Telecom Italia Spa (BIT:TIT): Proxy Contest with Marco Fossati

ISS Recommendation: Vote FOR The Removal of the Board and FOR The Assogestioni Slate

Telecom Italia (TI), the Italian incumbent telecom operator, is the target of an unusual proxy contest: the dissident is proposing to remove the current board, but not proposing a new one. On the other hand, the company's main shareholder (Telco, where Telefonica has a 46% voting stake), only proposing a slate of three directors for 15 available seats, is seemingly willing to give up its controlling position.

In 2011, at the last election of directors, Mario Fossati, who holds 5.0% of TI through his investment vehicle Findim, presented a list of director nominees for the three seats reserved for minorities, but those seats were won by the list presented by Assogestioni, the Italian association of asset managers. At the current meeting Fossati is seeking the removal of all directors except for Luigi Zingales, an independent nominated by Assogestioni in 2011, and implicitly proposing to leave the same management. The dissident is not proposing a new slate, but instead will support the slate of seven nominees proposed by Assogestioni. He argues that change is necessary because of deep conflicts of interest—manifested in the composition of the board itself—between TI and Telefonica, particularly around the latter's push for a sale of key TI subsidiary TIM Brazil.

Is Change Needed?

Company Performance

For the five years prior to Telco announcing an increase in Telefonica's stake (which triggered speculation of a sale of TIM Brazil), TI underperformed its peer group by 23 percentage points. For the three years prior to that event, the underperformance was 11 percentage points. But there are caveats in TI's relative TSR performance: first, we note that the Italian economy has performed poorly vs. others in Europe: poor economic conditions are a drag for local companies, but the issue is how well they did against that background. A second issue is pricing of services, which explain high margins in Italy. High margins in an open market can only attract competition and regulatory pressure for lower tariffs, and that is what effectively happened.

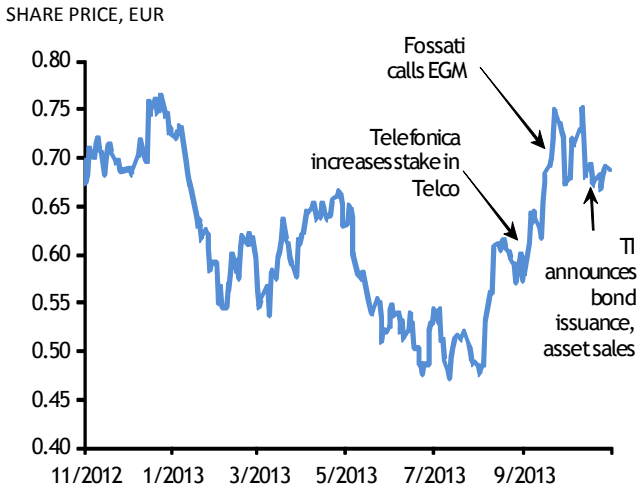
TI's stock and operating performance has to

COMPANY DATA

	COMPANY	DISSIDENT
	Telecom Italia Spa	**Marco Fossati**
GICS SECTOR	Telecom Services	NA
SEATS AT STAKE	15	
DATES		
Shareholder Meeting	Dec. 20, 2013	

CHART FOCUS

Telecom Italia Share Price Performance



Source(s): Thomson One

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be evaluated relative to the "high" place (high margins) the company started from and Italy's domestic economic situation. From that perspective, we find that the company acted reasonably in defending its market position. The CEO/chairman responsible for this performance resigned after Telefonica increased its ownership in Telco. The new CEO is a 23 year TI veteran, formerly its COO and head of its domestic business.

Company Strategy

We do not believe that a different approach to operating strategy is the key issue in this contest. It is, rather, how to handle debt. A sale of the company's key subsidiary, TIM Brazil, is a key consideration in this regard.

Fossati believes the sale of Telecom Argentina was made without due process and at a low price. We believe the sale price would be equivalent to the market price of the stake as measured by the value of ADRs in New York, without any premium. The lack of an auction process would seem to confirm that valuation is underwhelming, though one also has to wonder if buyers would be available for an asset in this country under the present political conditions. We recognize that one has to believe in a panic selling scenario to justify this valuation, but one could also envision a panic selling scenario in anticipation of a decision by the Argentine regulator. If there was something questionable in this sale, this shouldn't repeat in a potential sale of TIM Brazil, which is several times the size of Telecom Argentina in terms of value.

While it is an open question how fast and how much the company should raise capital to stabilize credit ratings and whether a sale of TIM Brazil is needed, we do not see this as a key difference between Fossati's and TI's approaches. The key issue is that the largest shareholder, Telco, can block a big capital increase, therefore forcing TI to exclude one important alternative. According to the media and many analysts, Telefonica also apparently wants the sale of TIM Brazil, and any board would have to deal with this. The key is how independent that board will be to maximize value given the restrictions.

Corporate Governance:

Conflict of interest is a major issue in this proxy contest: Telefonica is a major competitor in Brazil and Argentina and has two out of 15 board seats. Moreover, Telco, in which Telefonica is a significant shareholder, nominated 10 other directors at a 15-member board at the last election: two of them are regarded as independent by ISS, while the rest are related to the financial institutions that are shareholders in Telco. Board deliberations on Latin America exclude the Telefonica representatives, but not the other Telco representatives.

After Telefonica increased its stake in Telco and got the option of acquiring 100% in September of this year, a rush of events happened at TI, perhaps too many to ignore causality:

1) Sept. 24, 2013: Telefonica increased its economic stake in Telco; while the increase doesn't give it voting control at this point, one could question whether Telefonica would passively increase its non-voting stake and acquire an option for full control without some kind of agreement with the other Telco shareholders;
2) Oct. 3: TI's CEO/chairman resigned; he had previously rejected a sale of the Brazilian and Argentinian subsidiaries;
3) Nov. 7: TI announced a bond issuance and asset sales to raise €4 billion;
4) Nov. 14: Sale agreement for Telecom Argentina announced.

It might have been that the potential downgrade from rating agencies in August, after TI announced poor 2Q13 results, triggered a rush for action. If Telco's own board was divided on the issue of how to tackle TI's debt problem, Telefonica's increased ownership probably solved the issue; a common position could have been then cascaded into TI's board. We note that while the company has procedures to deal with the conflict of interest by not involving the two Telefonica representatives, Telco representatives are not excluded from board deliberations. And one could also argue that decisions like how to allocate Capex among the different businesses will eventually be dealt by the en-

tire board. There is a limit on how to manage the conflict.

The sale of Telecom Argentina seems to have been made in a rush, acceptable only for a panic selling scenario; two independent directors opposed the sale. Consob, the Italian securities market regulator, is investigating both the issue of mandatory convertible bonds (where Telefonica participated but Fossati argues it was not given enough time to) and the sale of Telecom Argentina. But one could envision that, given the political environment in that country and Telefonica's increased stake in Telco, the company acted reasonably in the second case under certain assumptions.

That the board is divided, given the issues surrounding TI, is only logical; if Telefonica was not on the board, the issues at TI would remain, and a sale of assets in Brazil or Argentina would still be a possibility and would still likely cause friction at the board. But regardless of what Telefonica and the financial institutions' position might be, it's clear that their majority presence on the board is not ideal.

Which Nominees Will Add More Value?

This has become an unintended proxy fight for control, with the caveat that the sponsor is the industry body representing Italian and foreign asset managers operating in Italy. And it has come to this point because Telco is apparently willing to give up its majority position.

We note that two of Telco's nominees and two of the Assogestioni's nominees sit currently on the board, meaning that 40% of the new board is actually a continuation of the old board if 10 directors are elected. If shareholders elect to remove the whole board, the Voto di Lista electoral mechanism ensures that all the nominees from the Telco and Assogestioni lists will be elected as there are more seats than candidates. So the only real decision for shareholders is whether or not to support the removal.

In a sense, the decision would seem like a conundrum for shareholders: removing the board would lead to Telco having a clear minority, which could lead the Brazilian regulator to not deem Telefonica's increased stake at Telco a change in control at TI, and allow Telefonica to get effective control of Telco. Later, and given that Telco has been the only one to nominate majority slates at TI in the past, it's plausible that Telefonica/Telco would get back a majority of the board seats and the regulator would demand a sale of TIM Brazil. If shareholders vote against the removal of the TI board and leave a majority of Telco directors, the regulator might consider that Telefonica controls TI through Telco and Telefonica would not be able to convert its shares. But in the end, if Telefonica exercises significant influence over Telco and Telco over TI (which has triggered this proxy contest), and its intention is to have TI sell TIM Brazil, the TI board will eventually do so. One difference is how the sale process would be run: forced by the regulator, with a majority independent board at TI, or voluntarily, with a board controlled by Telefonica. The choices are not ideal, and to make matters worse, the term of the proposed directors is unknown at this time. But a majority independent board would be in a better position to weigh alternatives and move forward.

We believe that: 1) regardless of company performance, there are causes for concern arising from the conflict of interest with Telefonica/Telco; 2) supporting the removal of the board would effectively affect only six directors (the other four current directors are being renominated by Telco and Assogestioni, and will be elected in any scenario); with the same management in place, the risk of discontinuity is significantly lessened, and actually no party is claiming a risk of disruption); and 3) all the nominees from Assogestioni are independent.

Conclusion

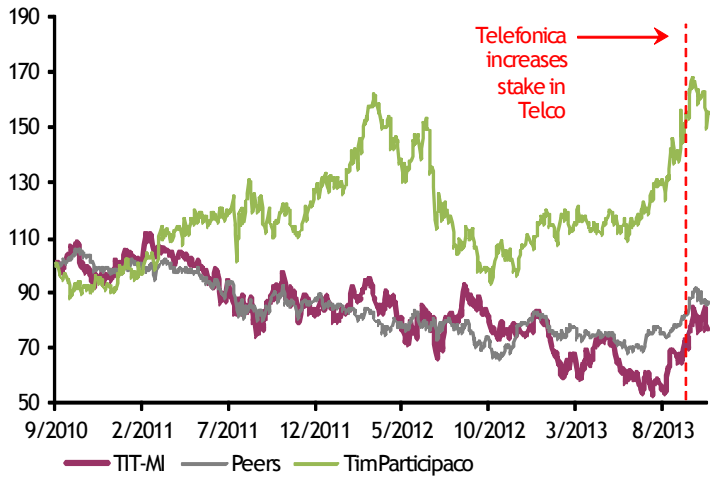
Based on the factors discussed above, on balance we conclude that the removal of the board and the presence of the Assogestioni slate on the TI board would likely prove beneficial to long-term shareholder value.

Trading Comparables

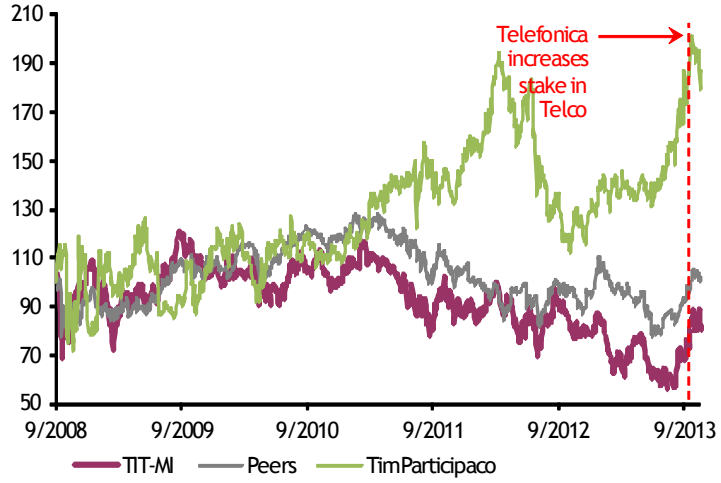
Company	Ticker	Market Cap	Enterprise Value	EV / LTM EBITDA	EV / LTM Sales	EV / 2013 EBIT	EV / 2014 EBIT	EV / 2013 EBITDA	EV / 2014 EBITDA	Price / LTM EPS	Price / 2013 EPS	Price / 2014 EPS	LT Growth	2014 PEG
Telekom Austria	TKA-VI	€ 2,777.95	€ 6,252.35	4.6x	1.5x	15.7x	15.3x	4.8x	4.8x	24.1x	19.6x	20.9x	3.4%	6.2x
Hellenic Telecommunication	HTO-AT	€ 4,176.08	€ 5,836.38	3.7	1.4	9.5	10.4	3.9	4.1	9.1	13.1	13.3	-8.7	-1.5
Portugal Telecom	PTC-LB	€ 3,006.38	€ 11,339.38	4.4	1.8	14.0	13.2	5.2	5.2	7.1	10.7	9.4	9.1	1.0
Belgacom	BELG-BT	€ 6,746.37	€ 8,547.37	4.9	1.3	9.1	9.7	5.0	5.2	10.4	11.2	12.1	-12.4	-1.0
Koninklijke KPN	KPN-AE	€ 6,659.26	€ 16,439.26	4.8	1.5	9.9	10.3	4.1	4.1	NM	10.8	11.3	-29.1	-0.4
Orange	ORA-FR	€ 25,729.06	€ 55,875.06	18.9	5.9	8.6	9.0	4.4	4.5	NM	8.7	9.2	4.3	2.1
Deutsche Telekom	DTE-XE	€ 50,165.19	€ 89,045.19	5.2	1.5	12.4	11.8	5.1	5.0	NM	16.8	15.9	7.6	2.1
Telefonica	TEF-MC	€ 55,082.33	€ 108,047.33	NA	1.8	11.0	10.8	5.4	5.4	13.8	11.3	10.8	0.2	47.1
BT GROUP	BT.A-LN	£26,392.7	£34,781.7	6.1	1.9	10.8	10.6	5.8	5.7	14.4	14.5	13.3	6.4	2.1
TeliaSonera	TLSN-SK	kr 236,851.0	kr 294,296.0	NA	2.9	12.4	11.7	8.3	8.1	12.0	13.3	12.7	0.8	15.8
Peer Group			**Median**	**4.8x**	**1.7x**	**10.9x**	**10.7x**	**5.0x**	**5.1x**	**12.0x**	**12.2x**	**12.4x**	**2.1%**	**2.1x**
			Mean	**6.6**	**2.2**	**11.3**	**11.3**	**5.2**	**5.2**	**13.0**	**13.0**	**12.9**	**(1.8)**	**7.3**
			Har Mean	**5.2**	**1.8**	**11.0**	**11.0**	**5.0**	**5.0**	**11.4**	**12.3**	**12.2**	**NA**	**NA**
Telecom Italia	**TIT-MI**	**€ 12,267.34**	**€ 42,839.34**	**6.2**	**1.5**	**7.2**	**7.3**	**3.8**	**3.8**	**NM**	**6.0**	**6.0**	**(1.9)**	**(3.2)**

Source: Thomson One; all amounts in LCU in millions; data as of Dec. 2, 2013. Estimates based on calendar years. TI's market cap reflects ordinary plus savings shares.

3-Yr Total Shareholder Return vs. Peers



5-Yr Total Shareholder Return vs. Peers



Source: Thomson One; see list of peers in table above

Historical Financial Performance

Telecom Italia Historical Financials

	2007	2008	2009	2010	2011	2012	5-Year CAGR
Revenue	€ 31,279.0	€ 30,158.0	€ 27,163.0	€ 27,571.0	€ 29,957.0	€ 29,503.0	-1.2%
Net Income	2,448.0	2,214.0	1,581.0	3,121.0	(4,726.0)	(1,627.0)	-192.2%
Ebitda	11,278.0	11,011.0	10,833.0	11,157.0	11,971.0	11,418.0	0.2%
FCF	5,527.0	5,554.0	2,949.0	4,071.0	5,483.0	5,207.0	-1.2%
EPS	0.13	0.11	0.08	0.16	(0.24)	(0.08)	-191.2%
Gross Margin	81.1%	79.1%	81.3%	83.8%	82.7%	82.0%	
Operating Inefficiency	38.2%	37.1%	35.5%	38.2%	36.6%	37.1%	
Gross Debt/EBITDA	3.7x	3.5x	3.6x	3.4x	3.2x	3.2x	

Source: Thomson One; data as of calendar years ended Dec. 31; EUR in millions; net income refers to net income from continuing operations; Ebitda defined as operating income plus D&A; FCF defined as cash flow from operating activities minus capex; gross margin defined as sales minus COGS over sales; operating inefficiency defined as SG&A over sales.

Major Shareholders

Telecom Italia Shareholders

Rank	Investor Name	% O/S	% Change Since Last Filing	Market Value of Position (€ million)
1	Telco, S.p.A.	22.39	-0.28	2,060.46
2	BlackRock Institutional Trust Company, N.A.	5.13	77.51	472.17
3	Findim Group, S.A.	5.00	0.00	460.20
4	UBS Global Asset Management (UK) Ltd.	1.92	68.42	176.72
5	Dodge & Cox	1.50	0.00	138.30
6	Pictet Asset Management Ltd.	1.30	1.10	119.62
7	APG Asset Management	1.30	100.00	119.33
8	The Vanguard Group, Inc.	0.88	-0.04	81.23
9	GMO LLC	0.87	6.53	79.64
10	Majedie Asset Management Limited	0.40	0.79	37.04
11	T. Rowe Price Associates, Inc.	0.38	-2.04	34.66
12	COMMERZBANK AG	0.37	-72.84	33.88
13	Assenagon Asset Management S.A.	0.36	334.68	32.68
14	Lyxor Asset Management	0.35	-0.29	32.66
15	BlackRock Advisors (UK) Limited	0.35	0.15	32.37
16	Aviva Investors France S.A.	0.31	-1.17	28.86
17	Intesa Sanpaolo S.p.A.	0.26	12.26	24.31
18	Dimensional Fund Advisors, LP	0.22	-2.42	20.12
19	AXA Investment Managers Paris	0.19	55.80	17.56
20	Aletti Gestielle SGR S.p.A.	0.19	-2.30	17.50

Source: Thomson One; EUR in millions; market value as of Dec. 2, 2013.

Background

Summary

Telecom Italia Spa (TI) is Italy's incumbent telecom operator. The company controls 67% of TIM Participacoes (TIM Brazil), one of Brazil's four largest mobile telecom operators, and indirectly, 23% of Telecom Argentina, one of Argentina's two largest (but 54% of the votes through a pyramid structure).

The company has been effectively controlled by Telco (22.4%) since May 2007. Telco is a holding company originally controlled by Italian financial institutions Generali, Intesa and Mediobanca, the Benetton family (who later sold) and Telefonica (Spain's incumbent telecom operator). This investment vehicle was leveraged and given Telecom Italia's poor share price performance, in need of recapitalization. Telefonica provided the needed capital in September 2013 receiving in exchange non-voting shares and increasing its economic stake to 66% from 46%. While the shares can be converted into voting shares starting in January 2014, this is subject to approval by regulators in Argentina and Brazil, as Telefonica is a direct competitor of TI in those countries. If regulators deem that Telefonica will control TI through Telco by converting the shares, therefore triggering the need to dispose of the subsidiaries, Telefonica will not be able to convert the shares. Telefonica also has an option to acquire up to 100% of Telco from January 2014 on, subject to the same condition.

Marco Fossati is the former CEO/chairman of Italian food company Star - Stabilimento Alimentare S.p.A.. He sold the company in 2006, becoming an investor in several listed companies. In 2011, at the last election of directors, Fossati (5.0% of TI through his investment vehicle Findim) presented a list of director nominees to occupy the three seats reserved for minorities, but the seats were won by the second most voted list, that of Assogestioni, the Italian association of asset managers. (Fossati also presented a list in 2008 and another for statutory auditors in 2009 and 2012, which were not elected either). At the 2011 election, only Fossati supported his candidates, whereas institutional investors overwhelmingly supported the Assogestini list. Telco got the 12 seats reserved for the majority list (i.e. the most voted list), but this was the case only because of its own votes as virtually no other shareholder supported it.

Fossati has for some time criticized Telefonica because of the conflict of interests with Telefonica. In mid 2010, he said that Telefonica should leave Telco given that it was bidding for Vivo, one of Brazil's four largest mobile telecom operators and a competitor of TIM Brazil. When Telco announced the recent change in ownership, Fossati launched a proxy contest to remove all directors except for one (nominated by Assogestioni in 2011; the other two left in 2011 and 2013). Fossati argues that the conflict of interest will not be manageable with Telefonica in control of Telco.

Underpinning the proxy contest is TI's high leverage and how to address it; the company's bonds have been recently downgraded to non -investment grade. Options are a sale of TIM Brazil, a sale of Telecom Argentina to Mexican billionaire David Martinez, a capital raise (which was recently implemented through convertibles), a dividend cut, and a sale of Italian and Brazilian mobile towers. Telefonica, the board and Fossati reportedly disagree on this point. Cesar Alierta, Telefonica's chairman, told the press that he wants the Italian company to focus on Europe and use the Brazilian asset to pay down debt. Former CEO/Chairman Bernabe was not apparently supportive of a sale of subsidiaries. The ownership change at Telco was followed by the replacement of Bernabe by Marco Patuano, a 23 year veteran from TI.

Please note that in preparation for this report, M&A Edge spoke with the company and certain Telecom Italia shareholders.

Speculation of a potential sale of TIM Brazil started in early September, before (but most likely not unrelated to) the Telco announcement, triggering a run-up in the shares of both TIM (+30%) and Telecom Italia (+50%), until speculation abated.

Key Dates

The following is a chronological list of key developments:

Aug. 3, 2013	Moody's puts TI on negative watch
Sep. 24	Telefonica increases economic stake in Telco
Oct. 3	TI's CEO/Chairman resigns
Oct. 9	Moody's downgrades TI's bonds to junk
Oct. 16	Fossati requests EGM to replace the board
Nov. 7	TI announces bond issuance, asset sales
Nov. 14	Sale agreement for Telecom Argentina
Nov. 15	S&P downgrades TI's bonds to junk
Nov. 22	Assogestioni and Telco announce slates of nominees
Dec. 20	EGM

The Dissident Platform

Fossati is seeking the removal of all directors (currently 14 members, after the resignation of one director on charges of insider trading), except for Luigi Zingales, an independent nominated by Assogestioni in 2011. The dissident is not proposing a new slate, but instead will support the slate of seven nominees proposed by Assogestioni. The slate was proposed after Fossati was unable to reach an agreement for a joint slate with Assogestioni.

The dissident began buying shares in TI in 2007, sitting on a paper loss exceeding 60%. The dissident believes that a new board should focus on:

- Containing the conflict of interest with Telefonica/Telco;
- Addressing the debt issue without selling core assets like TIM Brazil and Telecom Argentina; and
- Growing the domestic business.

Assogestioni does not have a particular platform, limiting itself to nominating independent candidates (see details of the mechanism for the election of directors in the next page).

The Company's Defense

TI in its defense argues that is has strict procedures to deal with conflicts of interest, excluding Telefonica's representatives from the appropriate board deliberations. The company has announced and partially executed a plan to raise €4 billion from asset sales, including Telecom Argentina, and a convertible bond issuance, which will address the company's leverage and Capex needs over the medium term. TIM Brazil is a core asset that the company would only sell at premium valuation and provided it finds an alternative growth option.

Framework of ISS Proxy Contest Analysis

When analyzing proxy contests, ISS focuses on two central questions: (1) Have the dissidents met the burden of proving that change is warranted at the company? and (2) If so, will the dissidents be better able to effect such change versus the incumbent board?

When the dissidents are seeking board control, ISS will require from the dissidents a well-reasoned and detailed business plan (including the dissidents' strategic initiatives), a transition plan that describes how the change in control of the company will be effected, and the identification of a qualified and credible new management team. ISS will compare the detailed dissident plan against the incumbents' plan and the dissidents' proposed board and management team against the incumbent team in order to arrive at our vote recommendation.

When the dissidents are seeking a minority position on the board, the burden of proof we impose on the dissidents is lower. In such cases, ISS will not require from the dissidents a detailed plan of action, nor will we require that the dissidents prove that their plan is preferable to the incumbent plan. Instead, ISS will require that dissidents prove that change is preferable to the status quo and that the dissident slate will add value to board deliberations by considering the issues from a different viewpoint than the current board members.

Mechanics of The Election of Directors

Directors at Italian companies are elected though a "Voto di Lista", or list voting system, which aims to ensure minority shareholders are represented. Shareholders or, in limited situations, incumbent members of the board present lists of board candidates, and shareholders cast votes for their preferred list (shareholders cannot vote for individual candidates). The candidate list that obtains the most votes (the majority list) designates the majority of directors (four fifths in the case of TI, equivalent to 12 seats in a 15 member board). The remaining seats are filled from the second most voted list (the minority list).

TI has a provision in its bylaws stating that if a majority of seats become vacant, the remaining directors shall be deemed to have resigned, triggering a renewal of the entire board. So to trigger an election, Fossati needed to propose a removal of a majority of directors. If shareholders approve the removal of the current board (first voting item), then shareholders will vote according to the Voto di Lista system. If they don't approve the removal, they will only vote on the replacement of two directors that have resigned (the board is proposing one candidate, and invites shareholders to nominate the other).

The results of the 2011 board election at TI, where voter turnout was 50.2%, show that Telco got the most votes (23.5%), but Assogestioni was close with a minority list (19.7%). Fossati only got 5.9%, one reason why he has chosen to support Assogestioni this time: Assogestioni plus Fossati's shares can outnumber Telco, meaning they could win a majority of board seats. Conversely, if they present two minority lists, that would mean that Telco would get the most votes and most seats. Assogestioni, because of its own articles of association, cannot work with a non-institutional investor like Fossati, and cannot present a list that represents a majority of the board (neither can its nominees take executive positions or the chairmanship). So Assogestioni presented a list of seven candidates hoping that the board size would stay at 15 (the minimum board size is seven and maximum 19). On the same day, however, Telco presented a list of only three candidates, not showing willingness to take a majority of seats.

We note that two of Telco's nominees and two of the Assogestioni's nominees sit currently on the board, meaning that 40% of the new board is actually a continuation of the old board if 10 directors are elected. If shareholders vote for the removal of the board all the nominees will be elected as there are more seats than candidates, regardless of which list gets the most votes. So the only real decision for shareholders is whether or not to support the removal.

When a new board is elected, the shareholder presenting the majority slate typically files proposals to fix the number of directors (between the

limits set by the articles, seven to 19 in the case of TI) and the length of the new directors' term (up to a maximum of three years). Neither Telco nor Assogestioni have filed these proposals, which is unusual: Assogestioni because it thought it was presenting a minority slate, and Telco because is presenting a minority slate. Any shareholder, regardless of number of shares held, can file resolutions at the meeting itself, and only those present would vote (with Telco likely having the decisive vote). If no resolution is filed regarding the size of the board, the size would default to the last size approved in 2011 (15 members). There's no default minimum length if no resolution is filed on the term for new directors. So shareholders would be voting by proxy on 10 candidates, without knowing their terms or whether there will be more directors elected at the meeting.

Italian law provides for the possibility that revoking the board without cause could potentially expose a company to liability to the removed directors if certain legal criteria are met. ISS's recommendations are made independent of and therefore do not reflect the risk of this possibility. Nothing in our recommendation is meant to be or to be construed as legal advice or an opinion of an investor's legal risk.

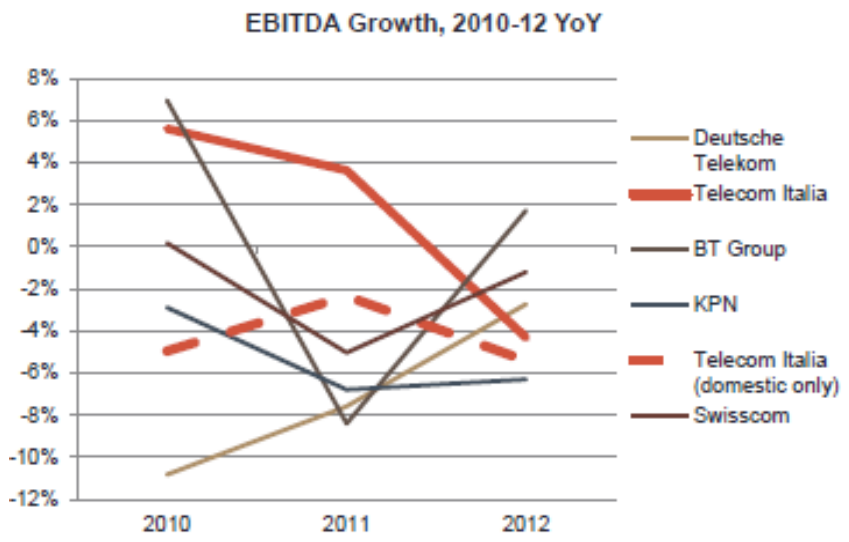
Question #1: Is Change Needed?

Telecom Italia Performance

The Dissident Challenge

Fossati argues that:

- TI has consistently delivered poor performance since 2008, as compared to the Euro Stoxx Telecom Index and peers like BT, Deutsche Telekom and Telefonica. This is evident in the relative share price performance declining by 70% over the past six years, a 25% decline in EPS and declining EBITDA growth rates; and
- Leverage, while declining since the financial crisis, has increased again in 2013, with the company's credit rating downgraded to junk.



Source: Findim presentation, Nov. 13, 2013.

The Company Response

The company has not responded to Fossati's arguments on performance.

ISS Analysis – Performance

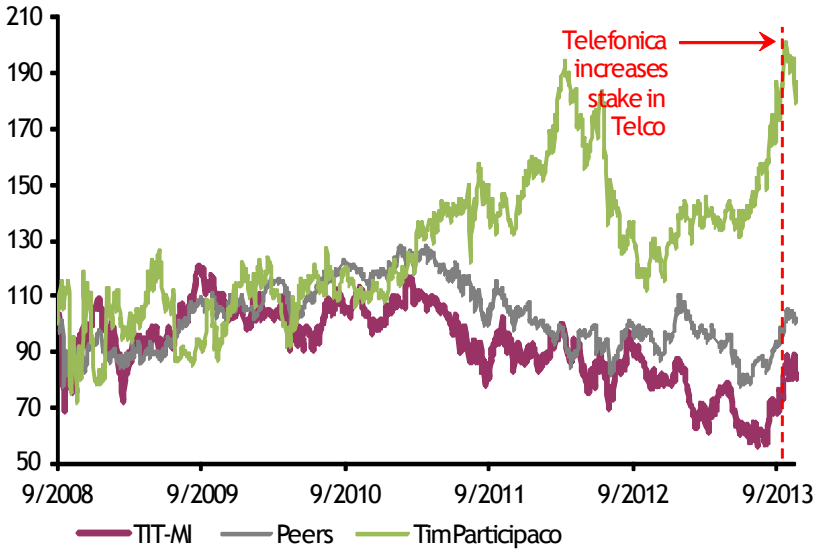
Stock Performance

We selected a group of 10 European incumbent telecom operators as a peer group:

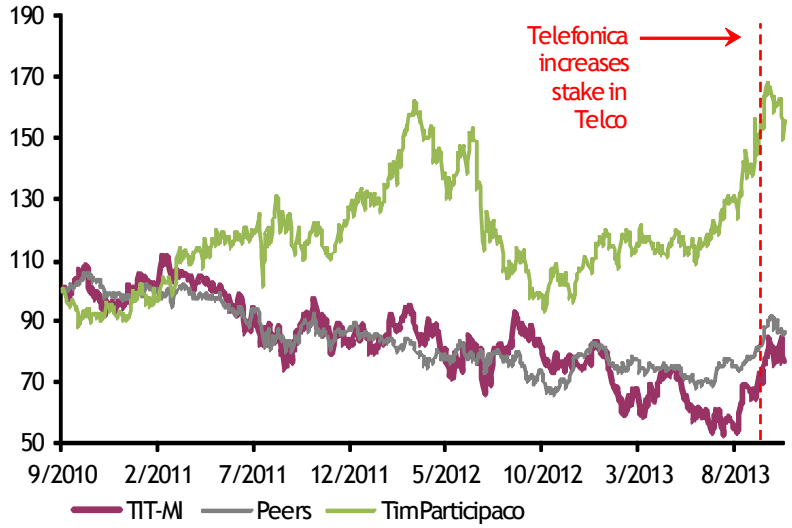
Telekom Austria AG
Hellenic Telecommunications Organization SA
Portugal Telecom SGPS SA
Belgacom SA
Koninklijke KPN NV
Orange SA
Deutsche Telekom AG
Telefonica SA
BT GROUP PLC
TeliaSonera AB

Scale is certainly a factor in evaluating relative performance, but one could argue that local market conditions and different regulations make cross country comparisons difficult. If one were to select only the biggest operators (and TI certainly is of the them), then one would take two that belong to countries that have done much better than Italy (Deutsche Telekom from Germany and Orange from France), or Telefonica from Spain, a country that has done poorly but with the impact buffered by the extensive foreign operations that the company has. For the same reasons, we have excluded the use of the obvious index for comparisons, the Euro Stoxx Telecom Index, because of heavy concentration on three stocks (Telefonica 36%, Deutsche Telekom 25% and Orange 14%).

5-Yr TSR vs. Peers



3-Yr TSR vs. Peers



Source: Thomson One. All series in Euros.

For the five years prior to Telco announcing the increase in Telefonica's stake (which triggered speculation of a sale of TIM Brazil), TI underperformed its peer group by 23 percentage points. For the three years prior to that event, the underperformance was 11 percentage points (see charts on the left).

The underperformance is arguably slightly worse than it seems, as TI's stake in TIM Brazil represents approximately 15% of its EV and TIM's performance is obviously embedded in TI's stock. TIM's stock has outperformed that of TI by more than 106 percentage points over the past five years. But there are caveats in TI's relative TSR performance, something we discuss in the next section.

Operational performance: Domestic Business

We note that the domestic business represents approximately 85% of the company's EBITDA, if Brazil and Argentina's EBITDA (fully consolidated for accounting purposes) is adjusted by economic ownership (67% Brazil and 23% Argentina). There are many factors that have affected the stock performance of TI vs. other European operators: first, we note that the Italian economy has performed poorly vs. others in Europe: poor economic conditions are a drag for local companies, but the issue is how well they did against that background. For example and as a rough reference, the Italian economy contracted by 1.4% per year on average in the 5 years ending in 2012, and TI's revenues fell by 5.9%.

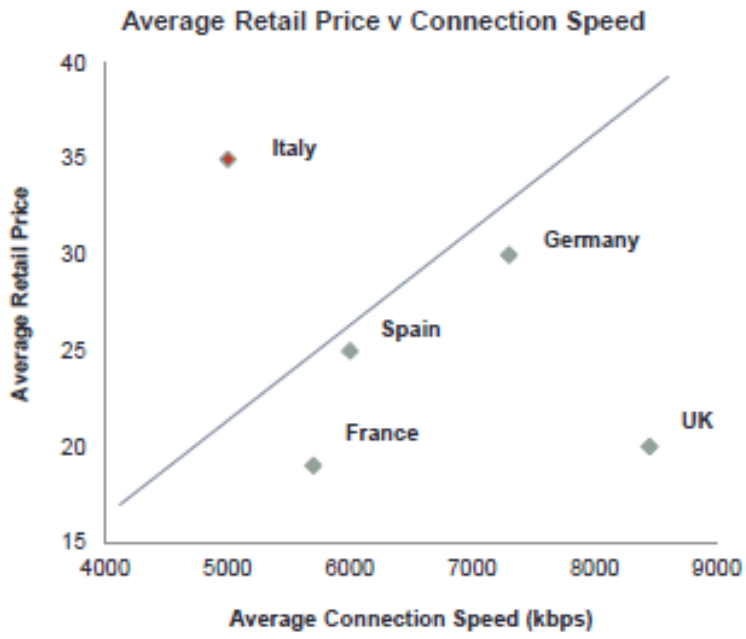
The "difference" between the two figures (last column in the table on the next page) indicates to what extent revenues declined by more than GDP (note however that GDP growth is real and revenue growth is nominal, so the figures are intended as a rough guide). The 4.5% "underperformance" is in line with the telecom incumbents' domestic revenues in countries like Germany, Spain and France, showing that it's not that TI necessarily underperformed in relative terms.

GDP Growth vs. Incumbent Domestic Revenue Growth

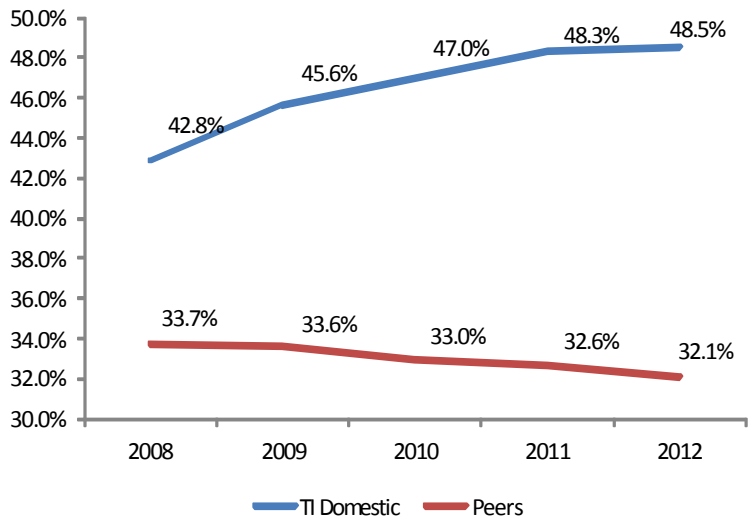
Country Name	GDP Annual Growth	Domestic Revenue CAGR	Difference GDP/Revenue growth
Austria	0.7%	-2.5%	-3.2%
Belgium	0.4%	1.5%	1.1%
Germany	0.8%	-3.6%	-4.4%
Spain	-0.8%	-6.2%	-5.4%
France	0.1%	-5.2%	-5.3%
Greece	-4.4%	-5.8%	-1.4%
Italy	-1.4%	-5.9%	-4.5%

Source: World Bank, financial statements. Real GDP growth vs. nominal domestic revenue CAGR for 2007-2012 (Germany 2008-2012). Incumbents include Telekom Austria for Austria, Belgacom for Belgium, Deutsche Telekom for Germany, Telefonica for Spain, Orange for France, and Hellenic Telecom for Greece.

A second issue is pricing of services, which explain high margins in Italy. Analysts agree, and Fossati itself makes a point in its presentation to investors (see chart on the top right), that retail telecom prices in Italy are likely the highest in Western Europe. Another piece of evidence on pricing is Vodafone's margins per country (Vodafone is one of TI's largest competitors in Italy in the mobile market): Vodafone makes a 40.3% margin in Italy, vs. 35.0% in Germany and 24.0% in the UK and Spain. Most importantly, TI's margins are even higher at 47% in the mobile business (Vodafone was making an also high 46% three years ago). High margins in an open market can only attract competition and regulatory pressure for lower tariffs, and that is what effectively happened. Notably, the market didn't enter into an aggressive price competition for some time, and TI was even able to increase domestic margins as revenues were falling (see the chart on the bottom left– note that peer margins reflect total, not only domestic, margins so they are only a proxy for comparison purposes).



EBITDA Margin



Source: Findim (top chart) and Thomson One/financial statements (bottom chart)

By 2012/2013, the Italian market entered into a price war. Data shows that TI tried to keep its premium pricing, and the end result was a gradual loss of market share. Some developments accelerated the deterioration, like two negative regulatory developments causing lower revenues for operators: TI's domestic revenues fell by 10.0% in the first three quarters of 2013, though the company was able to keep its EBITDA margin almost unchanged (48.6% from 49.9%). TI was not alone: Vodafone Italy's revenues fell by 14.0%, with EBITDA margin declining from 42.5% to 36.9% in the six month ended September 30, 2013, vs. the similar period the year before (Vodafone is mainly mobile while TI includes mobile and fixed lines).

Operating performance: Argentina and Brazil

For the last three years, TIM Brazil has kept its mobile market share of revenues constant, expanding subscriber market share and expanding its EBITDA margin from 24.6% in 2008 to 26.7% in 2012. Fossati is not raising issues with performance in Brazil.

Over the last three years, Telecom Argentina has increased its mobile market revenue share from 31.7% to 36.8%. EBITDA margin has been around 30% without any clear trend. Fossati is not raising issues with performance in Argentina.

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In summary, TI's stock and operating performance has to be evaluated relative to the "high" place (high margins) the company started from and Italy's domestic economic situation. From that perspective, we find that the company acted reasonably in defending its market position. The CEO responsible for this performance resigned after Telefonica increased its ownership in Telco. The new CEO is a 23 year TI veteran, formerly its COO and head of its domestic business.

Telecom Italia Strategy

The Dissident Challenge

Fossati believes that a tactical focus on debt reduction is not solving the underlying issues, which is lack of growth. In particular, he states that:

- Growth has decelerated for the last few years, and the company has one of the lowest Capex/ EBITDA ratios among peers.
- Telecom Argentina is being sold without an auction process (as occurred with Hansenet in 2009), at a 31% discount to its enterprise value and 26% discount to its equity market value, even though TI has a controlling position. Moreover, selling the best recent performing asset in the portfolio, which currently contributes 13% of TI's total EBITDA, might not be required given growth is the only way for TI to survive and thrive; and
- The recently issued €1.3 billion, 3-year mandatory convertible pays over 6%. By contrast, the current average yield for BBB- rated bond issues with 3-year duration is ~3% . Telefonica is participating in the offer but Fossati and other minority shareholders were not given the opportunity to subscribe. As a pure capital raise, this deal should had been brought to a shareholder vote first: if not approved at the upcoming EGM, TI must still pay some penalty interest to the buyers.

Fossati's strategy focuses on:

1) Growth and partnerships

- Invest in an aggressive NGN/Fibre strategy for Italy; grow mobile ARPU and revenues with data services, convergence, quad-play and do not sell TIM Brazil now;
- Because of Brazilian anti-trust laws, TI will likely be asked to sell TIM Brazil because Telefonica will control both TIM and VIVO (a "win-win" scenario for Telefonica). TI should defer a sale of TIM Brazil until its business strategy is optimized and the market environment can yield a maximum price;
- Shared investment to reduce capital requirements; and
- Organizing TI into three capability-based operating units, to facilitate

organic growth: Wireless, Fixed Line and Services. This would achieve some goals like encouraging each unit to adopt best practice, facilitating business heads to think outside the box to capture new growth opportunities, allowing business to form strategic partnerships (best-in-class) and creating environment for businesses to evolve from monopolistic-utility mind-set to entrepreneur-growth mind-set.

2) Short Term funding:
- Execute a dividend holiday for one year;
- Convertible share issuance;
- explore tower sale & lease back options; and
- explore property sale & lease back options

The Company Response

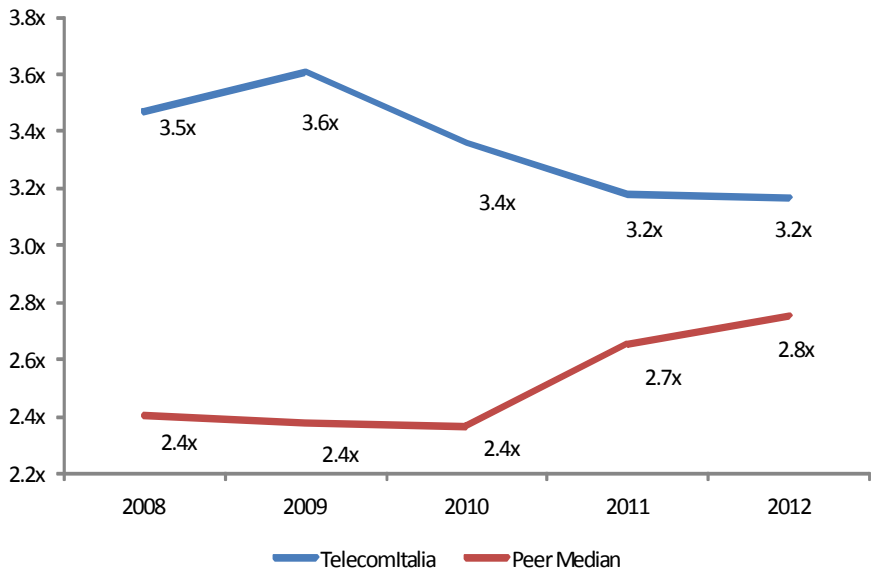
The company is focusing in the Italian market on ultrabroadband network development and a fully convergent approach in the retail segment with one single brand. Stabilizing the domestic business is the key priority, for which significant Capex is needed. The company has a high capex/revenue multiple relative to peers. TIM Brazil is a core asset, and as such it could only be disposed at a premium valuation and provided an alternative growth option is found.

TI has stated that leverage will be addressed in the short to medium term through €4 billion in extraordinary transactions: Disposal of Telecom Argentina (approximately €0.7 billion), mandatory convertible (€1.3 billion), and sale of towers in Brazil and Italy and TI Media Broadcasting (€2.0 billion). Through these measures and operating cash flow, the company expects to reduce leverage from 2.9x net debt/EBITDA to 2.1x by 2016. TI notes that its liquidity position of €6.7 billion plus undrawn facilities of €6.7 billion provide enough buffer to cover debt maturities and Capex over the coming years.

ISS Analysis – Strategy

We do not believe that a different approach to operating strategy is the key issue in this contest. It is, rather, how to handle debt. For years, the company's leverage has been significantly above that of peers, and the company's bonds have recently been downgraded to junk status. Presumably, debt is a main driver of the company's strategy and apparent board divide (e.g. two directors voted against the sale of Telecom Argentina).

Gross Debt/LTM EBITDA



Source: Thomson One

Telecom Argentina:

Telecom Argentina would seem like an obvious candidate for an asset sale, either to reduce debt or finance Capex in Italy. The local currency is not convertible in practice, and figures from the Argentina subsidiary include a dose of mirage: figures are translated into Euros by using the official exchange rate, which is widely considered as undervalued: the unofficial exchange rate is approximately 65% higher. Moreover, the market value of the company that Fossati cites, using data from the local stock exchange and using the official exchange rate, indicates a market cap of €4.5 billion, as compared to the implied market cap of €3.0 billion using the company's ADRs traded in New York. The reportedly €640 million in cash that the

company has, using the official exchange rate, could partially evaporate together with the other figures by the time the Argentine Peso becomes convertible with an accompanying sharp devaluation, as has repeatedly happened in that country.

On top of this, the political environment is difficult to navigate. The Argentine regulator required TI to divest its subsidiary following Telefonica's entry in Telco's ownership in 2007. After a long legal battle, the company managed to reduced its economic stake but keep control of the subsidiary. Since then, the Argentine government has taken some actions, like the nationalization of YPF, the country's largest oil company, from Spanish Repsol, that seem to indicate a tougher environment. Telefonica's increased stake in Telco, even if done through non-voting shares, could lead the regulator to consider that Telefonica exercises control of TI and demand a sale of Telecom Argentina.

The $960 million (€710 million) that TI will receive for Telecom Argentina includes $100.5 million to cover a three-year technical partnership and the renegotiation of a shareholder agreement with Argentina's Werthein Group, which owns 32% of the Argentine provider. Even if the entire price were to be considered as the price of the stake, the sale would be equivalent to the market price of the stake as measured by the value of ADRs in New York, without any premium. The lack of an auction process would seem to confirm that valuation is underwhelming, though one also has to wonder if buyers would be available for an asset in this country under the present conditions. To summarize, we recognize that one has to believe in a panic selling scenario to justify this valuation, but one could also envision a panic selling scenario in anticipation of a decision by the Argentine regulator.

TIM Brazil:

The market has heavily bet on a sale of TIM Brazil, which seems Telefonica's preferred route. We note that with Patuano's statements regarding Brazil (core asset) its not possible to infer a significant difference between the company's strategy and that of Fossati, other than degrees of attachment to this subsidiary.

Fossati is concerned because he believes that Telefonica will push the board to sell TIM Brazil, which some analysts value at €8-9 billion-, but Patuano has assuaged these concerns by remarking that that remains a core asset. He clarified that there is "always a price for a core asset" but that he wouldn't sell unless he can present shareholders with an alternative source of growth. A sale would not be subject to shareholder approval, as in the case of Telecom Argentina.

Telefonica's Brazilian unit would be one of the potential buyers of a portion of TIM in a breakup scenario, one that is believed as the most likely by analysts; Patuano said, on the other hand, that "It would be the only and last chance [for another telecoms operator] to enter Brazil." We note that Fossati also believes that value can be maximized by selling the company in one piece. Telefonica apparently prefers this sale to solve the debt problem instead of further capital raisings (and Telco can arguably block a capital increase at a shareholder meeting given the two thirds vote requirement and low voter turnout). We believe that selling Brazil is not an unreasonable business decision to partially address the debt problem, but as Patuano remarked, it would depend on what growth alternative the company finds.

Leverage:

Both TI and Fossati seem to be relying on relatively minor measures, in an apparent effort to make time (perhaps to be in a better position to dispose of more assets or subsidiaries, if need be). One difference is that Fossati proposes a one year dividend holiday, which might be equivalent to keeping €450 million at the company; TI on the other hand proposes the sale of Argentina (€700 million approximately). But the decision to sell the Argentine company might be justifiable, beyond the financing needs.

Excluding Argentina, the analysts consensus EBITDA for TI is approximately €9.2 billion per year over the next three years. With an average of €4.2 billion in Capex per year, operating free cash flow would be close to €5.0 billion per year, very similar to the €3.8-5.0 billion per year in debt maturities (dividends require an additional €450 million per year). But the company certainly needs a buffer, because the competitive situation in Italy cannot be regarded as stable. The recently issued convertible bond plus

the sale of Telecom Argentina provide an immediate surplus of approximately €2.0 billion, with the tower and other sales an additional two billion over the next two years (though this is a sale & leaseback that will lower EBITDA and have little impact on credit ratings; we note that this transaction had been evaluated at least in 2008 for the first time and no progress was made). This plus cash and undrawn lines of credit exceeding €12.0 billion seem to provide a sufficient buffer to cover maturities. Arguably, if the company needs to recur to cash in hand and bank credit lines because it has difficulties and is unable to issue bonds, then TI would be far from an ideal scenario: rating agencies saw that and downgraded TI's bonds to junk status, not reverting their decision even with the company's announcement of its measures to raise €4.0 billion through asset sales and convertible bonds.

We note that TI's bonds (€24.7 billion, or two thirds of the company's total gross debt) don't have financial covenants. Syndicated bank credit lines don't have financial covenants either, and contain a mechanism to adjust cost of funding to credit rating (though the maximum negative impact is limited). The impact on cost of funding from a deterioration in credit standing would therefore have a relatively limited impact in the medium term.

While it is an open question how fast and how much the company should raise to stabilize credit ratings and cover Capex, we do not see this as a key difference in Fossati's and TI's approach. The key issue is that the largest shareholder, Telco, can block a big capital increase, forcing TI to exclude one important funding alternative. Telefonica reportedly also wants the sale of TIM Brazil, and any board would have to deal with this. The key is how independent that board would will be to maximize value given the restrictions.

Telecom Italia Corporate Governance

The Dissident Challenge

Fossati questions Telefonica's motives in increasing its stake at TI and the impact is having on minorities:

- Why would Telco sell shares to Telefonica if the upcoming strategic plan was solid and attractive?
- Why should Telco shareholders (Italian financial institutions) receive €1.09 per share (the price Telefonica paid for the Telco shares) vs. a market price of TI of approximately 70 cents?
- Would Telco vote for a GVT-style deal (an example of a potential partnership in Brazil) if it creates a stronger competitor to Telefonica's Brazilian subsidiary, Vivo?
- Can non-Telefonica directors nominated by Telco act impartially given the call option that Telco granted to Telefonica to eventually get full control?

The Company Response

TI notes that its directors are not bound by any orders or instructions of the shareholder that nominated them. Moreover, concerning the conflict of interest with Telco/Telefonica and besides its own procedures for dealing with related party transactions, the Cade, Anatel and CNDC Procedures (procedures agreed with South American regulators) provide for precise precautionary measures to ensure separation between the activities of TI and those of Telefonica in the Argentine and Brazilian markets, by dealing with the corresponding issues in separate meetings, without calling or involving the two directors nominated by Telefonica.

ISS Analysis – Corporate Governance

Conflict of Interest

Conflict of interest is a major issue in this proxy contest: Telefonica is a major competitor in Brazil and Argentina and has two out of 15 board seats (nominated through Telco). Moreover, Telco nominated 10 other directors at a 15-member board at the last election: two of them regarded as independent by ISS, while most of the rest related to the financial institutions that are shareholders in Telco. Board deliberations on Latin America exclude the Telefonica representatives, but not the other Telco representatives.

Telefonica's intentions at TI are the target of plenty of speculation: many understand it bought the stake in Telco in 2007 to fend off a possible takeover from A&T or Carlos Slim (who is Telefonica's competitor in Latin America). Telefonica is not a financial investor, so there have to be strategic intentions behind any move. If Telefonica is simply trying to block other competitor's moves, it is accordingly limiting TI's own strategic options. When Telefonica bought into Telco in 2007, it triggered the Argentinian regulator to force TI to sell its stake in the Argentine company (later TI sold only part of the stake, after a local court reversed the regulators' decision and to avoid further issues). With the current situation (Telefonica with the same voting stake but 66% economic control of Telco), the Argentinian regulator could consider this as a change in control even if Telefonica doesn't convert the shares into voting shares. So a forced disposal of Telecom Argentina seems more likely and plausibly a reason leading to the early disposal of the subsidiary.

Brazil is different: the regulator demanded safeguards when Telefonica entered into Telco in 2007, but did not demand a sale. If the regulator deems that Telefonica's voting control at Telco means control of TI, then Telefonica will not be able to convert the Telco shares into voting shares and continue increasing its stake. Ironically, the exclusion of Telefonica's (and maybe Telco's) representatives from the TI board or they having only minority representation could potentially be a counterargument against the Brazilian regulator deeming a change in control at TI; with the green light from this regulator, Telefonica could convert its shares and have effective voting control of Telco. If Telefonica was later to propose and win a majority of board seats at TI, the regulator would change its position again and demand a sale of TIM Brazil, the goal that Telefonica pursues.

After Telefonica increased its stake in Telco and got the option of acquiring 100% in September this year, a rush of events happened at TI, perhaps too many to ignore causality:

- Sept. 24, 2013: Telefonica increased its economic stake in Telco; while the increase doesn't give it voting control at this point, one could question whether Telefonica would passively increase its non-voting stake and acquire an option for full control without some kind of agreement with the other Telco shareholders;
- Oct. 3: TI's CEO/chairman resigned; he had previously discarded a sale of the Brazilian and Argentinian subsidiaries;
- Nov. 7: TI announced bond issuance, asset sales to raise €4 billion;
- Nov. 14: Sale agreement for Telecom Argentina announced.

It might have been that the potential downgrade from rating agencies in August, after TI announced poor 2Q13 results, triggered a rush for action. If Telco's own board was divided on the issue of how to tackle TI's debt problem, Telefonica's increased ownership probably solved the issue; a common position could have been then cascaded into TI's board. We note that while the company has procedures to deal with the conflict of interest by not involving the two Telefonica representatives, Telco representatives are not excluded from board deliberations. And one could also argue that decisions like how to allocate Capex among the different businesses will eventually be dealt by the entire board; there's a limit on how to manage the conflict.

The convertible Bond and Telecom Argentina:

The convertible bond issuance was apparently done in a rush, announced at 7:40 pm on Nov. 7, and closed later that night. Fossati argues he didn't have time to participate, but Telefonica, a listed company that might have needed its own board approval plus a waiver from the other Telco shareholders to buy the convertible, subscribed for €103 million. Fossati was reportedly called that evening, and was unavailable; when he was available, the bookrunner argues he didn't show interest. By the time he contacted the bookrunner the next morning with interest in participating, the placement had already closed.

TI is looking for shareholder approval after issuing the convertible, forcing shareholders to vote for it or leave TI paying a penalty to bond investors. One could question what the emergency was (calling a shareholder meeting requires 45 days), given the company's ample liquidity and that the Moody's downgrade had already happened. The S&P downgraded TI a week after the issuance.

Fossati also questions the interest rate paid by the bonds, 6.15% for a three-year bond: we note the company issued a seven-year unconvertible bond at 5.05% on Sept. 19. Of course, the discount is another factor affecting the interest rate, but the minimum conversion price is at a 5.5% discount to the unaffected stock price. One could easily argue that the strong interest from investors (with the books closing so fast) is evidence the conditions were attractive.

The sale of Telecom Argentina, as previously discussed, also seems to have been made in a rush, acceptable only for a panic selling scenario; two independent directors opposed the sale. Consob, the Italian market regulator, is investigating both the issue of mandatory convertible bonds and the sale of Telecom Argentina. But one could envision that, given the political environment in that country and Telefonica's increased stake in Telco, the company acted reasonably in the second case.

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That the board is divided, given the issues surrounding TI is only logical; If Telefonica was not on the board, the issues at TI would remain, and a sale of assets in Brazil or Argentina would still be a possibility and would still likely cause friction at the board. But regardless of what Telefonica and the financial institutions' position might be, it's clear that their presence on the board constituting a majority is not ideal.

ISS Conclusion – Is Change Needed?

After evaluating the dissident and incumbent arguments with respect to the company's financial and shareholder return performance, strategic track record and governance profile, we conclude the dissidents have met their burden of proving that change on the board is warranted.

Question #2: Will the Dissidents Add Value?

The Assogestioni Slate

Assogestioni is running seven candidates (ISS classification in brackets):

- Luigi Zingales (independent): Professor of entrepreneurship and finance at University of Chicago, Booth School of Business. Independent director of TI since 2006, appointed lead independent director in April 2011.
- Lucia Calvosa (independent): Lawyer, professor of commercial law at University of Pisa. Independent director of TI since 2012.
- David Benello (independent): Global ambassador at Monitise PLC, director emeritus of McKinsey & Company. Independent director of Telekom Malaysia Berhad since 2011.
- Francesca Cornelli (independent): Professor of finance at London Business School. Research Fellow at Centre for Economic and Policy Research. Independent director of Cofide SpA since April 2010.
- Giuseppe Donagemma (independent): Senior advisor at Alix Partners, Italy. Operating Advisor at AVM Private Equity, Italy. Former EVP and GM of Europe region at Nokia Siemens Network.
- Maria Elena Cappello (independent): Former CEO and General Manager, Head of Strategy and Business Development Europe at Nokia Siemens Network Italia SpA. Member of the management board of A2A SpA (since June 2012) and independent director of Prysmian SpA (since April 2012).
- Francesco Serafini (independent): Former EVP WW Emerging Markets at Hewlett-Packard, Switzerland. Director of Solutions 30 SA.

We note that:
- Two nominees on this slate currently serve on the board of TI;
- All candidates except one have public board experience;
- Three out of seven nominees are women.

The Telco Slate

Telco has presented a slate with three candidates:

- Marco Emilio Angelo Patuano (non-independent): CEO of TI since April 13, 2011. Former COO of TI, with the company since 1990.
- Julio Linares Lopez (non-independent): COO of Telefonica since December 2007. Director of TI since 2007.
- Stefania Bariatti (independent): Lawyer. Professor of Private International Law, University of Milan. Board member of ASTM SpA. Board chair of SIAS SpA.

We note that:
- Two nominees on this slate currently serve on the board of TI, namely the CEO, and Linares Lopez, COO, of Telefonica.
- The third nominee on this slate is not an incumbent. She serves of the boards of two listed companies in Italy.

ISS Analysis – Will the Dissidents Add Value?

Assogestioni, the trade association for the investment management industry in Italy, has presented one list to the board. With the stated goal of changing Italy's corporate governance, Assogestioni owns a small stake (usually no more than five shares) in most companies on the FTSE MIB index. Besides writing letters to public companies demanding change, the association also presents minority list candidates for major companies. Assogestioni has a list of principles for selecting candidates. Candidates cannot be board members in three other public companies or financial institutions. A first scan of candidates is typically conducted through an outside executive search company. We note that the former chairman of Assogestioni, Domenico Siniscalco, is Morgan Stanley Italy's chairman, and he recently resigned when TI appointed the bank to run its €1.3 billion con-

vertible bond issuance.

Assogestioni has demonstrated commitment to change corporate governance practices at Italian companies. In July 2001, through a formal communication to Consob, Assogestioni opposed SAI's acquisition of the insurance company Fondiaria because of the lack of information and the inconsistency of the acquisition with respect to the strategy of SAI. In another case, on March 6, 2003, the association wrote a letter to Parmalat, Consob and Borsa Italiana, denouncing the lack of transparency at the Parmalat group. As a result, Parmalat announced that the group's CFO had resigned. In a third case, asset manager Mediolanum lowered to 3% from 5% the stake needed to propose a slate of independent directors after pressure from Assogestioni.

This has become an unintended proxy fight for control, with the caveat that the sponsor is the industry body representing Italian and foreign asset managers operating in Italy. And it has come to this point because Telco is apparently willing to give up its majority position. The only real decision that shareholders have to make is whether or not to remove the current board.

In a sense, the decision would seem like a conundrum for shareholders: removing the board would lead to Telco having a clear minority, which could lead to the Brazilian regulator to not deeming Telefonica's stake at Telco a change in control at TI, and allow Telefonica to get effective control of Telco. Later, and given that Telco has been the only one to nominate majority slates at TI in the past, it's plausible that Telefonica/Telco would get back a majority of the board seats and the regulator would demand a sale of TIM Brazil. If shareholders vote against the removal of the TI board and leave a majority of Telco directors , the regulator might consider that Telefonica controls TI through Telco and Telefonica would not be able to convert its shares. But in the end, if Telefonica exercises significant influence over Telco and Telco over TI (which has triggered this proxy contest), and its intention is to have TI sell TIM Brazil, the TI board will eventually do it. One difference is how the sale process would be run: forced by the regulator, with a majority independent board at TI, or voluntarily, with a board controlled by Telefonica. The choices are not ideal, and the term of the proposed directors is unknown at this time. But a majority independent board would be in a better position to weigh alternatives and move forward.

We believe that:

- Regardless of company performance, there are causes for concern arising from the conflict of interest with Telefonica/Telco;
- Supporting the removal of the board would effectively affect only six directors (the other current four being nominated by Telco and Assogestioni will be elected in any scenario). With the same management in place, the risk of discontinuity is significantly lessened, and actually no party is claiming a risk of disruption; and
- All the nominees from Assogestioni are independent.

Based on the factors discussed above, on balance we conclude that the removal of the board and the presence of the Assogestioni slate on the TI board would likely prove beneficial to long-term shareholder value.

ISS Conclusion and Vote Recommendation

We believe that regardless of company performance, there are causes for concern arising from the conflict of interest with Telefonica/Telco. Supporting the removal of the board would effectively affect only six directors (the other four current directors are being nominated by Telco and Assogestioni and will be elected in any scenario); with the same management in place, the risk of discontinuity is significantly lessened, and no party is claiming a risk of disruption. Lastly, all nominees from Assogestioni are independent. Based on these factors, on balance we conclude that the removal of the current board and presence of the Assogestioni slate would likely prove beneficial to long-term shareholder value.

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