Mergers Could Accelerate European Tower Sector Evolution (fitchratings.com)

Private equity interest may increase: In general, European telcos have not proven attractive to private equity investment in recent years. Aging systems, the inclusion of copper-line networks, and the huge amount of investment needed to revive the telcos' business have limited their interest for PE investors. That said, low telco share values progress in the installation of 5G and fibre, and the increasing pace of the decommissioning of legacy infrastructure, all suggest that in the future PE interest may increase. In November 2020, KKR, Cinven and Providence Equity Partners completed one of the largest acquisitions in Europe that year, purchasing Másmóvil Ibercom at an enterprise value of about €4.62 billion[13].

Meanwhile high-profile PE firms such as Advent and Amundi have shown interest in Telecom Services and the potential to consolidate that market. Some PE firms now have specialised entities/teams such as Carlyle Tech, clearly showing their focus on the sector[14]. Another source of PE activity could be tower operators choosing to sell their assets directly to PE investors or to specialist tower companies owned by PE companies[15].

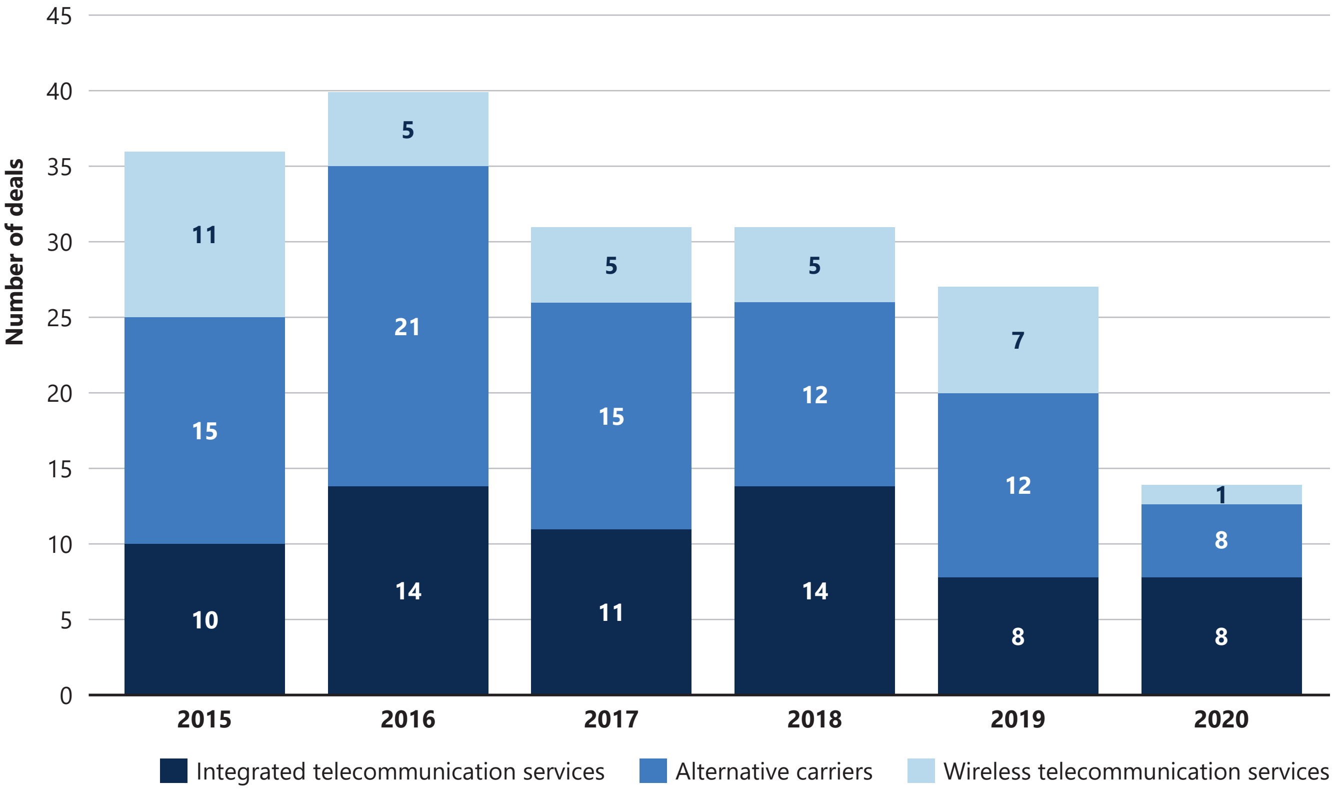
Implications for private debt: M&A and PE-related activity is a major driver of opportunity for private lenders. Small add-on investments can often be funded with cash on the balance sheet, and some Telecom Services companies have high cashflow generation so can self-finance small, bolt-on acquisitions. This has been the case to date for Pemberton portfolio companies Opera and Eureka.

But for larger acquisitions, Telecom Services companies will need to tap the syndicated loan market or direct lenders, which should create new opportunities for Pemberton.

Opportunities ahead

Telecom Services have proven to be an attractive sector for investment over recent years due to strong revenue growth, coupled with solid cashflow generation. On the basis of expected M&A activity and increasing interest by private equity investors, we believe Telecom Services will continue to offer attractive investment opportunities for Pemberton, and we look forward to supporting our portfolio companies and private equity clients.

Figure 4 – PE/VC investments in European telecoms since 2015



Data compiled 25th August 2020
Analysis includes European telecommunication acquisitions or private placements announced since 1st January 2015, through 25th August 2020, with private equity or venture capital buyers.
Asset purchases and terminated deals excluded.
Integrated telecommunication services includes operators or primarily fixed-line telecommunications networks and companies providing both wireless and fixed-line telecommunications services not classified elsewhere as well as internet services providers offering internet access to end users.

Source: S&P Global Market Intelligence

13. Private equity TMT activity making comeback in Europe | S&P Global Market Intelligence (spglobal.com)
14. PE interest in Europe's telcos is rising due to COVID-19 – experts | S&P Global Market Intelligence (spglobal.com)
15. European telecom towers become hot assets amid rollout of 5G – Private Equity News (penews.com)

Contact us

These are our thoughts based on our view of the market. We would love to hear your opinions, so please feel free to contact us with your questions or comments.

Florent Martel
Director | Credit

T: +44 (0) 20 7993 9317
M: +44 (0) 7921 463 709
E: florent.martel@pembertonam.com

Carsten Guenther
Partner | Credit

T: +44 (0) 20 3319 6966
M: +44 (0) 7710 165 029
E: carsten.guenther@pembertonam.com

Pemberton Capital Advisors LLP
52 Grosvenor Gardens, London SW1W 0AU, United Kingdom
Registered in England No. OC359656.

General Enquiries
E: info@pembertonam.com
T: +44 (0) 20 7993 9300

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