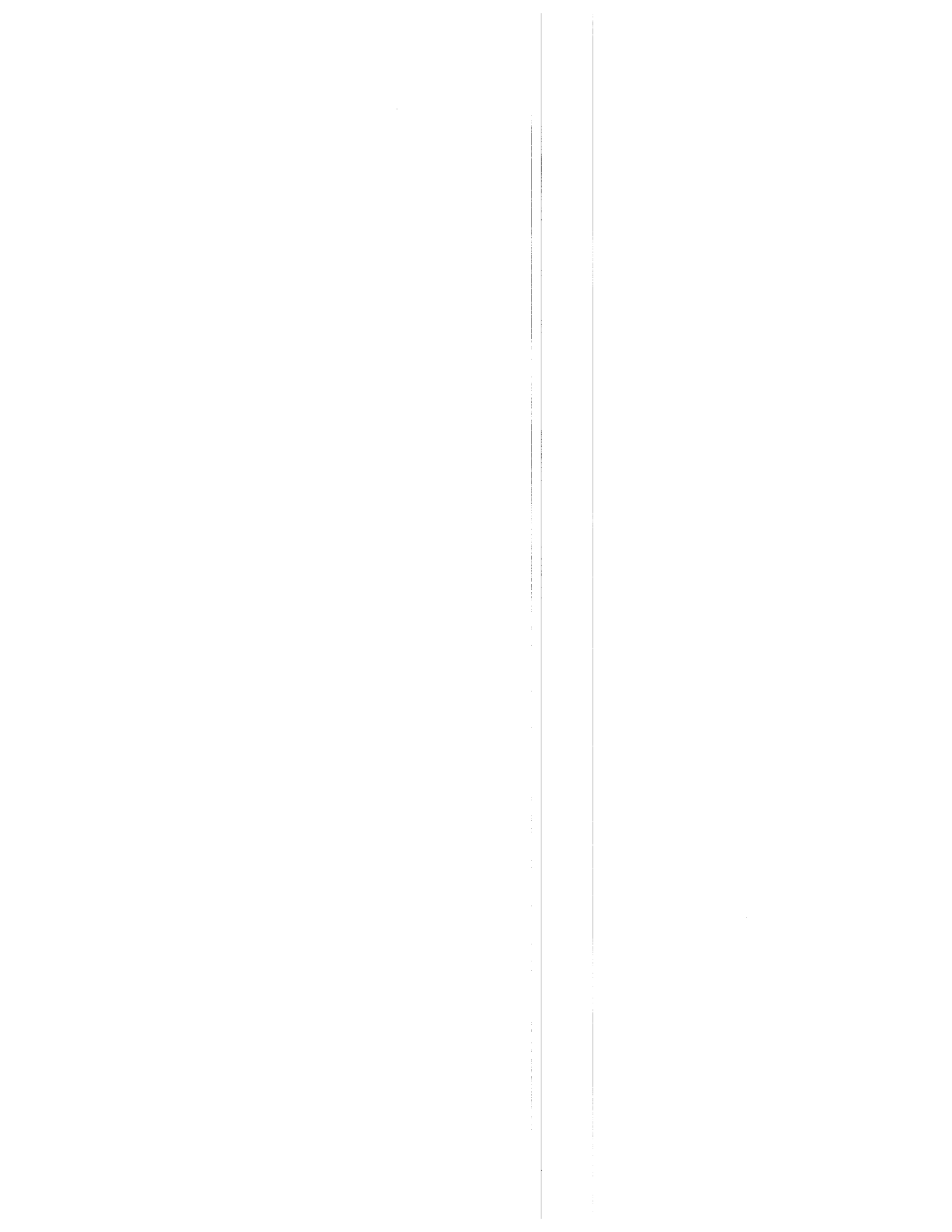


# **ANEXO III**

Documentos de Research



## Tele Norte Leste

### Neutral

Target price (BRL)	31.00
Share price (BRL)	27.17
Potential return (%)	14.1

Dec	2009a	2010e	2011e
HSBC EPS	3.81	5.57	5.92
HSBC PE	7.1	4.9	4.6

Performance	1M	3M	12M
Absolute (%)	-2.4	6.5	8.0
Relative <sup>A</sup> (%)	-6.2	6.3	-12.0

30 July 2010

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Issuer of report: HSBC Securities (USA) Inc

### Disclaimer & Disclosures

This report must be read with the disclosures and the analyst certifications in the Disclosure appendix,

Downgrade to N: Investor patience wearing thin

- ▶ PT deal complexity rekindles governance fears about Oi
- ▶ TNL and TMAR upside capped by rights price for 2010 at least
- ▶ We downgrade TNL and TMAR stock to Neutral (all share classes) from Overweight. Cut target prices for TNL P4 to BRL31 (from BRL40) and for TMAR5 to BRL56 (from BRL76)

**PT sells Vivo, flips into Oi.** Having agreed on 28 July to sell its stake in Vivo to Telefonica for EUR7.5bn, Portugal Telecom (PT) almost immediately announced it would invest in Oi, Brazil's largest telecoms operator. The transaction is complex, comprising direct and indirect investment at Oi's control group and thereafter building up a minimum 22.38% equity stake through a series of capital increases, costing up to BRL8.4bn. The deal has not proven popular with the market with TNL and TMAR shares closing down 9-16% on the Brazilian and US exchanges on the day of announcement.

**Our view.** We share investors' concerns over the complex structure of the proposed transaction, the unattractive terms for minorities (with the rights priced fixed, and now well above the market price), the long delay before the rights issue actually takes place (unlikely before Q1 2011 earliest), and the unclear purpose of any capital raised (but which, given Oi/PT management comments, also includes unspecified international M&A risk). Investors face a difficult choice: either dilution if they do not take up their rights, or otherwise having to effectively "double-down" on a company where governance issues are still apparently problematic. With rights prices fixed (e.g. TNL P4 at BRL28.26, in turn implying USD15.96 for TNE at BRL/USD1.77), we believe this will effectively cap the upside on these shares for the rest of 2010 at least. In the meantime, we see risk that the deal will re-ignite corporate governance concerns leading to selling pressure from international funds in particular. We have been positive on Oi's fundamentals, upgrading it to Overweight in December 2009, based on our expectation of value creation from its merger with Brasil Telecom. However, we believe that concerns over the proposed transaction will override this and dominate sentiment (negatively) for the rest of this year.

**Valuation and rating.** Believing that TNL and TMAR shares will not trade on fundamentals while the rights issue is overhanging, we now value all share classes based on their rights price plus a premium (to represent risk of the deal failing, with valuations reverting to a more positive fundamental basis).

Index <sup>A</sup>	BOVESPA INDEX	Enterprise value (BRLm)	41,589
Index level	66,808	Free float (%)	81
BIC	TNL P4 SA	Market cap (USDm)	6,824

## Financials & valuation

### Financial statements

Year to	12/2009a	12/2010e	12/2011e	12/2012e
<b>Profit &amp; loss summary (BRLm)</b>				
Revenue	29,881	30,494	31,469	32,414
EBITDA	8,940	10,509	11,051	11,441
Depreciation & amortisation	-5,705	-4,521	-4,703	-4,832
Operating profit/EBIT	3,236	5,988	6,348	6,609
Net interest	-2,385	-2,449	-2,539	-2,355
PBT	881	3,575	3,846	4,290
HSBC PBT	2,519	4,368	4,639	5,083
Taxation	-862	-810	-1,038	-1,189
Net profit	-436	1,742	1,741	1,923
HSBC net profit	1,456	2,129	2,264	2,446

### Cash flow summary (BRLm)

Cash flow from operations	5,550	7,004	7,202	7,487
Capex	-5,108	-3,788	-3,945	-4,094
Cash flow from investment	-13,136	-3,788	-3,945	-4,094
Dividends	-2,394	-1,384	-1,585	-1,712
Change in net debt	10,844	-992	-1,671	-1,681
FCF equity	442	3,402	3,454	3,610

### Balance sheet summary (BRLm)

Intangible fixed assets	11,305	10,431	9,638	8,845
Tangible fixed assets	22,470	22,633	22,669	22,723
Current assets	18,391	18,723	18,859	18,992
Cash & others	8,030	8,000	8,000	8,000
Total assets	60,926	60,648	60,063	59,492
Operating liabilities	8,369	7,759	7,820	7,758
Gross debt	29,918	28,896	27,225	25,544
Net debt	21,888	20,896	19,225	17,544
Shareholders funds	7,994	8,353	8,509	8,719
Invested capital	35,767	36,029	35,346	34,802

### Ratio, growth and per share analysis

Year to	12/2009a	12/2010e	12/2011e	12/2012e
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#### Y-o-y % change

Revenue	59.5	2.1	3.2	3.0
EBITDA	47.3	17.6	5.2	3.5
Operating profit	-0.4	85.1	6.0	4.1
PBT	-53.8	306.0	7.6	11.5
HSBC EPS	18.0	46.2	6.3	8.0

#### Ratios (%)

Revenue/IC (x)	1.1	0.8	0.9	0.9
ROIC	11.2	13.6	14.4	15.0
ROE	16.6	26.0	26.9	28.4
ROA	6.0	9.1	8.4	8.8
EBITDA margin	29.9	34.5	35.1	35.3
Operating profit margin	10.8	19.6	20.2	20.4
EBITDA/net interest (x)	3.7	4.3	4.4	4.9
Net debt/equity	142.6	126.3	109.4	93.6
Net debt/EBITDA (x)	2.4	2.0	1.7	1.5
CF from operations/net debt	25.4	33.5	37.5	42.7

#### Per share data (BRL)

EPS reported (fully diluted)	-1.14	4.55	4.55	5.03
HSBC EPS (fully diluted)	3.81	5.57	5.92	6.39
DPS	6.26	3.62	4.14	4.48
Book value	20.90	21.84	22.24	22.79

### Key forecast drivers

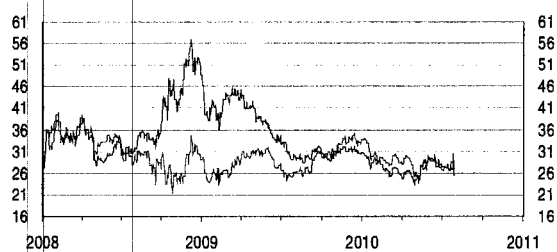
Year to	12/2009a	12/2010e	12/2011e	12/2012e
Fixed	35,588	35,580	35,734	35,785
Mobile	9,878	10,810	11,871	12,804
Gross revenues	45,708	46,773	48,223	49,445
Tax and deduction	-15,827	-16,279	-16,754	-17,031
Net revenues	29,881	30,494	31,469	32,414

### Valuation data

Year to	12/2009a	12/2010e	12/2011e	12/2012e
EV/sales	1.4	1.4	1.3	1.2
EV/EBITDA	4.8	4.0	3.6	3.3
EV/IC	1.2	1.2	1.1	1.1
PE*	7.1	4.9	4.6	4.2
P/Book value	1.3	1.2	1.2	1.2
FCF yield (%)	2.1	16.4	17.0	18.2
Dividend yield (%)	23.0	13.3	15.2	16.5

Note: \* = Based on HSBC EPS (fully diluted)

### Price relative



Source: HSBC

Note: price at close of 28 Jul 2010

# Confusion reigns at PT/Oi

- ▶ A complex deal and an uncertain outcome re-ignite investors' corporate governance fears at Oi
- ▶ Cash call dismays the market and may increase selling pressure, with rights price capping upside
- ▶ Downgrade all share classes to Neutral from Overweight; reduce target prices for TNLP4.SA to BRL31 (from BRL40) and for TNE.N to USD17 (from USD22); TMAR5 cut to BRL56 (from BRL76)

## PT sells Vivo, flips into Oi

Having earlier announced it had reached an agreement to sell its stake in Vivo to Telefonica for EUR7.5bn, PT announced on 28 July that it would buy a minimum 22.38% economic stake in Oi, Brazil's largest telecoms operator, through a series of direct and indirect investment transactions, for a total consideration of not more than BRL8.44bn. True to form with Oi, already noted for its labyrinthine ownership structure, the proposed transaction is highly complex, taking place in multiple stages and comprising both direct and indirect investments in three different corporate entities.

PT will buy 35% minority stakes in AG Telecom and LF Telecom, telecoms holding company subsidiaries of Brazilian conglomerates, each of which owns 19.325% of Telemar Participações (TmarPart) as well as "other significant financial assets," which have not been disclosed in the transaction presentation materials. TmarPart is the privately held holding company for Tele Norte Leste (TNL), which is the publicly listed holding company for Telemar Participações (TMAR), the

telecoms operating company that serves customers in Brazil under the Oi brand.

At the same time, PT will purchase a direct 10% stake in TmarPart. It is not presently clear where this stake will come from, although we believe this will be purchased from either Brazilian pension funds (Previ, Funcef, Petros) or from the Brazilian state development bank, BNDES. BNDES recently reduced its stake to 16.773%, having sold down c14.5% at auction to Petros and Funcef in June.

In addition to this initial investment there will also be a series of rights offerings, taking place at the various shareholding structure levels.

There will be a BRL4.24bn capital increase at the TmarPart level. PT has said it will maintain its stake at 10%, by investing BRL424m at this stage. PT has said it will invest up to a maximum of BRL4.7bn for all transactions at the TmarPart stage of the process.

PT's stake in TmarPart gives it a voice through the right to appoint two board members at TmarPart and one executive director at the

publicly listed holding company Tele Norte Leste. TmarPart effectively controls Tele Norte Leste through ownership of 53% of common shares (TNLP3.SA); however, as it owns no preference shares (TNLP4.SA), its total equity stake is only 17.9%. Proportionately, therefore, PT's investment at this stage represents an approximate 4.21% economic stake.

PT's remaining economic stake (a minimum of 22.38% cited in the press release) must therefore be built through a series of capital increases at the Tele Norte Leste (TNLP) subsidiary holding company level and the Telemar Norte Leste (TMAR) operating company level. PT's participation in the rights issues will take two forms: (a) subscription to rights pertaining to its economic stakes in TNL and TMAR through its initial investment in TmarPart, and (b) its intention to purchase any unsubscribed rights, preferring common shares over preference shares, from minorities of TNL and TMAR up to a maximum expenditure of BRL2bn and BRL1.7bn, respectively.

Given that the level of rights uptake is uncertain, it is not possible to be precise as to either the overall post-rights ownership structure at TNL or TMAR, or the capital required or equity ownership acquired specifically by PT. If rights are fully subscribed by minorities, it is plain that there is no scope for PT to increase its equity ownership beyond the 4.21% stake agreed at the TmarPart level (its investment in AG and LF provides it with around 2.4%, while we assume that the purchase of a 10% direct stake which provides the remaining 2% is already arranged with a seller or sellers).

As an addendum to PT's investment in Oi, the strategic agreement provides for a reciprocal investment by TMAR (operating company) in PT up to 10%. No further detail is provided on this, although we assume that the investment will be made through open market purchases.

## Capital increase cascade

Although the deal is presented top-to-bottom in terms of the ownership levels, it is more intuitive to think of it bottom up. The operating company TMAR plans to raise BRL12.0bn. To avoid dilution, TNL must subscribe to rights proportionate to its 82% equity ownership. As TNL does not generate cash, and the company has said that it does not wish to raise debt, funding for the rights must be provided by a capital increase of its own. Hence, to that end, TNL will also raise BRL12.0bn. Clearly, 82% of BRL12.0bn is BRL9.85bn and, hence, there is a surplus of BRL2.15bn. We believe that any excess funds that may be raised would be retained, although the purpose of their ultimate use is not clear (future M&A or further equity purchases of TMAR stock would be two options).

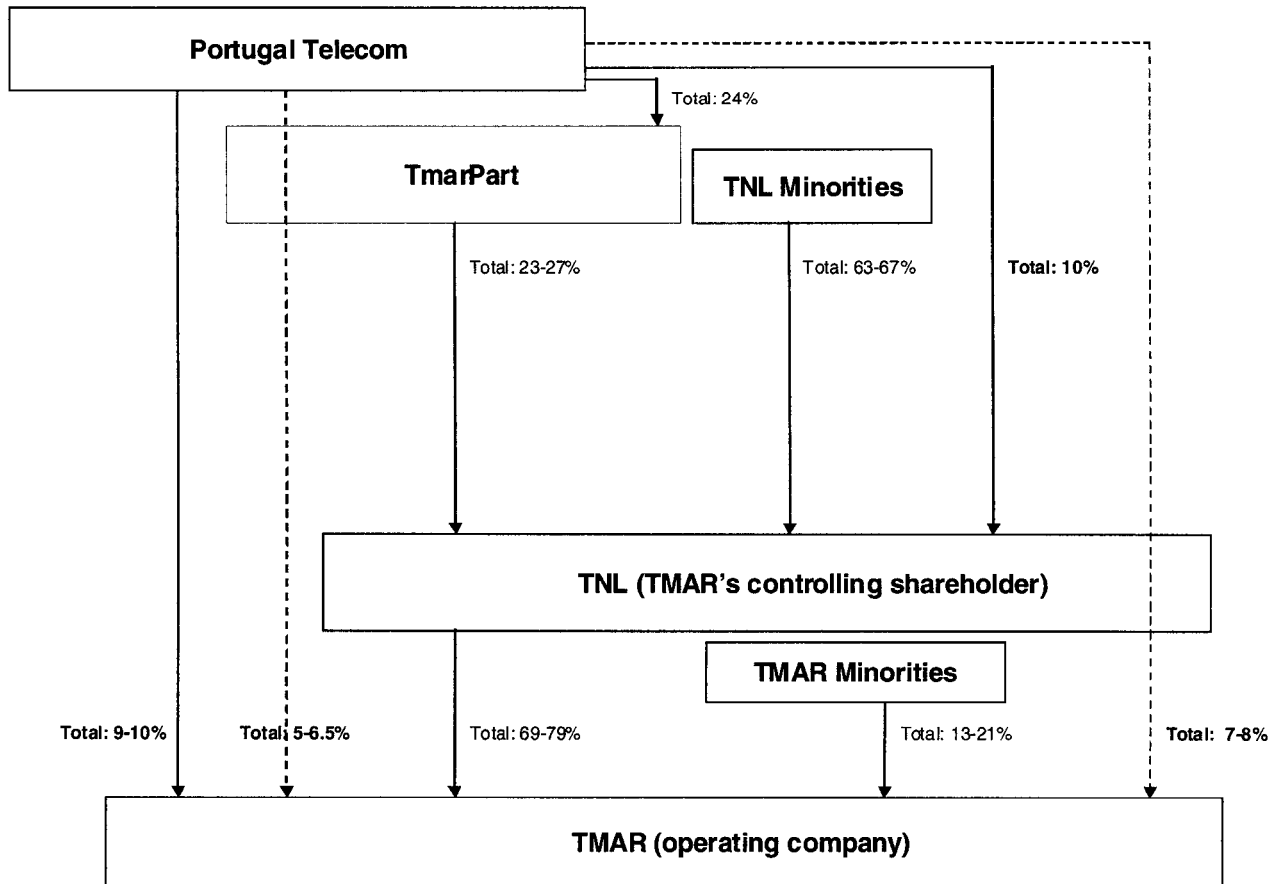
Similarly, as TmarPart does not generate revenues either (and similarly does not plan to raise debt for this purpose), it is also planning a capital increase to fund rights proportionate to its 17.9% stake in TNL's own BRL12.0bn issue, which should amount to a total of BRL2.15bn. TmarPart is planning a BRL4.24bn rights issue, around double that is required to fund rights to prevent dilution of its stake in TNL. Again, we do not have visibility on the use of any excess funds raised, but can only surmise that they may be used for future investments in the sector, domestically or abroad, or for increasing TmarPart's stake in TNL.

In the following section, we estimate possible ownership structures for TMAR under various scenarios.

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*Shaila Narang contributed to this report. Ms Narang is employed by a non-US affiliate of HSBC Securities (USA) Inc., and is not registered/qualified pursuant to FINRA regulations.*

Summary: Potential ownership structure of TMAR based on various rights issue take-up scenarios



Source: Company reports, HSBC

## Possible post-deal structures

We analyzed various scenarios under which PT could achieve a total stake in TMAR of at least 22.38%. We kept the following additional conditions or preferences in mind:

- ▶ No more than one share right per existing share with PT only acquiring shares not taken up by existing shareholders
- ▶ Controlling shareholder common shares stake should remain above 50%
- ▶ Full BRL2bn and BRL1.7bn investment by PT in TNL and TMAR, respectively and 24% PT share of TmarPart
- ▶ PT to acquire as many common shares as possible, but with increasing preference share acquisitions as needed in order to maintain at least a 22.38% total share of TMAR
- ▶ PT to acquire as many common shares as possible, without having the total stake in TMAR fall below 22.38%

- ▶ TNL's investment in TMAR cannot exceed the amount raised by the TNL capital call
- ▶ In scenarios where minority investors subscribe to the rights issue, we assume only Brazilians investors participate, since we estimate that if 100% of minority investors subscribe, we would view it as extremely difficult for PT to achieve the 22.38% total stake in TMAR

In the two tables at the bottom of this page, we offer four possibilities for PT's estimated share in TMAR based on various take-up scenarios. See the two tables on the following page for detailed calculations and dilution estimates. In scenarios 1 and 2, we assume no minorities take-up the TMAR rights issue, and the difference between the two scenarios is the level of take-up by Brazilian minorities in TNL, up to 100% representing c29% of total minorities. In scenarios 3 and 4, we increase the minority take-up of TMAR to include up to 100% of Brazilian minorities (c56% of total minorities).

PT stake (est.) in TMAR given zero minority take-up in TNL		
Scenarios 1 and 2: Zero minority take-up in TNL with:	0% minority take-up TMAR	Brazil-only minority take-up TMAR
TmarPart stake in TNL at 0% minority take-up	27.3%	27.3%
TNL stake in TMAR	78.7%	68.5%
TmarPart stake in TMAR through TNL	21.5%	18.7%
TmarPart direct stake in TMAR	5.5%	5.5%
Total TmarPart stake in TMAR	27.0%	24.2%
PT stake in TmarPart	24.0%	24.0%
<b>PT stake in TMAR through TmarPart</b>	<b>6.5%</b>	<b>5.8%</b>
PT stake in TNL at 0% minority take-up	10.1%	10.1%
<b>PT stake in TMAR through TNL</b>	<b>7.9%</b>	<b>6.9%</b>
<b>PT direct stake in TMAR</b>	<b>8.8%</b>	<b>10.2%</b>
<b>Total PT stake in TMAR</b>	<b>23.2%</b>	<b>23.0%</b>

Source: HSBC  
Note: Brazil-only implies only domestic shareholders take-up minorities

PT stake (est.) in TMAR given Brazilian minority take-up in TNL		
Scenarios 3 and 4: Brazilian minority take-up in TNL with:	0% minority take-up TMAR	Brazil-only minority take-up TMAR
TmarPart stake in TNL if Brazilian-only minorities take-up	22.7%	22.7%
TNL stake in TMAR	78.7%	68.5%
TmarPart stake in TMAR through TNL	17.9%	15.6%
TmarPart direct stake in TMAR	5.5%	5.5%
Total TmarPart stake in TMAR	23.4%	21.1%
PT stake in TmarPart	24.0%	24.0%
<b>PT stake in TMAR through TmarPart</b>	<b>5.6%</b>	<b>5.1%</b>
PT stake in TNL if Brazilian minorities subscribe	10.3%	10.3%
<b>PT stake in TMAR through TNL</b>	<b>8.1%</b>	<b>7.1%</b>
<b>PT direct stake in TMAR</b>	<b>8.8%</b>	<b>10.2%</b>
<b>Total PT stake in TMAR</b>	<b>22.5%</b>	<b>22.4%</b>

Source: HSBC  
Note: Brazil-only implies only domestic shareholders take-up minorities

**TNL shareholder structure and dilution scenarios**

**TNL shareholder structure pre-deal**

	Common	%	Preferred	%	% of total
TmarPart	70	53.8%	0	0.0%	17.9%
Portugal Telecom	0	0.0%	0	0.0%	0.0%
Others	60	46.2%	261	100.0%	82.1%
Total	131	100.0%	261	100.0%	100.0%

**TNL shareholder structure post-deal 0% minority take-up**

Shares in m	Invest BRLm	Common	%	Preferred	%	% of total
TmarPart	2,708	140	55.6%	0	0.0%	27.3%
Portugal Telecom	2,000	52	20.5%	0	0.0%	10.1%
Others	-	60	23.9%	261	100.0%	62.6%
Total	4,708	253	100.0%	261	100.0%	100.0%
	Rights price (BRL):	38.5462		28.2634		

**TNL shareholder structure post-deal 100% Brazilian minority take-up, but 0% international take-up**

Shares in m	Invest BRLm	Common	%	Preferred	%	% of total
TmarPart	2,708	140	50.1%	0	0.0%	22.7%
Portugal Telecom	2,000	19	6.8%	45	13.3%	10.3%
Others	3,250	121	43.1%	294	86.7%	67.0%
Total	7,957	280	100.0%	339	100.0%	100.0%
	Rights price (BRL):	38.5462		28.2634		

Source: HSBC

**TMAR shareholder structure and dilution scenarios**

**TMAR shareholder structure pre-deal**

Shares in m	Common	%	Preferred	%	% of total
TNL	104	97.4%	93	69.7%	82.0%
Portugal Telecom	0	0.0%	0	0.0%	0.0%
Others	3	2.7%	40	30.3%	18.0%
Total	107	100.0%	133	100.0%	100.0%

**TMAR shareholder structure post-deal 0% minority take-up**

Shares in m	Invest BRLm	Common	%	Preferred	%	% of total
TNL	4,708	178	90.9%	93	62.5%	78.7%
Portugal Telecom	1,733	15	7.6%	15	10.3%	8.8%
Others	-	3	1.4%	40	27.2%	12.5%
Total	6,441	196	100.0%	149	100.0%	100.0%
	Rights price (BRL):	63.7038		50.701		

**TMAR shareholder structure post-deal 100% Brazilian minority take-up, but 0% international take-up**

Shares in m	Invest BRLm	Common	%	Preferred	%	% of total
TNL	7,957	125	91.1%	93	51.4%	68.5%
Portugal Telecom	1,733	7	4.7%	26	14.4%	10.2%
Others	1,265	6	4.1%	62	34.2%	21.2%
Total	12,000	137	100.0%	181	100.0%	100.0%
	Rights price (BRL):	63.7038		50.701		

Source: HSBC

## Timing and price of the issue

The timeline given by both PT and Oi implies that the rights issue will take place up to 155 days after completion of PT's due diligence process for its initial investment in AG and LF, which is expected to be at end-October 2010. This puts the rights issue well into Q1 2011 or even as late as early Q2.

The various rights prices for the different public share classes involved (TNL and TMAR – not TmarPart, which is privately held) are as follows:

- ▶ TNLP3 (Tele Norte Leste common stock) BRL38.5462
- ▶ TNLP4 (Tele Norte Leste preferred stock) BRL28.2634
- ▶ TMAR3 (Telemar Participações common stock) BRL63.7038
- ▶ TMAR5 (Telemar Participações preferred stock) BRL50.7010

Rights prices have been set as the volume weighted average price (VWAP) as traded on the BOVESPA exchange over the 60 days to 27 July. Note that the widely held Tele Norte Leste ADR (TNE.N) is based on Tele Norte Leste preferred stock, and hence implies USD15.97 using a current BRL/USD exchange rate of 1.77.

## Implications of the deal

### Corporate governance risk

The complex structure of the deal appears to be highly unpopular. We believe that the already complex ownership structure of Oi has for some time been a barrier to many potential investors in the company. Historically, chief among the concerns has been the fact that privately held TmarPart effectively controls the publicly listed holding company TNL and, with it, TMAR, through its majority ownership of voting shares but with only an approximate 18% total equity

stake. As a result, minority shareholders have tended to feel under-represented in decision-making proportionate to their economic interests.

The commensurately complex nature of the present transaction with PT, involving multiple rights issues, matches this underlying complexity of ownership, with many investors noting that the rights issues appear designed to maintain TmarPart's firm control of TNL and TMAR.

Clearly, unless they fully subscribe to their rights, minority investors face dilution to some degree. Alternatively, fully subscribing to such a large rights offering (BRL12bn is around the same size as TMAR's market capitalization) presents its own challenges from a capital allocation point of view, asking investors to effectively "double-down" in an asset where they may not be fully comfortable with governance, and increasing exposure in what may not be considered the most attractive sector in Brazil. (Brazil's ITEL index of telecoms stocks is down 10.4% year-to-date versus IBOVESPA, down just 2.6% YTD.)

We believe that this transaction will have done nothing to improve the perception of corporate governance risk at the Oi group of companies in the short to medium term, even though the presence of PT could potentially improve things longer term. On balance, however, we believe the main risk to shares of TNL and TMAR is on the downside from large investors, particularly international funds, which may decide that risks and uncertainties regarding the transaction are too much for comfort, leading to selling pressure on shares of TNL and TMAR.

### Rights price caps potential upside

With rights prices fixed at the trailing 60-day average to 27 July, this places an effective cap on upside for the stocks in question, we believe. Given the timing outlined in the presentation materials, we expect the rights issue in March or

April 2011, as this is effectively the last step of a fairly long list of transaction stages, not least involving PT's disposal to Telefonica of its stake in the Brasilcel joint venture, which control's Brazil's leading mobile operator, Vivo, which may not close for another two months.

This suggests to us little or no upside potential for TNL or TMAR shares for the remainder of 2010 at least and potentially well into Q1 2011, while downside risks still exist from selling pressure as noted, as well as other potential negative news flow regarding the transaction itself, Oi or PT, Brazil, Latin America, and equities in the region generally.

### M&A risk

Oi has provided little detail on the use of cash that is being raised: to re-cap, up BRL12bn is being raised by the TMAR operating company (although we believe the actual figure raised will be well short of this given likely low participation by minorities as per our analysis earlier), while excess capital, after funding the exercise of rights up the holding structure, may also be accrued at the TNE and TmarPart levels based on our calculations. The company has said that it intends to use the capital to reduce leverage at Oi, for general operational purposes and, more worryingly, in our view, for international expansion.

The "strategic agreement" with PT contains a provision for TMAR (operating company) to purchase up to a 10% stake in PT. We believe an investment of this size this might cost in the region of EUR750m (EUR8.50 current price times 876m shares out times 10%), or around BRL1.7bn. This still leaves potentially a lot of cash remaining for other M&A.

Oi's CFO, Alex Zornig, commented on a conference call with investors following the announcement of the transaction on 28 July that

the company would be an "interesting hunter" of acquisitions with a particular focus on the emerging markets.

Despite the company's first international acquisition set to be in the distinctly non-emerging market of Portugal, the notion of Oi's embarking on an international expansion plan concerns us for a number of reasons, including:

- ▶ Risk of overpayment for assets
- ▶ Risk of dilution of management effort and focus
- ▶ Difficulty of driving economies of scale or scope across multiple geographies
- ▶ Historically negative investor reaction to out-of-market M&A in the telecoms sector over the past 10 years

On this last point, we would urge investors to look at possible comparisons such as the marked stock price underperformance of names like Bharti Airtel as it signaled its intention to expand internationally by entering into negotiations (which ultimately ended without a deal) with MTN in May 2008.

### Downgrade to Neutral

We upgraded TNL and TMAR (all share classes) to Overweight in December on what we felt was a promising fundamental story.

At its heart, TMAR has a stable legacy telephony business with low-single-digit rates of line loss causing minimal revenue and profit leakage – something of a rarity in the global fixed-line sub-sector where line loss of 5-10% driving revenue shrinkage is not uncommon. With "no leaks in the boat" as it were, this provides a solid platform for growth from TMAR's new business lines like broadband, pay-TV, and mobile, where we see strong secular demand drivers continuing for several years in Brazil.

In addition to its favorable business exposure, Oi has the additional advantage of being able to drive profit (and potentially even revenue) growth via its ongoing merger with Brasil Telecom. In contrast to our lukewarm views on fixed-mobile mergers such as America Movil/Telmex Internacional, the merger between Oi and Brasil Telecom involves combining two similar diversified (fixed and mobile) telecoms businesses in the same geographic market, which we believe provides a much better platform for synergies. See our 30 June report, *Tele Norte Leste: A merger we actually like*.

However, given the announcement on 28 July of PT's investment and the subsequent rights issues, we believe that the fundamental story will be overshadowed for some time to come. We find the deal troubling from many aspects, which we have enumerated in the previous section. As a result, we believe that share price upside will be limited.

In order to reflect this belief in our target prices, we move away from a DCF valuation and instead set valuations based on the rights offer prices for various share classes and incorporate a slight premium to reflect the chance that the deal may break down with TNL and TMAR shares reverting to a fundamental valuation above the rights price (which is where all stocks were trading prior to the announcement).

## Valuation, rating, and risks

We are downgrading TNL (all share classes) and TMAR to Neutral from Overweight after lowering our target prices on TNLP4.SA to BRL31,

TNLP3.SA to BRL41, TNE.N to USD17, and TMAR5.SA to BRL56.

For the local shares, we employ a blend of 85% rights offering value per share (see "Timing and price of the issue" section on page 8 for rights offering prices) and 15% DCF-based valuation. The DCF component, detailed below, simulates upside risk that the deal might break down, with shares thereafter reverting to a more fundamental valuation basis, which is captured by a DCF approach.

For the DCF component of our target prices, we derive a WACC of 10.2% in order to attain our BRL53 DCF value per share for TNLP3.SA. We then take a 17% discount (six-month historical trading discount) of this in order to attain our TNLP4.SA preference DCF share value of BRL44. Finally, in order to attain our USD17 per ADR target price, we employ a 1.84 end-2010e BRL on our BRL31 TNLP4.SA target price.

We value the operating company Telemar Norte Leste preference shares (TMAR5.SA) using the same WACC parameters for the DCF component. Note, however, that these valuations are just for the DCF component, which represents only 15% of our blended target price.

Under our research model, for stocks without a volatility indicator, the Neutral band is +/-5ppts around the hurdle rate for Brazilian stocks of 12%, or 7-17% around the current share price. Our 12-month target price on the TNLP4 share class (which drives our rating on all three share classes of Tele Norte Leste Participacoes that we

Tele Norte Leste and Telemar target prices and ratings

Ticker	Share class	Currency	Current price	15% DCF value	85% rights offer value	New target price	Return target	Old price	Rating	Old rating
TMAR5	Preference	BRL	48.0	83	51	56	16.6%	76	Neutral	Overweight
TNLP3	Common	BRL	35.2	53	39	41	16.5%	48	Neutral	Overweight
TNLP4	Preference	BRL	27.2	44	28	31	14.1%	40	Neutral	Overweight
TNE	ADR	USD	15.4			17	10.7%	22	Neutral	Overweight

Source: Company reports and HSBC estimates

Note: TNE ADR target price attained by employing a 1.84 BRL/USD on BRL31 TNLP4 target price.

cover) suggests a potential return that is within the Neutral band of our model; therefore, we rate all share classes Neutral. Similarly, our 12-month target price on the TMAR5 share class suggests a potential return that is within the Neutral band of our model; therefore, we rate TMAR5 Neutral.

Downside risks, in our view, include execution risks surrounding the integration of the newly acquired Brasil Telecom, particularly an inability to capture expected synergies.

Upside risks to, in our view, include factors (e.g. hostility from regulatory or antitrust authorities) that might increase the probability that the deal fails, which we believe would lead to the shares being valued on a more fundamental basis.

# Disclosure appendix

## Analyst Certification

The following analyst(s), economist(s), and/or strategist(s) who is(are) primarily responsible for this report, certifies(y) that the opinion(s) on the subject security(ies) or issuer(s) and/or any other views or forecasts expressed herein accurately reflect their personal view(s) and that no part of their compensation was, is or will be directly or indirectly related to the specific recommendation(s) or views contained in this research report: Richard Dineen, Sean Glickenhau and Luigi Minerva

## Important disclosures

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This report addresses only the long-term investment opportunities of the companies referred to in the report. As and when HSBC publishes a short-term trading idea the stocks to which these relate are identified on the website at [www.hsbcnet.com/research](http://www.hsbcnet.com/research). Details of these short-term investment opportunities can be found under the Reports section of this website.

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## Rating definitions for long-term investment opportunities

### Stock ratings

HSBC assigns ratings to its stocks in this sector on the following basis:

For each stock we set a required rate of return calculated from the risk free rate for that stock's domestic, or as appropriate, regional market and the relevant equity risk premium established by our strategy team. The price target for a stock represents the value the analyst expects the stock to reach over our performance horizon. The performance horizon is 12 months. For a stock to be classified as Overweight, the implied return must exceed the required return by at least 5 percentage points over the next 12 months (or 10 percentage points for a stock classified as Volatile\*). For a stock to be classified as Underweight, the stock must be expected to underperform its required return by at least 5 percentage points over the next 12 months (or 10 percentage points for a stock classified as Volatile\*). Stocks between these bands are classified as Neutral.

Our ratings are re-calibrated against these bands at the time of any 'material change' (initiation of coverage, change of volatility status or change in price target). Notwithstanding this, and although ratings are subject to ongoing management review, expected returns will be permitted to move outside the bands as a result of normal share price fluctuations without necessarily triggering a rating change.

\*A stock will be classified as volatile if its historical volatility has exceeded 40%, if the stock has been listed for less than 12 months (unless it is in an industry or sector where volatility is low) or if the analyst expects significant volatility. However,

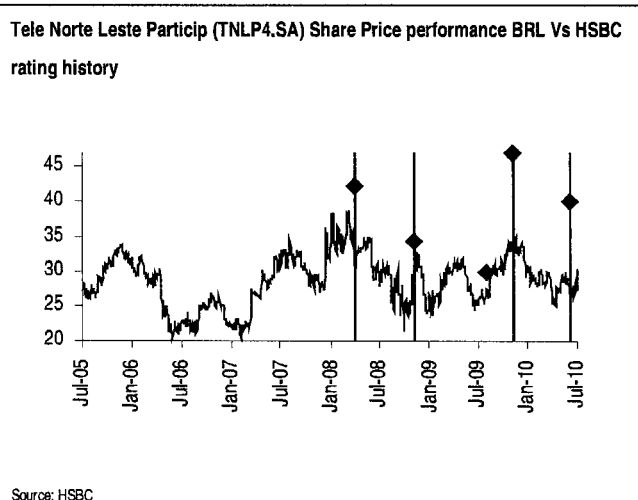
stocks which we do not consider volatile may in fact also behave in such a way. Historical volatility is defined as the past month's average of the daily 365-day moving average volatilities. In order to avoid misleadingly frequent changes in rating, however, volatility has to move 2.5 percentage points past the 40% benchmark in either direction for a stock's status to change.

### Rating distribution for long-term investment opportunities

As of 29 July 2010, the distribution of all ratings published is as follows:

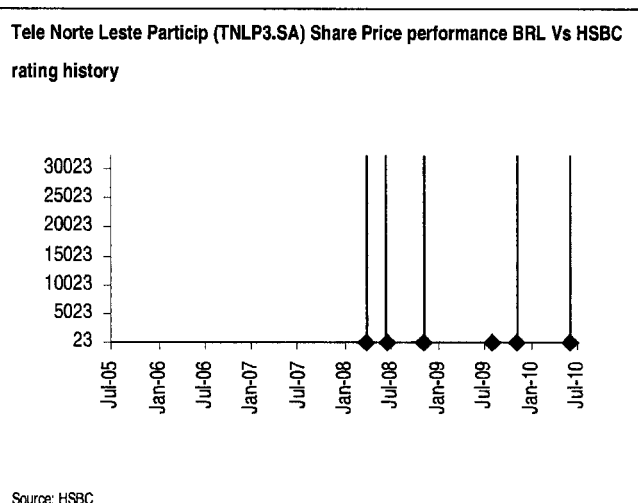
<b>Overweight (Buy)</b>	51%	(20% of these provided with Investment Banking Services)
<b>Neutral (Hold)</b>	36%	(18% of these provided with Investment Banking Services)
<b>Underweight (Sell)</b>	13%	(18% of these provided with Investment Banking Services)

### Share price and rating changes for long-term investment opportunities



Recommendation & price target history		
From	To	Date
N/R	Neutral	23 April 2008
Neutral	Neutral (V)	01 December 2008
Neutral (V)	Overweight (V)	04 December 2009
Overweight (V)	Overweight	30 June 2010
Target Price	Value	Date
Price 1	42.20	23 April 2008
Price 2	34.40	01 December 2008
Price 3	30.00	27 August 2009
Price 4	47.00	04 December 2009
Price 5	40.00	30 June 2010

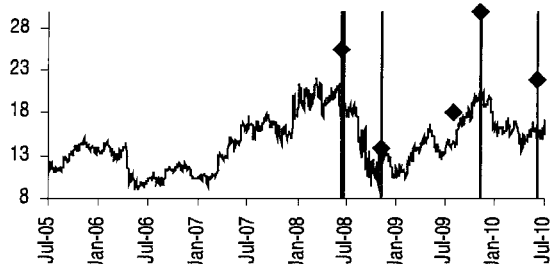
Source: HSBC



Recommendation & price target history		
From	To	Date
N/R	Overweight	23 April 2008
Overweight	Neutral	07 July 2008
Neutral	Neutral (V)	01 December 2008
Neutral (V)	Overweight (V)	04 December 2009
Overweight (V)	Overweight	30 June 2010
Target Price	Value	Date
Price 1	76.80	23 April 2008
Price 2	49.60	07 July 2008
Price 3	38.20	01 December 2008
Price 4	36.00	27 August 2009
Price 5	55.00	04 December 2009
Price 6	48.00	30 June 2010

Source: HSBC

Tele Norte Leste Particip (TNE.N) Share Price performance USD Vs HSBC rating history



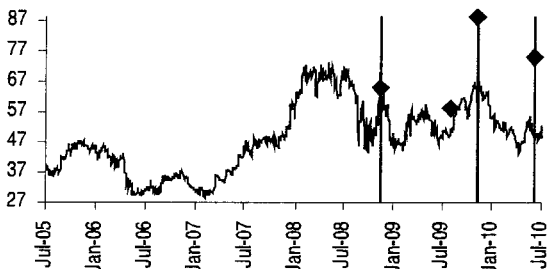
Source: HSBC

Recommendation & price target history

From	To	Date
N/A	Neutral	07 July 2008
Neutral	Neutral	11 July 2008
Neutral	Neutral (V)	01 December 2008
Neutral (V)	Overweight (V)	04 December 2009
Overweight (V)	Overweight	30 June 2010
Target Price	Value	Date
Price 1	25.60	07 July 2008
Price 2	13.90	01 December 2008
Price 3	18.00	27 August 2009
Price 4	30.00	04 December 2009
Price 5	22.00	30 June 2010

Source: HSBC

Telemar Norte Leste (TMAR5.SA) Share Price performance BRL Vs HSBC rating history



Source: HSBC

Recommendation & price target history

From	To	Date
N/R	Neutral (V)	05 December 2008
Neutral (V)	Overweight (V)	04 December 2009
Overweight (V)	Overweight	30 June 2010
Target Price	Value	Date
Price 1	65.20	05 December 2008
Price 2	58.00	27 August 2009
Price 3	88.00	04 December 2009
Price 4	75.00	30 June 2010

Source: HSBC

## HSBC & Analyst disclosures

### Disclosure checklist

Company	Ticker	Recent price	Price Date	Disclosure
TELE NORTE LESTE PARTICIP	TNLP4.SA	27.17	29-Jul-2010	4, 6, 7
TELEMAR NORTE LESTE	TMAR5.SA	48.01	29-Jul-2010	7

Source: HSBC

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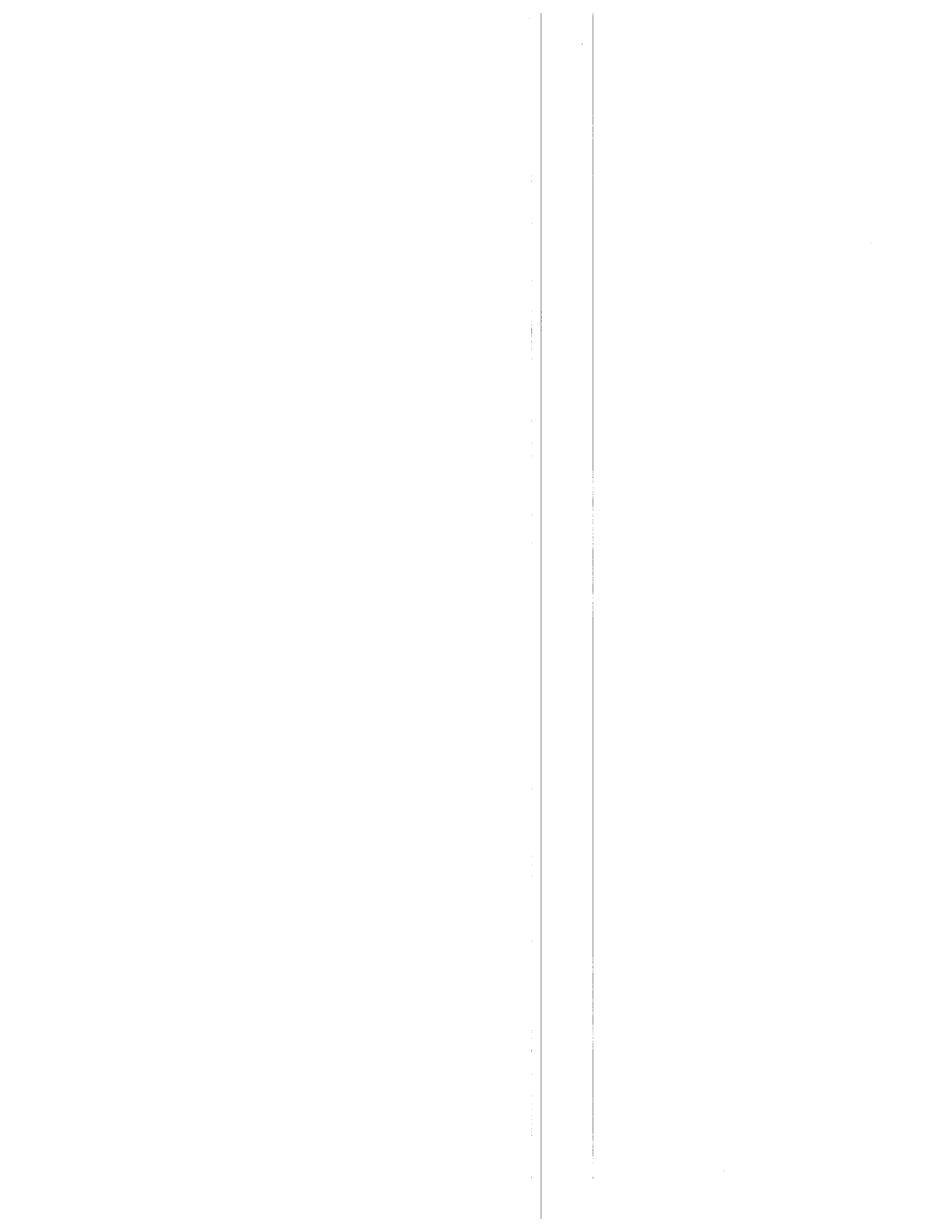
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## Capital Increase Suggests Preference for Operating Co. (TMAR)

Oi has released the numbers on the capital increase for TNLP and TMAR, although we should only get a clearer picture on Monday night or Tuesday, after the company releases more information on the controlling shareholders' final positions in each company.

There were apparently no surprises regarding the size of the capital increase in TNLP, totaling R\$2.98bn, although it is mainly in voting shares (56.4mn ONs and 28.4mn preferred shares). This indicates that PT's choice was probably equally split regarding ON and PN shares, as we believe TMARpart subscribed for only voting shares.

The capital increase in the operating company, TMAR, totaled ~R\$6.0bn, being quite balanced (subscription of 46.9mn new voting shares and 58.7mn new preferred shares). We were initially expecting lower participation in the subscription, with a total capital increase of R\$4.6bn (R\$3.0bn from TNLP and R\$1.6bn from PT). This difference of R\$1.4bn suggests that TNLP may have increased its stake in TMAR, or that PT or even TMARpart (controlling group) invested more in TMAR. Another possibility is greater participation by minorities, as TMAR5's price was close to the subscription price. On Tuesday, with the release of the new capital structure, we will be able to find out whether controlling shareholders subscribed to TMAR shares more aggressively.

Of the R\$6.0bn inflow, ~R\$1.7bn should be spent on the acquisition of Portugal Telecom shares of up to a 10% stake, which is under way, as TMAR has already acquired a 3% stake (according to the press). The remaining R\$4.3bn should go towards capex and debt reduction. We do not believe this money will change TMAR's investment case.

In our view the fact that the larger subscription in voting shares of TNLP indicates that there is unlikely to be a unification of classes (or swapping of PN for ON) in the near future – or, if it happens, the spread (TNLP3/TNLP4) should not be below 1.36x (applied in the subscription). Therefore, we expect TNLP3 to expand its premium to TNLP4 (currently at 25%), maybe above 30%. However, confirmation that TNLP and controlling shareholders increased their stake in TMAR could suggest that plans for TMAR to be collapsed with TNLP may be still on the table.

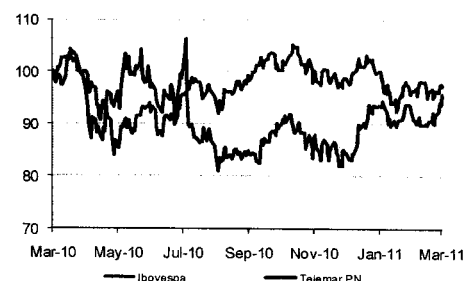
Despite greater dilution in TMAR, accounting for a larger portion of the capital increase, we still prefer TMAR5 and BRTO4 over TNLP4. In addition, we believe TNLP3 may rally in the short term, returning to a ~30% premium to TNLP4.

With the equity issue, we estimate EV/EBITDA11 multiples of approximately 3.6x for TMAR5, 3.8x for TNLP4 and 4.3x for TNLP3. We reiterate our Outperform rating for Oi stocks, with TPs of R\$65.00 for TMAR5, R\$46.00 for TNLP3 and R\$35.20/US\$18.00 for TNLP4/TNE. We prefer BRTO4 (Outperform, TP of R\$18.00) and TMAR5. (...continued on following page...)

Oi  
(TNLP4/TNE)  
Telecom

Outperform

Target Price: R\$35.20/US\$18.00  
Upside: 27.1%



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(BRL mn)	2010A	2011E	2012E	2013E
EPS (R\$)	4.20	4.19	3.94	3.96
Net earnings	1,003	1,001	940	947
EBITDA	6,337	6,389	5,874	5,655
Shareholders' equity	4,591	4,800	7,453	7,292
ROE %	21.8%	20.9%	12.6%	13.0%
P/E	6.4	6.4	6.4	6.4
EV/EBITDA	3.9	3.4	3.4	3.4
P/BV	2.4	2.3	1.5	1.5
Dividend yield %	6.9%	4.9%	7.3%	6.8%

Key Figures	25-Mar-11
Local price	27.70
ADR	16.87
Price range - 52 weeks (R\$)	23.26 - 30.79
Shares outstanding (mn)	392
3-month ADTV (R\$m)	27.0
Market cap (R\$m)	10,854
EV (R\$m)	31,159
Net debt (R\$m)	20,305
Net debt/EBITDA (LTM)	3.2

**Figure 1: Number of TNLP Shares Pre and Post Offering**

TNLP	Pre-Oferring	Post Oferring
ON	130,611,732	187,028,818
PN	261,223,463	297,932,466
<b>Total</b>	<b>391,835,195</b>	<b>484,961,284</b>

Source: Company and Bradesco Corretora

**Figure 2: Number of TMAR Shares Pre and Post Offering**

TMAR	Pre-Oferring	Post Oferring
ON	107,063,093	154,032,214
PN	131,551,262	190,248,118
<b>Total</b>	<b>238,614,355</b>	<b>344,280,332</b>

Source: Company and Bradesco Corretora

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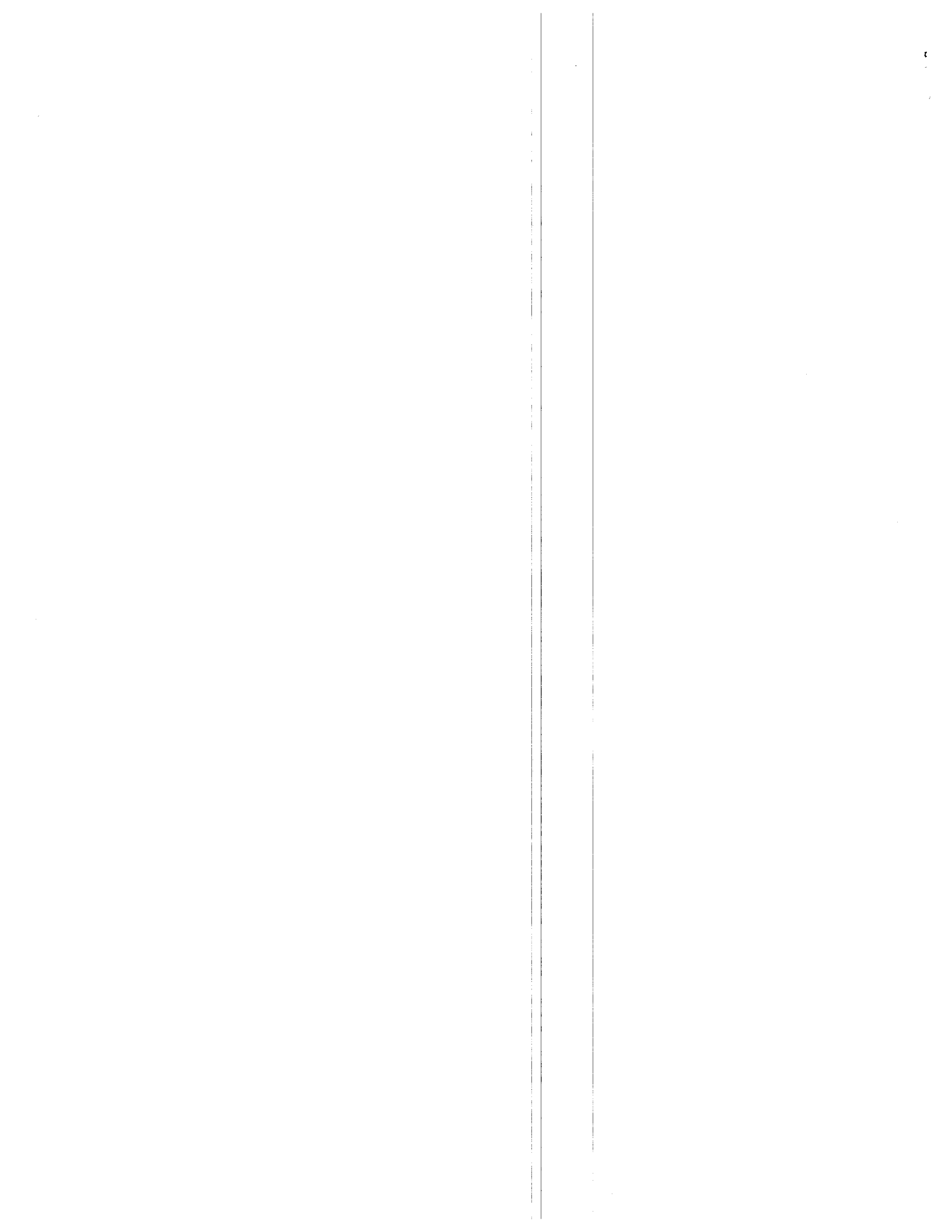
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15 June 2011

# Brazilian Telecoms

## Lower PT's for TNE & TMAR after meeting with Oi

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#### Trimming price target based on tougher recovery

We are decreasing our valuations for TNE to \$22 and TMAR to R\$71 based on decrease in our earnings estimates. After our recent meeting with Oi, we now believe that the road to operational recovery will be slightly longer than we expected. After a period of low investments, Oi is being forced to increase capex and sales/advertising costs, which will impact its margins negatively. We thus maintain our HOLD rating on TNE. On TMAR, we maintain our BUY rating because shareholders are protected by withdrawal rights based on fundamental value.

**This report changes price targets and/or estimates for several companies under coverage. For a detailed listing of these changes, see pp. 2-4**

#### Lowering estimates

Slower operational improvement means lower ARPU and higher line disconnections. As a result we decreased our '11 and '12 revenue estimates by 2%-3%. Our forecasts for wireless and broadband net adds is increasing but on the back of aggressive promotions that would have a negative impact on ARPU. Similarly, aggressive promotions should have a negative impact on EBITDA margin. Our new 31.4% estimate for '11 and 32.2% for '12 are down about 200-300bps. Our EBITDA forecast is therefore coming down close to 10% in each of the two years. Our capex forecast doesn't change significantly as we had already included the higher investments required.

#### Free cash flow

Due to strong capex and high interest payments, free cash flow may be close to zero in '11. Depending on the exercise of withdrawal rights during the corporate restructuring, cash flow could be negative and net debt increase. The minority shareholders of TMAR might exercise their rights because the economic valuation of their shares could be higher than the value suggested by the exchange ratios. Based on our valuation, TNE would have to pay R\$2.0bn to TMAR minorities, which represent 10% of total shares. Net debt increase in '11 would affect FCF in '12 given the increasing interest expenses.

#### Pay TV and triple play

Broadband and pay TV are strategic because of the impact triple play has on LIS churn. As it is more difficult to disconnect more than one service, double and triple play slows down disconnection rates. Currently, TNE's LIS are coming down 6% y.o.y. That rate should decline in '12 with the expansion of triple play. By offering triple play more aggressively, TNE will be able to compete more efficiently with Net, especially in middle-income segments. In the high-end segments, Net will maintain an advantage because of HD and Globo channels, which are expensive for Oi to offer. Pay TV subs could double in '11.

#### Valuation and Risks

Our DCF-based price targets use WACC of 10.1%, including country risk of 140bps and risk-free rate of 3.75%. This results in cost of equity of 14.5%. We also include 300bps for risks related to corporate restructuring with an accretive/dilutive impact on minorities. Risks: 1) better/worse macroeconomic environment in Brazil; 2) positive/negative regulatory changes; 3) corporate restructuring risks; 4) more/less competition from new operators and technologies; and 5) accretive/dilutive M&A transactions.



### Industry Update

#### Top picks

Telemar (TMAR5.SA),BRL51.52	Buy
Tele Norte Leste (TNE.N),USD15.92	Hold

#### Companies featured

Telemar (TMAR5.SA),BRL51.52	Buy		
	2010A	2011E	2012E
EPS (BRL)	8.10	2.31	3.40
P/E (x)	6.1	22.3	15.1
EV/EBITDA (x)	1.4	2.1	2.2
Tele Norte Leste (TNE.N),USD15.92	Hold		
	2010A	2011E	2012E
EPS (BRL)	3.84	1.11	1.64
P/E (x)	7.3	22.9	15.4
EV/EBITDA (x)	1.4	1.4	1.3

Deutsche Bank Securities Inc.

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**New management structure show focus on operations**

The position of COO was created to free the CEO from the day-to-day operational decisions. The new COO is James Meaney, who was CEO of Contax. The CEO will thus concentrate on more strategic decision making process.

**Sales strategy**

TNE revamped its sales team in May. In wireless, they have increased the minimum charge, which increases ARPU. Also, the prepaid charge now includes all calls and not just on-net traffic. This increases traffic and accelerates the use of the prepaid card. Billing has been adapted to follow the industry trend of separating usage charges from the cost of the equipment. After 12 months, the charge is effectively eliminated.

**Restructuring process**

By the end of June, the companies involved should announce the appointment of the independent commissions. Each commission should have three independent members. Within 30-60 days (by the end of Aug), the committees should work on valuations. Each committee can hire a legal advisor and a financial advisor. Once the committees have decided the valuations, they have to meet and negotiate exchange ratios.

The ratios have to be presented to the three boards of directors. With the approval of the boards, the companies have 30 days to call general shareholders meetings. Since only ON shares vote (controlling consortium), we can assume that the values negotiated by the independent committees will be approved by the boards and the shareholders. In terms of regulatory approval, the process requires the approval of Anatel, the CVM and the SEC. Importantly, shareholders cannot be called to vote until Anatel has approved the transaction.

Withdrawal rights: Only shares with limited liquidity have this right: TNLP3, TMAR3, TMAR5, and TMAR6. According to the by-laws, the valuation of TMAR shares has to be done at economic value, which should be determined by an independent consultant. TNLP shareholders receive book value. Brasil Telecom shareholders don't have withdrawal rights.

**Wireless growth**

The weakness in April (123k net adds versus over 1mn in March) was caused by disconnections of subs that were not generating enough ARPU to pay for Fistel. This should have a positive impact on 2Q'11 ARPU.

**Portugal Telecom influence**

TNE created a new committee presided by PT to make decisions on infrastructure and technology. This is a way to leverage off the experience of PT on the development of new technologies to deploy additional services.

**Broadband**

Of '11 capex, R\$2bn is being spent in increasing broadband capacity. The idea is to increase average speeds and have 25% of subs with over 4Mbps by YE'11 (currently is only 14%). Average speeds have been increasing, to 1.9Mbps in 1Q11, from 1Mbps at YE'09. One important objective is to match GVT's speeds in the areas where GVT is present. With the new speeds and more aggressive sales growth should accelerate in '12.

**Acquisition of PT stake**

TNE has acquired 7% of PT: 3% in 1Q11 and 4% in 2Q11. The target is to reach 10%. There is no deadline to complete the acquisition.

## Change of estimates

Changes in our 2011 and 2012 forecasts are as follows. EBITDA margin is impacted by lower revenue (due to lower ARPU and LIS) and higher promotional activity.

**Figure 1: Old and new estimates for TMAR and TNE**

	2011 Estimates			2012 Estimates		
	New	Old	% Ch.	New	Old	% Ch.
<b>TMAR Estimates (US\$m except EPS):</b>						
Net Revenues	17,180	17,565	-2.2%	16,484	17,054	-3.3%
EBITDA	5,391	6,007	-10.3%	5,306	5,905	-10.1%
EBITDA Margin	31.4%	34.2%	-282 bps	32.2%	34.6%	-243 bps
Operating Income	2,068	2,287	-9.6%	2,075	2,311	-10.2%
Net Income	481	902	-46.6%	669	863	-22.5%
EPS (US\$)	1.40	2.44	-42.7%	1.94	2.34	-16.9%
Capex	3,341	3,476	-3.9%	3,200	3,300	-3.0%
<b>Subscribers (000):</b>						
Year-end LIS	18,831	19,105	-1.4%	18,121	18,595	-2.5%
Wireline net adds	(1,194)	(920)	NM	(710)	(510)	NM
Year-end wireless subs	45,273	43,502	4.1%	51,273	46,702	9.8%
Wireless net adds	5,971	4,200	42.2%	6,000	3,200	87.5%
Year-end ADSL subs	5,113	4,684	9.2%	5,813	4,984	16.6%
ADSL net adds	759	330	130.0%	700	300	133.3%
<b>TNE Estimates:</b>						
Net Income (US\$m)	314	534	-41.3%	438	851	-48.5%
TNE EPADR (US\$)	0.67	0.97	-31.1%	0.94	1.55	-39.6%

Source: Deutsche Bank

## Valuation

**Tele Norte Leste:** Our 12-month price target of \$22/ADR is based on DCF, using a WACC of 10.1% resulting from cost of equity of 14.5% and cost of debt of 6.7%. Our country risk estimate of 140bps is based on our forecast for the spread between Brazilian sovereign bonds and US treasury bonds. We include 300bps premium for risks related to corporate restructuring. Our risk-free rate estimate of 3.75% is based on the yield of long-term US treasury bonds. Our perpetuity growth rate is 1.7% and is based on our assumption for Brazilian GDP growth in the long term and the potential growth of the company's different businesses. We use a DCF approach as it better accounts for long term expectations and allows for cross check comparisons with our Latin American telecom sample.

The main downside risks we see for TNE are: 1) regulatory changes, including minimum targets and methodology for tariff and MTR increases; 2) increasing competition, not only from mobile operators, but also from new technologies (squeezing margins); and 3) deterioration of macro-economic conditions, with a negative impact on demand for telecom services and financing cost. Upside risks: a better economic environment with stronger FX rates; less competition than expected; and a positive outcome in the corporate restructuring.

**Telemar Norte Leste:** Our 12-month price target of R\$71/share is based on DCF with WACC of 10.1% resulting from cost of equity of 14.5% and cost of debt of 6.7%. Our country risk estimate of 140bps is based on our forecast for the spread between Brazilian sovereign bonds and US treasury bonds. We are including 300bps premium for risks related to corporate restructuring. Our risk-free rate estimate of 3.75% is based on the yield of long-term US treasury bonds. Our perpetuity growth rate is 1.7% and is based on our assumption for Brazilian GDP growth in the long term and the potential growth of the company's different

businesses. We use a DCF approach as it better accounts for long term expectations and allows for cross check comparisons with our Latin American telecom sample.

The downside main risks we see for TMAR are: 1) regulatory changes, including minimum targets and methodology for tariff increase; 2) increasing competition, not only from mobile operators, but also from new technologies (squeezing margins); 3) deterioration of macro-economic conditions, with a negative impact on consumption of telecom services; and 4) corporate restructuring risk.

# Appendix 1

## Important Disclosures

Additional information available upon request

### Disclosure checklist

Company	Ticker	Recent price*	Disclosure
Telemar	TMAR5.SA	51.52 (BRL) 15 Jun 11	8
Tele Norte Leste	TNE.N	15.92 (USD) 15 Jun 11	8,14

\*Prices are sourced from local exchanges via Reuters, Bloomberg and other vendors. Data is sourced from Deutsche Bank and subject companies.

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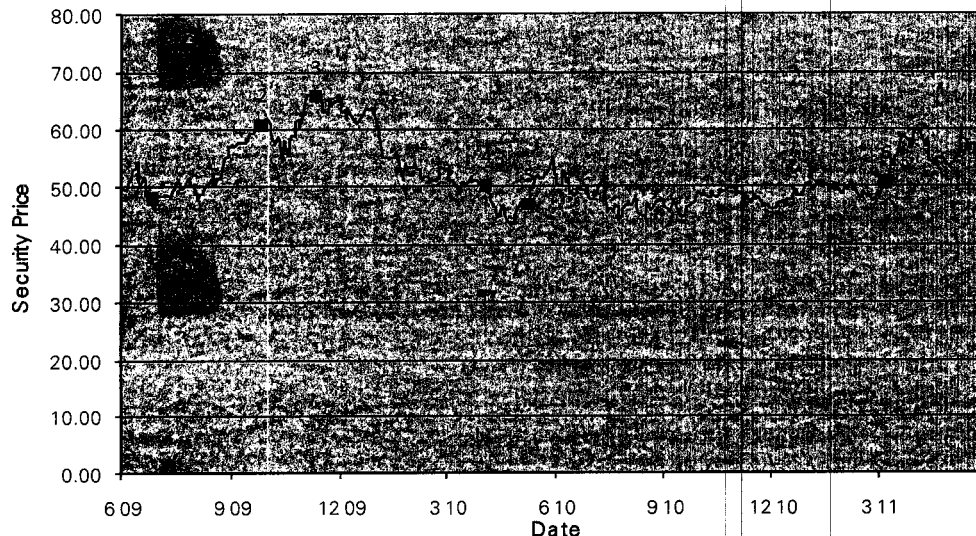
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**Historical recommendations and target price: Telemar (TMAR5.SA)**

(as of 6/15/2011)



Previous Recommendations

- Strong Buy
- Buy
- Market Perform
- Underperform
- Not Rated
- Suspended Rating

Current Recommendations

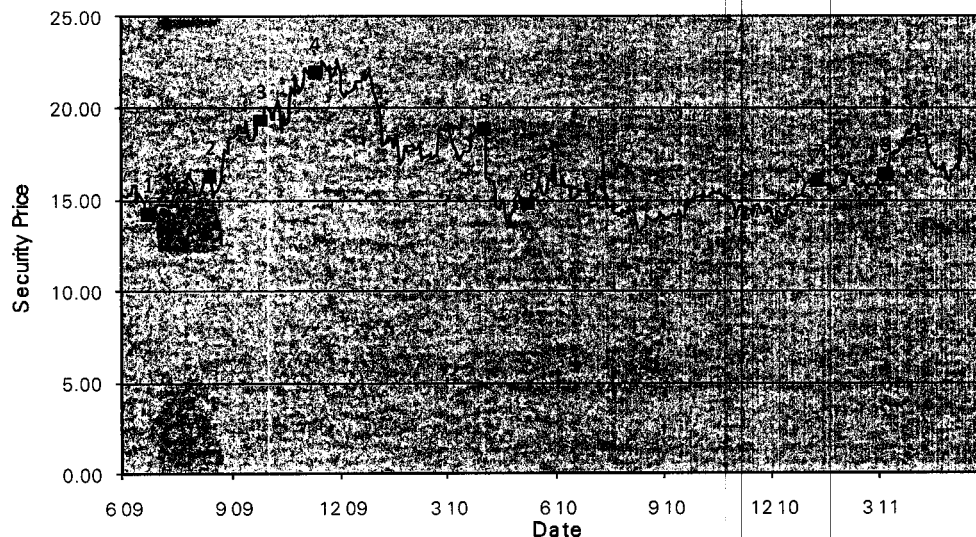
- Buy
- Hold
- Sell
- Not Rated
- Suspended Rating

\*New Recommendation Structure as of September 9, 2002

1.	13/7/2009:	Buy, Target Price Change BRL100.00	4.	19/4/2010:	Buy, Target Price Change BRL83.00
2.	12/10/2009:	Buy, Target Price Change BRL108.00	5.	25/5/2010:	Buy, Target Price Change BRL80.00
3.	26/11/2009:	Buy, Target Price Change BRL96.00	6.	23/3/2011:	Buy, Target Price Change BRL74.00

**Historical recommendations and target price: Tele Norte Leste (TNE.N)**

(as of 6/15/2011)



Previous Recommendations

- Strong Buy
- Buy
- Market Perform
- Underperform
- Not Rated
- Suspended Rating

Current Recommendations

- Buy
- Hold
- Sell
- Not Rated
- Suspended Rating

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2.	30/8/2009:	Hold, Target Price Change USD25.00	7.	25/1/2011:	Hold, Target Price Change USD25.00
3.	12/10/2009:	Hold, Target Price Change USD32.00	8.	23/3/2011:	Hold, Target Price Change USD22.00
4.	26/11/2009:	Hold, Target Price Change USD30.00	9.	24/3/2011:	Hold, Target Price Change USD23.00
5.	18/4/2010:	Hold, Target Price Change USD23.00			

Equity rating key

Equity rating dispersion and banking relationships

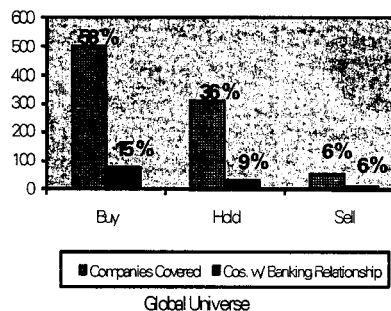
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## Latin America Telecommunications

### 2011 Latin America Telecom Outlook

#### **Integration of large groups (and more competition) is a major theme in 2011**

After major M&A transactions in 2010, large integrated telecom operators may dedicate a sizable chunk of time and energy this year to merging their operations. The ultimate goal is to gain scale, offer a complete suite of telecom services to all types of consumers, leverage on the different infrastructures, and fend-off competition, both from other big incumbent groups and from smaller challengers (like GVT and TIM in Brazil and cable companies in Mexico). There may be an opportunity for challengers to gain share, while big groups focus internally. Superior broadband and pay-TV services will determine the winners when it comes to services to households, we think.

#### **Mobile services in a new growing phase (via data services and traffic migration)**

Now that penetration rates are approaching 100% in many LatAm countries and subscriber base growth is decelerating, a new wave of growth may come from increased demand for data services via mobile devices (smartphones, iPads) and a faster migration of voice traffic from fixed to mobile phones (as mobile tariffs keep coming down). This combined with a more rational competitive environment across the region (especially in Brazil), may continue to drive margins up. Overall, we are more bullish on the prospects of mobile businesses than fixed line.

#### **Intense M&A in 2010 (more to come ahead); Busy regulatory agenda (always)**

M&A activity was intense in the sector in 2010 (and in 2009/2008). In recent years, major groups were formed (TNE-BRP, AMX-TMX, TEF-VIV) and other important transactions took place (Vivendi bought GVT, TIM bought Intelig, etc.). We expect M&A activity to remain strong in the years to come and potential targets are TIM (and TEO), NIHD, GVT (more as a buyer), Entel PCS, Axtel, Megacable. The regulatory agenda is extensive, ranging from new mobile licenses (3G and maybe 4G), to elimination of foreign ownership restrictions and mobile termination rate discussions.

#### **Our picks: TIM, AMX, Vivo; Least preferred: Telmex and Telesp**

Our top picks among LatAm Telco names remain TIM and AMX. We expect TIM's financial results to keep improving along with the company's operating turnaround. For investors looking for strong FCF generation, AMX is a superior, defensive investment option. We like Vivo as we think it is the best way to play the new, integrated Telesp+Vivo company (which is cheaper than its global peers). We don't like pure fixed-line companies Telmex and Telesp, as their businesses are under attack and shrinking.

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## **Main Themes for 2011**

In this note, we discuss the topics that we expect to dominate the headlines in the Latin America telecom sector in 2011. In general, the telecom market should benefit from the good economic prospects in the region, with many countries expected to grow at mid-single digits (we expect Brazil to grow 4.0% in 2011, Mexico 4.4%, Colombia 5.2%, Chile 6.5%, while the International Monetary Fund forecasts that Argentina and Peru will grow 4.0% and 6.0%, respectively). With a growing middle class, credit expansion, and low unemployment rates it is reasonable to expect Latin Americans to not only talk more but to access more sophisticated data services (with more money and credit, access to smartphones and iPads may be easier).

After major M&A transactions in 2010, we expect the big Latin America telecom groups to spend a great amount of time and energy in 2011 integrating their operations in the region. The final goal is to gain scale, to leverage on the different infrastructures (integrating backbones and backhauls and putting together fixed-line, cable and mobile access networks), so that they can offer a complete array of telecom services to all types of consumers and also fend off competition.

We continue to think the winners will be the companies offering high-quality, super fast broadband connections, and top-quality pay-TV services (in that context, fixed-line incumbents need to up their investments to deploy fiber to improve access networks). Whoever manages to combine these services with fixed telephony and superior customer services will be the households' provider of choice. Adding mobile telephony to the package (i.e. quadruple play offers) may help, but we still think that the decision on the provider of mobile services is more individual, rather than taken by the family head.

### **More competition is expected, especially in fixed-line services**

We believe that telecom challengers, especially in Brazil, may take advantage of the fact that the big groups are focused on integrating their businesses to gain market share. We believe companies like GVT, which provides ultra-high speed broadband connections and high-quality fixed-line services, and mobile operator TIM may stand to gain the most. GVT has just launched services in Rio de Janeiro and has plans to launch São Paulo in the third quarter of 2011, increasing competition in the country's most important cities. In Mexico, the competitive environment may also get fiercer, with cable companies and Axtel investing to improve their access networks.

On the mobile front, NII Holdings bought 3G licenses and is deploying networks in Mexico and Brazil (and Peru and Chile). Even though it is already operating in these countries, NII's competitive position may improve once it starts offering more sophisticated 3G services. Consequently, competition tends to increase in the margin.

### **We are more optimistic with mobile businesses**

Overall, we are more bullish on the prospects of mobile businesses rather than fixed-line, at this point. In Brazil, after analyzing the main operating and financing metrics reported by wireless companies, our take is that the mobile business is in better

shape now than a year ago. The subscriber base is growing at double-digits, voice usage is increasing as more voice traffic migrates to mobile networks, and data usage is soaring. At the same time, competition is more rational (and focused on services, rather than handsets), which is driving margins up.

**M&A will continue to be a relevant theme in the years to come**

M&A is probably one of the most important themes for Latin American telecom companies. In 2010, major M&A transactions took place. AMX bought Telmex and Telmex Internacional, Telefonica bought Portugal Telecom's stake in Vivo and announced plans to merge Telesp and Vivo, while Portugal Telecom deployed part of the proceeds received from the sale of its stake in Vivo to buy a controlling stake in Telemar. In 2009, GVT was bought by French media group Vivendi, while TIM bought corporate data provider Intelig (and its high quality backbone). In 2008, Telemar bought Brasil Telecom.

A lot has happened on the M&A front in recent years, but we believe there is more to come. TIM is a candidate to be involved in M&A transactions in the future. It could merge with GVT, or be bought by one of the existing big telecom groups, or buy Nextel Brazil operations. In addition to TIM, GVT could be looking at Nextel Brazil as an alternative for the company to start offering mobile services.

In Mexico, Televisa may continue to consolidate the cable market, with an eye to offering national triple-play services. Megacable is a natural take-over candidate, in our opinion, and would fit perfectly into Televisa's strategy. Televisa may also continue to seek partners to develop its mobile strategy in the country after cancelling the deal it announced with NII Holdings (it could even reach a different deal with Nextel Mexico or try to reach an agreement with Telefonica).

Also in Mexico, if current legislation changes (allowing foreigners to control fixed-line operations), we expect Telefonica to look for acquisition opportunities. In that context, fixed-line challenger Axtel would be a natural takeover candidate (Maxcom and Alestra could also be included in the list, although they are smaller than Axtel).

Other M&A opportunities may arise in countries like Chile, where Entel PCS, Chile's #2 player with 35% market share and almost 7mn mobile clients, looks like an attractive operation for AMX, which has been struggling to make its Chilean operation profitable. A merger between Entel and triple-play operator VTR would also make sense.

Lastly, we think the big groups will continue to seek for assets that could complement their telecom infrastructure. Some examples of companies controlling metropolitan backbones include Eletropaulo Telecom and AES Telecom in Brazil.

**Many topics on the regulatory front, but mobile termination rates may be the most relevant of all in 2011**

As has been the case in previous years, the regulatory agenda is extensive, ranging from new mobile licenses (3G and maybe 4G), to revised pay-TV regulation, elimination of foreign ownership restrictions and mobile termination rate discussions.

After 3G licenses were auctioned in Mexico and Brazil in 2010 (in Chile 3G auctions were held in 2009), we don't expect additional licenses to be sold in these markets in 2011, although the Mexican government has announced plans to sell some leftover spectrum from last year's 3G auction and spectrum in the 3.4Ghz band still in 2011. In Brazil, Anatel has said it plans to sell spectrum in the 2.5Ghz band, which would be used for 4G services, already in 2011 (when original plans were to sell this spectrum in 2012), but we think it is unlikely.

Discussions on mobile termination rates are certainly among the most relevant of all regulatory themes in 2011. Mobile termination rates are expected to finally start coming down in Brazil, but we think they may be cut gradually and much slower than some expected. **We think cuts in 2011 and 2012 may be close to 8.5% in nominal Reais in each of the next two years.**

In Mexico, the recent agreement announced between AMX's Telcel, Telmex and Telefonica indicates that mobile termination rates will continue to fall gradually in the next few years (**as per the agreement, mobile termination rates will fall by 5% in 2011, to P\$0.95 per minute, and will continue to fall gradually until reaching P\$0.69 per minute in 2014**). However, fixed line challenger Axtel may obtain in court the right to pay much lower tariffs (~P\$0.44 per minute), which could drive the other fixed-line companies (including Telmex) to follow suit.

New pay-TV regulation may be approved by the Brazilian Senate in 2011, allowing telecom operators to offer pay-TV services using their own physical infrastructure (copper wires and fiber) and foreigners to control cable TV operations in the country. In Mexico, the country's congress has been debating a bill that, if approved, would eliminate foreign ownership restrictions on fixed-line companies.

We also note that the Brazilian government has placed strong importance on a policy to offer relatively cheap-priced broadband services across the country. Brazil's National Broadband Plan, as the program is called, needs to be followed closely as it may define the type of direct participation the Brazilian government will have in the country's telecom sector.

*We discuss regulatory issues in much more detail below.*

## **What we like...**

Our top picks among Latin American telecom names are TIM Participações (TSU) and America Movil (AMX). TIM's turnaround is well underway and we expect revenue growth to accelerate more markedly in 2011, supported by the recent launch of data services, Intelig's turnaround, and increased voice revenues. We model for EBITDA to grow in excess of 20% in 2011 and another 15% in 2012. The company is trading at 3.5x 2011 EV/EBITDA, a major discount to its global peers trading at 5.0x.

AMX is a good defensive investment. It has a solid balance sheet even after the acquisition of TII and TMX (net debt-to-EBITDA of 0.7x), strong free cash flow generation (we model for free cash flow generation of US\$9.0bn in 2011 or a 8% FCF yield) and some growth (we model for AMX's EBITDA to grow 11% in 2011 and 6% in 2012). Given its low leverage and strong cash generation, we expect the company to

be able to return all the excess cash to shareholders, either via dividends or buybacks. AMX is definitely a superior, diversified and defensive investment option.

We also like Vivo. In our view, even after its recent outperformance Vivo is still the best vehicle to play the new Vivo+Telesp company as we think the terms of the swap ratio may end up favoring Vivo's minorities. In addition, according to our estimates, the new company's valuation looks relatively compelling when compared to its global peers. The new company is trading at 9.9x 2011 P/E, this is a big discount to its global peers which are trading at 11.5x.

### **What we don't like...**

We don't like Telesp's business, which is under attack and shrinking. The merger with Vivo may be good or not (for minorities). We would play the integrated company via Vivo.

We also don't like Telmex's business, which is shrinking at a fast pace (EBITDA fell 11% YoY in 3Q10). In addition, we expect dividend payments to be relatively modest and focus should be on the company's deleveraging. Although the company resumed stock buybacks in December last year, TMX is now trading at 11.3x 2011 P/E, a valuation similar to AMX. However, AMX's results are much stronger and the company is growing faster. We would certainly buy AMX rather than TMX at these valuation levels.

### **We have a Neutral view on NII Holdings and Axtel**

Even though NII Holdings (NIHD) may continue to grow nicely in 2011, we are concerned with the company's long-term prospects. We think that transforming NII into a 3G operator is a great challenge, especially given the need for infrastructure capacity in Mexico and Brazil. Doing it without a partner may prove even tougher.

We are still concerned with Axtel's high leverage and long-term strategic issues (its network is not capable of delivering high-speed broadband connections, and it does not offer pay-TV or mobile services). However, operations are improving, the company is deploying fiber and M&A could trigger the stock up.

***Please find detailed financial forecasts for all the telecom companies we have under coverage at the end of the report.***

Table 1: Latin America Telecom Stock Data

Last updated: Valuation	18/jan/11 Rating	Ticker	ADR or US\$		Local share		Upside in \$	Mkt. cap \$m	EV \$m	Daily avg. vol \$ '000
			Price	Target	Price	Target				
<b>Wireline/Integrated</b>										
Telmex	Sell	TMX US	16.58	16.14	10.01	10.20	+2%	15,123	20,533	17,671
Axtel	Neutral	AXTELCPO MM	4.13	4.65	7.11	8.40	+18%	740	1,509	1,537
Tele Norte Leste PN	Buy	TNE US	16.05	21.16	26.85	36.00	+34%	6,132	19,576	41,491
Tele Norte Leste ON	Buy	TNLP3 BZ	21.19	29.39	35.49	50.00	+41%	8,105	21,549	4,215
Telemar NL PN	Buy	TMAR5 BZ	29.93	44.39	50.11	75.50	+51%	7,134	18,560	3,115
Telesp Fixed PN	Neutral	TSP US	24.95	25.87	42.06	44.00	+5%	12,706	12,899	4,647
<b>Mobile</b>										
America Movil	Buy	AMX US	59.00	66.44	35.56	42.00	+18%	119,018	135,355	187,488
NII Holdings	Neutral	NIHD US	42.37	48.00	42.37	48.00	+13%	7,427	8,426	59,389
Vivo Holdings PN	Buy	VIV US	33.79	41.15	55.48	70.00	+26%	13,277	14,719	44,235
TIM Part. PN	Buy	TSU US	37.10	44.09	6.08	7.50	+23%	8,989	10,167	35,273
TIM Part. ON	Neutral	TCSL3 BZ	4.47	5.64	7.49	9.60	+28%	11,074	12,251	2,328

Source: Reuters, company reports and BTG Pactual estimates

Table 2: Latin America Telecom Valuations

Last updated: Valuation	18/jan/11 Rating	P/E		EV/EBITDA		EV/sub* Last Q (US\$)	EV/OpFCF**		FCF yield %		Dividend yield %	
		2011E	2012E	2011E	2012E		2011E	2012E	2011E	2012E	2011E	2012E
<b>Wireline/Integrated</b>												
Telmex	Sell	11.3	10.7	5.2	5.0	1,314	6.9	6.7	12.1%	12.1%	6.1%	6.7%
Axtel	Neutral	-73.8	48.9	4.7	4.2	1,168	13.3	10.1	8.4%	11.8%	0.0%	0.0%
Tele Norte Leste PN	Buy	5.5	5.0	3.0	2.9	339	5.0	4.9	13.3%	13.8%	14.3%	15.4%
Tele Norte Leste ON	Buy	7.3	6.7	3.3	3.2	373	5.5	5.4	10.1%	10.4%	10.8%	11.8%
Telemar NL PN	Buy	6.6	6.0	2.8	2.7	321	4.7	4.6	19.3%	20.4%	12.5%	13.6%
Telesp Fixed PN	Neutral	9.3	9.4	4.3	4.2	1,141	7.8	7.4	9.0%	9.7%	10.2%	10.1%
<b>Mobile</b>												
America Movil	Buy	11.5	10.3	5.8	5.2	507	9.0	8.0	8.0%	9.2%	7.7%	8.7%
NII Holdings	Neutral	20.9	33.6	5.6	5.8	981	nm	-142.1	-17.2%	-6.9%	0.0%	0.0%
Vivo Holdings PN	Buy	10.3	8.7	4.1	3.6	255	9.1	6.1	5.6%	11.3%	6.4%	8.7%
TIM Part. PN	Buy	11.9	7.7	3.4	2.8	217	7.5	5.1	10.3%	14.3%	3.7%	8.0%
TIM Part. ON	Neutral	14.7	9.4	4.2	3.5	261	9.3	6.4	8.3%	11.6%	3.0%	6.5%

Source: Reuters and BTG Pactual estimates

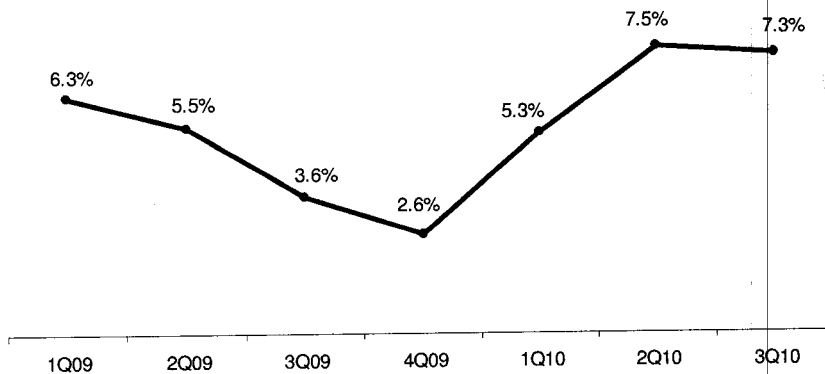
## We are more bullish on the mobile sector

Overall, we are more positive on the prospects of mobile businesses rather than fixed line, at this point. Even though Latin American markets are highly penetrated, service revenue growth is accelerating as traffic migrates to mobile devices (from fixed-line phones) and demand for mobile data services grows exponentially. At the same time, competition has been quite rational in most countries (especially in Brazil, a country in which the competitive environment has historically been intense). This combination is helping drive margins up, especially in Brazil.

### In Brazil, revenues are growing and margins expanding

After analyzing the main operating and financing metrics reported by wireless companies, our take is that the Brazilian mobile business is in better shape now than a year ago. The subscriber base is growing at double-digits, usage is increasing significantly as more voice traffic migrates from fixed-line to mobile networks, and data usage is picking up, all of this while maintaining network quality at good levels. All in all, service revenue growth is accelerating again (*chart 1*), supported by growth in both data and voice services.

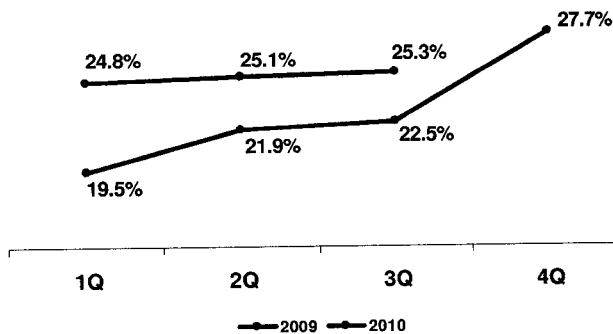
Chart 1: Growth in consolidated service revenues has been accelerating in Brazil (YoY)



Source: Company reports. Service revenues of Vivo, TIM and Claro.

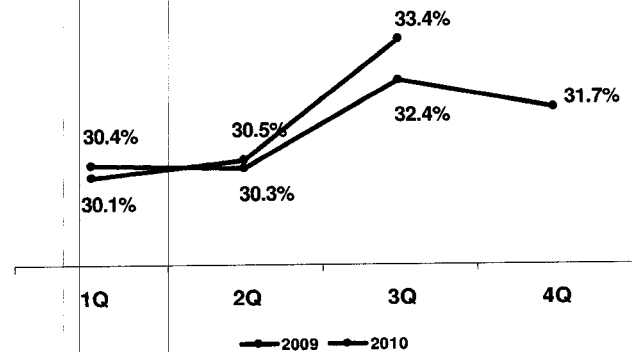
At the same time, competition is more rational now, especially in Brazil, as the focus of the promotions has shifted from handsets to services. Operators' strategy of selling only SIM cards, i.e. no subsidized handsets, is supporting the sharp drop in subscriber acquisition costs and bad debt. The combination of growing revenues and contained costs has been driving the sector's overall EBITDA margins up in Brazil (charts 2 and 3). We expect that trend to continue in 2011.

Chart 2: TIM's EBITDA margin evolution



Source: Company report and BTG Pactual estimates

Chart 3: Vivo's EBITDA margin evolution



Source: Company report and BTG Pactual estimates

**But keep an eye on competition as Claro and Oi are getting more aggressive**

Although we start 2011 with a more positive view on the mobile sector, AMX's Claro and Oi are showing signs of increased marketing aggressiveness. Based on Anatel's monthly data, in October and November Claro led the acquisition of post-paid clients in the country, grabbing more than 50% of all postpaid net additions in the period (Vivo led postpaid net additions throughout the year until September).

Oi has also shown some signs of a revival in the prepaid segment. In November, Oi's market share of net additions stood at 21.3%, above the 7.7% obtained in the first 10 months of the year. After spending much of the year hoarding cash in order to reduce

its relatively high leverage, the entrance of Portugal Telecom in the company's control group and the announced capital increase of up to R\$12bn could push Oi's management to change the company's strategy back towards a more aggressive marketing approach.

### **MVNOs in Brazil seem to be more of an opportunity than a threat**

In our view, the regulation on mobile virtual network operators (MVNOs) announced at the end of 2010 in Brazil proved to be relatively benign to existing network operators, as they won't be forced to sell capacity to MVNOs.

We see MVNOs as a new business opportunity for existing network operators as they may help optimize network usage and improve sales capillarity. Existing operators may look to establish partnerships with retailers, banks and credit card operators, and big communities (like religious groups and soccer teams).

We may even see pure mobile operators, like TIM and Nextel Brazil, reaching the conclusion that an agreement with fixed-line and broadband provider GVT is interesting. They could sell GVT mobile minutes in exchange for GVT's backbone capacity, for instance.

### **NII to become a stronger competitor with 3G (although maybe not strong enough to threaten the existing operators)**

In 2010, NII Holdings successfully bought 3G spectrum in Mexico and Brazil with an eye to offering 3G services in both countries (in fact, it has already started building out in Mexico and may soon start works in Brazil). Even though investments are sizable, which makes obtaining adequate returns a big challenge, NII's competitive position in these markets may improve once it starts offering 3G services. In other words, it is fair to assume that competition will increase at the margin, although we cannot see any clear competitive advantage for NII.

The fact that the company is smaller in size, has no long-distance backbone infrastructure in these markets, and will be reaching the market many years after the existing players makes us wonder whether NII will be able to effectively compete for clients. Going for 3G without a telecom partner (with backbone infrastructure) may prove quite a challenge for the company.

### **Integrated assets and more competition**

The competitive landscape in the Latin America telecommunications sector is changing. As we have seen in other regions around the globe, mobile and fixed-line services and networks are being combined in Latin America (as well as pay-TV services). Customers are also demanding more convergent products, combining voice, broadband and pay-TV. Transport infrastructure, which used to be typically owned by fixed-line companies, is now vital to support mobile data offerings.

In our view, integrated telecom companies' competitiveness largely depends on their ability to deliver packages of services including high-speed broadband connections and pay-TV services, combined with fixed-telephony and superior customer services. Whoever manages to combine these abilities tends to stand out.

## More competition ahead

Incumbent integrated telecom operators (like AMX/TMX, Telefonica, Telemar) will not only have to compete against each other (especially in Brazil) but will also have to face competition from emerging challenger telecom operators (like GVT and TIM in Brazil and cable operators and Axtel in Mexico).

The competitive environment in Brazil could be intense. Telmex, via Embratel and potentially NET, has plans to continue to expand its presence in the country, offering local telephony (via NET or fixed-wireless connections), pay-TV via satellite and broadband (at this point only in the 100 cities NET is operating). The company is deploying a cable network in cities where NET is not present, in order to position itself to start offering broadband connections as soon as possible and pay-TV services via cable as soon as NET is authorized to enter new cities (Anatel removed the limitation on pay-TV concessions at the end of 2010, creating room for NET to request licenses in cities where it is currently not present).

Telefonica, now with Vivo, may take advantage of Vivo's long-distance backbone outside São Paulo to start offering telephone services (including voice and data) to corporate clients in these markets. In addition, we would expect Telefonica to increase investments in the company's last mile access network in order to improve the quality and speed of its broadband connections. Today, both NET and (soon) GVT offer better and faster broadband connections in São Paulo.

We also expect Telemar to materially increase investments in its relatively poor quality access network, once the company's capitalization is concluded (expected for 1Q11) and it is less cash-constrained. With GVT already operating in the most important capitals in Telemar's concession region, including the city of Rio de Janeiro, the need for better broadband connections grows by the day.

In our opinion, the differences between the level of competition in the Brazilian and Mexican markets are basically explained by GVT's and NET's very strong operations. GVT's unmatched broadband offers and NET's high quality pay-TV and broadband packages make it much more difficult for Brazilian incumbents (Telesp and Telemar) to resist the attacks.

## GVT is expanding aggressively

Telecom challenger GVT has aggressive plans to expand network coverage and territorial reach in 2011. GVT has just launched services in the city of Rio de Janeiro and it expects to launch in the city of São Paulo in the third quarter of 2011. In 2010, GVT expanded its coverage area to cities in the countryside of São Paulo state and in the Northeast region. The company also has a target list of more than 100 cities to enter. We estimate GVT's capex in 2010 at around R\$1.4bn (more than double 2009) and in a recent interview the company's CEO said that it may be even more in 2011.

GVT's network, combining optical fiber rings with a short copper last mile, enables the company to provide ultra-high speed broadband connections. At this point, more than 60% of the company's client base has been enjoying broadband speeds of 10Mbps and higher. The entry level plans are now 5Mbps, for which the company is charging

R\$50 per month, compared to Telefonica and Telemar selling 4Mbps packages for R\$70 and R\$60, respectively.

The company is also planning to launch pay-TV services in the second half of 2011. It plans to offer a combination of satellite services and IPTV (it can only offer IPTV services after PL29, now PLC116, is approved), with investments that may add up to R\$200m.

All-in, competition in Brazil's telecom landscape will be between three large-scale operators, with all three offering a complete range of nationwide telecom services, and three players operating non-integrated telecom services in the country: TIM (mobile services), GVT (fixed-line and broadband services) and Nextel (trucking/mobile services).

### **In Mexico, the lack of triple play is pressuring Telmex**

In Mexico, fixed-line incumbent Telmex faces a less intense competitive environment than in Brazil, with the company's powerful infrastructure being its main competitive advantage. However, Cofetel's decision to block Telmex from offering pay-TV services has created room for cable TV operators (with triple play packages) to take market share away from Telmex.

When it comes to broadband services, Telmex seems to be well positioned (the company is the leading provider of broadband services in the country), even though it has been offering relatively low-speed connections. Telmex's top packages offer speeds of 5Mbps, which are faster and more reliable than cable operators' packages offering speeds between 1Mbps and 2Mbps. Telmex's strategy of selling computers in installments together with broadband contracts has been helping the company expand its broadband client base.

However, we would expect the competitive environment to intensify in Mexico, with cable operators and Axtel investing to improve their networks and increasing broadband speeds. Televisa's goal of consolidating the Mexican cable TV market in order to offer national triple play services should also increase competition.

### **Pay-TV is central to triple play strategies**

With the aim of protecting their voice client base and continuing to grow in broadband, Latin American telecom companies have been looking for alternatives to add pay-TV packages to their existing voice and broadband offerings. Telecom companies both in Mexico and Brazil have regulatory limitations to offer pay-TV services.

In Brazil, the existing regulation prevents telecom companies from using their existing copper and fiber infrastructure to provide pay-TV services. However, they are allowed to offer pay-TV services using other networks such as satellite (DTH) or MMDS. If approved, draft bill PLC116 (also known as PL29), under discussion in the Senate, would allow telecom companies to offer pay-TV services using their own copper/fiber infrastructure.

Given that discussions are taking longer than anticipated by the telecom players, and that cable providers are aggressively taking market share away from the telcos with their own triple-play offers, Brazilian telecom operators decided to use satellite (DTH) to complement their offers. Telefonica (in São Paulo), Telemar and Embratel are all offering pay-TV services using DTH. Offering pay-TV using satellite technologies has higher operating costs than providing the service using an existing infrastructure, since the companies would have to run two networks simultaneously – including satellite rental costs. DTH is a less efficient technology when it comes to the quality of the transmission in densely populated areas, and it is also more exposed to weather interferences.

However, implementing a pay-TV offer via DTH demands less network investments and has a faster time-to-market. When deciding to offer the service via DTH, telecom companies are probably also taking into account the fact that their Latin American copper networks are old and of poor quality, consequently demanding sizable investments to make them capable of handling the broadcasting of video signals.

#### **Anatel removed some important regulatory barriers at the end of 2010**

At the end of 2010, Anatel removed some key regulatory barriers for telecom operators to offer Pay-TV via cable in Brazil. First, it announced that the clause blocking incumbent telecom companies from offering cable TV services will be removed from the new concession contracts valid from 2011 to 2015. In addition, it approved a regulation allowing anyone interested to apply for a cable TV concession (before, cable TV concessions had to be auctioned by Anatel). The latter would help telcos overcome a clause in the Cable Law that allowed telcos to offer cable TV services only if no other company was interested in the service. In fact, the Cable Law is still in place and one of its clauses blocks foreigners from controlling cable TV operations, which ends up preventing Telesp (controlled by Telefonica) and GVT (controlled by Vivendi) from offering cable TV services (approval of PLC116, expected for 2011, would remove this barrier).

Oi, controlled by Brazilians, would be the only large telco able to apply for cable TV concessions. However, we think Oi's network is not ready to handle capacity-hungry video signals, and massive investments would be needed before it starts the service. In addition, Oi would have to work on its pay-TV strategy given that today it offers services via satellite only to lower-end users (it does not carry Globo's highly desired pay-TV programming).

NET, which is the leading provider of cable TV services in the country with a market share of ~48%, in theory would face extra competition from Oi sooner rather than later (although we think it would take Oi long before it can offer cable TV services). But it would also be able to apply for concessions in regions where it is not currently present and start expanding geographically (NET has listed at least 15 cities with high pay-TV potential in Brazil, especially in the northeast).

#### **In Mexico, Telmex is still blocked**

In Mexico, Telmex's concession title blocks the company from offering pay-TV services entirely. However, under the Convergent Agreement, Cofotel has promised

to change Telmex's concession title to allow it to offer pay-TV services if the company agrees to number portability (already in place in Mexico), and interconnection and interoperability of its network with other operators' networks. Telmex has been arguing it has met all three conditions, but Cofetel has not changed the company's concession title yet, effectively blocking the company from offering its own pay-TV services.

To try to minimize the lack of a direct pay-TV offer, Telmex has entered into a commercial agreement with Echostar and Mexican MMDS pay-TV operator MVS to create DISH Mexico, a nationwide provider of pay-TV services via satellite. This agreement is important to Telmex because it can give its clients voice, broadband, and video in the same offer, even though we think it will not make money with it. **Ultimately, Telmex has an agreement to buy DISH's control the day its concession title is changed.**

We believe fixed-line telcos' search for adequate pay-TV packages and the competitiveness of their triple play offers will remain an important theme in 2011.

### **Busy Agenda on the Regulatory Front (as always)**

On the regulatory front, the agenda is extensive ranging from new mobile licenses (3G and maybe 4G), elimination of foreign ownership restrictions and mobile termination rate discussions. We should also see governments in Latin America focused on incentives to develop the broadband and pay-TV markets, especially in Brazil.

### **Termination rates should be reduced in Brazil and Mexico**

#### **MTR cuts may be smaller than expected in Brazil; Good for mobile companies**

Brazilian telecom regulator Anatel held a public hearing in 2010 proposing a 10% cut in fixed-to-mobile tariffs in 2011 and 2012. The 10% cut may be softened by Anatel's intention to readjust tariffs by the telecom inflation index (IST), which reached 4.6% last year (although depending on the productivity factor the tariff readjustment could be much smaller). Since mobile termination rates (MTRs) are set in accordance with fixed-to-mobile tariffs, we would expect MTR adjustments to follow whatever is decided regarding fixed-to-mobile tariffs.

It is important to note that while fixed-to-mobile tariffs are regulated by Anatel, mobile termination rates are not. They are defined based on free negotiations between fixed-line and mobile companies. If these companies cannot agree on mobile termination rates, Anatel jumps in and helps define the rates. Anatel is now suggesting that whenever an agreement is not reached, mobile termination rates would be readjusted by 85% of the readjustment applied to fixed-to-mobile tariffs. If, for instance, fixed-to-mobile tariffs are cut by 10%, mobile termination rates would be reduced by 85% of that amount.

Given that Anatel's definition of a fully allocated cost model (FAC) to set mobile termination rates is behind schedule (and may not be put to work before 2013), it is likely that the free negotiation mechanism (with Anatel's intervention when needed) will be the model used to define mobile termination rates in 2011 and 2012.

This is a quite positive development for Brazilian mobile companies (and somewhat negative for fixed-line companies). A scenario in which tariffs drop by some 8.5% per year in the next couple of years is much better than the 20% cuts supposedly suggested by Anatel's technical team (and we think much less than investors and analysts have been modeling). Proposed cuts are in table 3 below.

**Table 3: Mobile termination rate cuts in Brazil**

MTR (VU-M) cut schedule	2011	2012	2013	2014	2015
Prior proposal (nominal)	20%	20%	15%	10%	5%
New proposal (nominal)*	8.5%	8.5%			

Source: Anatel and BTG Pactual estimates. (\*) 85% of the readjustment applied to F2M tariffs, expected to be cut by 10% per year in the next 2 years.

In addition, it is reasonable to assume that lower mobile termination rates (and, consequently, lower mobile tariffs) may be at least partially offset by an increase in off-net traffic. The jump in traffic we have been seeing as a consequence of lower average tariffs is a good evidence of positive price-elasticity in the Brazilian market.

#### **In Mexico, Telefonica and AMX/TMX agreed on gradual MTR cuts in the next four years**

Mobile termination rates in Mexico have been coming down 10% per year since 2005, following an agreement established between fixed and mobile operators. As is the case in Brazil, mobile termination rates in Mexico are also set by free agreement between operators (Cofetel would only intervene if there is no agreement). At the end of 2010, Telefonica Mexico signed a new interconnection agreement with AMX's Telcel and Telmex, valid for 2011-2014. The agreement foresees a termination rate per minute of P\$0.95 in 2011 (vs. P\$1.00 at the end of 2010) and a gradual annual reduction that would drive MTRs down to P\$0.69 in 2014 (table 4). Telcel, Telefonica and Telmex account for 92% and 80% of the Mexican mobile and fixed-line markets, respectively, which makes this agreement an important one.

**Table 4: Mobile termination rates cuts in Mexico**

MTR agreement	2010	2011	2012	2013	2014
Tariff (P\$)	1.00	0.95	0.86	0.77	0.69
Annual change		-5.0%	-10.0%	-10.0%	-10.0%

Source: Company reports

#### **Axtel fighting (and winning) for the right to pay lower MTRs**

Fixed-line challenger Axtel, however, has been fighting in courts for many years for the right to pay much lower mobile termination rates. Back in September 2008, Mexico's telecom ministry (SCT) ruled that interconnection tariffs being paid by Axtel to connect to mobile operators' networks were too high. At the time, SCT decided that a fair interconnection tariff would be P\$0.55 per minute (while the agreed tariff at the time was P\$1.20). Mobile operators went to court and in July 2010 a first instance court decided in favor of Axtel (stating that a fair termination rate would be P\$0.44 per minute). Mobile operators appealed to a second instance court and a final ruling is expected for the next quarters.

If courts define the new tariff at P\$0.44 per minute, all fixed-line operators should demand the same rate, based on non-discriminatory principles. Even Telmex (now controlled by AMX) may be forced to ask for the lower rates.

### **New licenses may be auctioned in Brazil and Mexico**

#### **4G license auction in Brazil in 2011? We don't think so.**

In Brazil, Anatel has been making extra efforts to auction as much frequency as possible ahead of Brazil's 2014 World Cup. In that sense, Anatel's officials stated at the end of 2010 that the agency has plans to bring forward to 2011 the sale of 2.5Ghz of 4G spectrum (originally scheduled to be sold only in 2012).

We think it will be very hard for Anatel to bring forward the sale of 4G licenses. Firstly, because the 2.5Ghz frequency band is currently being used to offer pay-TV services by MMDS operators. In August 2010, Anatel decided that the 2.5Ghz spectrum would be primarily used for mobile services and that MMDS operators would have to return to Anatel 140Mhz (out of the 190Mhz they own) so that this spectrum could be re-auctioned. However, Anatel has said that MMDS operators would only have to return this spectrum by June 2013.

4G technologies (including LTE) are still in their early stages (even in more developed countries). The supply of this equipment is limited and prices are high (there are only a few LTE networks in operation today; both Verizon and AT&T are developing their networks at this moment). Maybe more importantly, handsets are either too expensive or non-existent. We expect Latin American operators to only start deploying 4G after global scale drives network equipment and handset prices down.

Although more spectrum is always desirable, we don't expect Brazilian mobile companies to suffer any spectrum constraints in the short term, especially now that Vivo just bought in excess of 20Mhz of national spectrum in Anatel's latest auction. In other words, there is no reason for these companies to pressure Anatel for more spectrum. Lastly, even if 4G licenses are only auctioned in 2012, operators would still have enough time to comfortably deploy 4G networks ahead of Brazil's 2014 World Cup.

#### **In Mexico, existing players may go after 3G spectrum leftovers**

The Mexican government has announced plans to sell some leftover spectrum from last year's 3G auction and spectrum in the 3.4Ghz band still in 2011. Cofetel has plans to sell a 30Mhz block in the 1.7-2.1Ghz band and an additional 30Mhz block in 1.9-2.1Ghz spectrum band. It has also announced plans to sell up to 150Mhz of spectrum in the 3.4-3.7Ghz frequency. This spectrum is being used to provide mobile services using Wi-Max technology.

In our view, existing mobile operators should be allowed to participate in the 3G auctions (spectrum caps will probably be eased), as we do not anticipate any newcomers in the market.

### **We expect NII Holdings to be able to operate 3G in Mexico**

Mexico's Secretaria de Comunicaciones y Transport (SCT) granted Nextel Mexico a 30Mhz national spectrum last year, despite various court injunctions (mainly filed by Iusacell) to stop the process. Most injunctions centered on the fact that NII purchased a 30Mhz national license paying up-front fees of only US\$14mn, compared to almost US\$300m paid for AMX for a similar amount of spectrum. The legal battle is still ongoing, but we expect Nextel's right to use the license will prevail in Mexican courts since the auction rules were clear and approved by Cofetel and SCT. Nextel is already building out its national 3G network in Mexico.

### **Universal broadband access is a priority for the new government**

Brazil's new government, which took office at the start of 2011, has made universal access to broadband services one of its top priorities in the telecommunications area. To achieve this goal, it plans to go ahead with a national initiative started at the end of President Lula's government to take broadband connections to lower-end households across the country. The program was called the National Broadband Plan (PNBL)

### **National Broadband Broadband Plan may take off in 2011**

The National Broadband Plan involves reaching more than a thousand cities by the end of 2011 and delivering broadband access to 68% of Brazilian households by 2014 (which seems a pretty aggressive goal, in our view). The government plans to achieve this by concentrating all state-owned telecom infrastructure in the hands of Telebras, which would provide backbone capacity to private-owned telcos, who would then sell broadband services to end consumers. According to press comments, Telebras will charge R\$250 per megabyte transported by its networks, compared to a market price of around R\$800.

Telebras' current infrastructure is basically a long-distance backbone, which belongs to energy generator Eletrobras (Telebras could obtain access to other state-owned companies' telecom infrastructure, such as Petrobras' for instance). Its backhauling capacity is limited and is under development (basically via digital microwave radios). We believe partnerships with existing telecom operators are key to the Plan's success (especially mobile companies, which have a vast access network throughout Brazil). Telemar/Oi has stated several times that it is interested in participating. Based on the Plan's goals announced back in August, in order to participate telecom operators and internet providers would have to guarantee minimum broadband speeds of 512Kbps, charging up to R\$35 per month.

With the aim of increasing the adoption of broadband services, a presidential decree was issued on December 31<sup>st</sup> 2010 exempting broadband modems from paying some federal taxes (including PIS, COFINS and IPI taxes). In doing so, the government believes it could help bring the price of 3G modems down to R\$200, from R\$300 today. There are also talks to reduce VAT taxes on broadband services, but since VAT is a state tax it has to be negotiated and approved by each of Brazil's 27 states independently.

### **Ongoing Debate to Ease Foreign Investment Restrictions in Mexico**

Mexico's Congress has been debating a bill that, if approved, would eliminate foreign ownership restrictions on fixed-line companies. Today, foreigners can only own up to 49% of the voting capital of Mexican fixed-line companies. In our view, this bill is now supported by Mexican Congress and should eventually be voted and approved by the House.

Eliminating foreign ownership restrictions would be particularly good for fixed-line telecom challengers, such as Axtel and Maxcom. Telefonica has more than once publicly acknowledged its interest in buying a fixed-line operation in Mexico.

The new bill would be marginally negative for Telmex, in our view. Even though, in theory, the company could potentially benefit from the new regulation, it is not for sale. However, if any of the smaller fixed-line telecom operations are bought by Telefonica, it would become a stronger and tougher competitor of Telmex.

Revenue	11,254	10,953	13,854	15,819	16,638	17,955	19,168	20,347
Operating expenses (ex depn)	(8,231)	(8,357)	(10,301)	(10,922)	(11,400)	(12,337)	(13,168)	(13,784)
EBITDA (BTG Pactual)	3,024	2,597	3,553	4,897	5,238	5,618	6,000	6,563
Depreciation	(2,245)	(2,394)	(2,700)	(3,039)	(3,229)	(2,831)	(2,491)	(2,544)
Operating income (EBIT, BTG Pactual)	779	202	853	1,858	2,010	2,787	3,509	4,019
Other income & associates	(97)	(289)	(6)	(29)	0	0	0	0
Net Interest	(913)	(748)	(435)	(636)	(527)	(294)	(228)	(108)
Abnormal items (pre-tax)	0	0	0	0	0	0	0	0
Profit before tax	(231)	(835)	412	1,192	1,483	2,493	3,281	3,911
Tax	(363)	859	(337)	(566)	(591)	(920)	(1,131)	(1,348)
Profit after tax	(594)	24	75	626	892	1,573	2,151	2,563
Abnormal items (post-tax)	0	0	0	0	0	0	0	0
Minorities / pref dividends	0	(8)	(48)	(84)	(27)	0	0	0
Net Income (local GAAP)	(594)	16	27	542	865	1,573	2,151	2,563
Net Income (BTG Pactual)	(594)	16	27	542	865	1,573	2,151	2,563
Tax rate (%)	0	0	82	47	40	37	34	34
<b>Per Share</b>								
EPS (local GAAP)	(0.42)	0.01	0.02	1.47	2.16	3.93	5.37	6.40
EPS (BTG Pactual)	(0.42)	0.01	0.02	1.47	2.16	3.93	5.37	6.40
Net DPS	0.00	0.00	0.01	0.44	0.66	2.04	3.53	4.83
BVPS	6.02	5.81	6.60	22.43	23.10	25.51	27.34	28.91
<b>Cash Flows</b>								
Net Income	(594)	16	27	542	865	1,573	2,151	2,563
Depreciation	2,245	2,394	2,700	3,039	3,229	2,831	2,491	2,544
Net change in working capital	(756)	1,075	614	(942)	1,234	214	(97)	50
Other (operating)	0	0	0	0	0	0	0	0
Net cash from operations	895	3,494	3,389	2,724	5,355	4,618	4,545	5,157
Cash from investing activities	(2,222)	(2,121)	(1,994)	(6,675)	(2,330)	(2,500)	(3,309)	(2,645)
Cash from financing activities	690	(1,153)	22	3,303	(3,144)	(1,656)	(1,416)	(1,936)
Bal sheet chge in cash & equivalents	343	(549)	1,559	148	(1,345)	973	(180)	576
<b>Balance Sheet (R\$ m)</b>								
Cash and equivalents	1,496	947	2,506	2,654	1,308	2,281	2,102	2,678
Other current assets	5,447	4,225	5,186	6,703	4,705	5,333	5,814	6,070
Total current assets	6,944	5,172	7,692	9,357	6,014	7,614	7,915	8,748
Net tangible fixed assets	8,329	8,088	8,847	10,199	10,631	10,310	11,128	11,229
Net intangible fixed assets	0	0	0	0	0	0	0	0
Investments / other assets	4,122	4,282	4,028	4,230	4,483	4,389	4,389	4,389
Total assets	19,395	17,542	20,566	23,785	21,128	22,313	23,432	24,366
Trade payables & other ST liabilities	4,257	4,110	5,685	6,260	5,497	6,338	6,723	7,028
Short term debt	1,735	1,590	2,000	3,120	955	811	811	811
Total current liabilities	5,991	5,700	7,685	9,380	6,452	7,149	7,534	7,839
Long term debt	3,918	2,910	2,540	4,883	4,170	3,473	3,473	3,473
Other long term liabilities	892	560	647	667	1,248	1,469	1,469	1,469
Total liabilities	10,801	9,170	10,871	14,930	11,869	12,091	12,476	12,782
Equity & minority interests	8,594	8,372	9,695	8,855	9,259	10,222	10,956	11,584
Total liabilities & equities	19,395	17,542	20,566	23,785	21,128	22,313	23,432	24,366

## Company Profile:

VIVO Holdings (VIV) is the largest listed mobile company in Brazil and the second largest in Latin America, after América Móvil. It was spun off in the privatization of the Telebrás system in July 1998. In 2006, all VIVO assets (TCP, TRO, CRT, TBE, TSD) were merged and the former stocks of the group were swapped into VIV. Vivo provides mobile services nationwide using mainly GSM technology. The Company is controlled by Telefonica group.

Financial ratios	2010	2009	2008	2007	2006
EBITDA / revenue	0.3x	0.3x	0.3x	0.3x	0.3x
Net profit / EBITDA	0.0x	0.1x	0.1x	0.1x	0.1x
EBITDA / net interest	7.7x	9.9x	19.1x	26.3x	60.8x
Net debt / EBITDA	1.1x	0.7x	0.4x	0.4x	0.2x
Net debt / (net debt + equity)	0.4x	0.3x	0.2x	0.2x	0.1x

Source: Company reports and BTG Pactual estimates. Valuations: based on the last share price of that year(E) based on share price as of 18 January 2011

	12/2005	12/2006	12/2007	12/2008	12/2009	12/2010E	12/2011E	12/2012E
<b>Income Statement</b>								
Revenue	8,411	10,116	12,442	13,081	13,641	14,334	15,744	17,010
Operating expenses (ex depre)	(6,882)	(7,624)	(9,572)	(10,182)	(10,505)	(10,681)	(11,354)	(11,960)
EBITDA (BTG Pactual)	1,529	2,492	2,870	2,899	3,136	3,653	4,390	5,049
Depreciation	(1,901)	(2,285)	(2,324)	(2,409)	(2,693)	(2,660)	(2,621)	(2,558)
Operating income (EBIT, BTG Pactual)	(372)	208	546	491	444	993	1,769	2,491
Other income & associates	(38)	3	(24)	0	0	0	0	0
Net Interest	(381)	(343)	(279)	(375)	253	(258)	(126)	18
Abnormal items (pre-tax)	0	0	0	0	0	0	0	0
Profit before tax	(792)	(133)	243	116	697	735	1,643	2,509
Tax	(133)	(169)	(167)	64	(6)	(156)	(380)	(545)
Profit after tax	(925)	(302)	76	180	691	579	1,263	1,965
Abnormal items (post-tax)	0	0	0	0	0	0	0	0
Minorities / pref dividends	(21)	0	0	0	0	0	0	0
Net Income (local GAAP)	(946)	(302)	76	180	691	579	1,263	1,965
Net Income (BTG Pactual)	(946)	(302)	76	180	691	579	1,263	1,965
Tax rate (%)	0	0	69	0	1	21	23	22
<b>EPS (local GAAP)</b>	(0.41)	(0.13)	0.03	0.08	0.28	0.23	0.51	0.79
<b>EPS (BTG Pactual)</b>	(0.41)	(0.13)	0.03	0.08	0.28	0.23	0.51	0.79
Net DPS	0.00	0.05	0.19	0.09	0.07	0.08	0.22	0.48
BVPS	3.76	3.40	3.33	3.32	3.36	3.60	3.89	4.20
<b>Cash Flow (R\$m)</b>								
Net Income	(946)	(302)	76	180	691	579	1,263	1,965
Depreciation	1,901	2,285	2,324	2,409	2,693	2,660	2,621	2,558
Net change in working capital	163	(892)	(398)	(30)	(4)	(101)	60	(73)
Other (operating)	0	0	0	0	0	0	0	0
Net cash from operations	1,140	1,091	2,002	2,559	3,380	3,138	3,944	4,450
Cash from investing activities	(2,551)	(1,588)	(1,930)	(3,272)	(2,148)	(2,500)	(2,400)	(2,300)
Cash from financing activities	1,629	576	(946)	386	659	(478)	(474)	(1,114)
Bal sheet chge in cash & equivalents	854	(579)	(21)	382	1,005	(104)	994	950
<b>Assets</b>								
Cash and equivalents	1,773	1,193	1,173	1,555	2,559	2,455	3,449	4,399
Other current assets	2,692	3,250	4,088	4,280	4,207	4,318	4,584	4,956
Total current assets	4,464	4,443	5,261	5,835	6,767	6,773	8,033	9,354
Net tangible fixed assets	9,712	9,108	8,726	9,616	9,818	9,662	9,441	9,183
Net intangible fixed assets	0	0	0	0	0	0	0	0
Investments / other assets	776	649	560	788	866	985	985	985
Total assets	14,952	14,200	14,546	16,239	17,450	17,420	18,459	19,522
Trade payables & other ST liabilities	4,129	3,794	4,235	4,397	4,320	4,329	4,655	4,953
Short term debt	260	341	804	1,483	1,417	926	926	926
Total current liabilities	4,388	4,135	5,039	5,880	5,737	5,256	5,581	5,880
Long term debt	1,655	1,880	1,342	2,067	2,743	2,415	2,415	2,415
Other long term liabilities	180	299	415	503	648	840	840	840
Total liabilities	6,223	6,314	6,796	8,449	9,127	8,510	8,836	9,134
Equity & minority interests	8,730	7,886	7,750	7,790	8,323	8,910	9,623	10,388
Total liabilities & equities	14,952	14,200	14,546	16,239	17,450	17,420	18,459	19,522

**Company Profile:**

TIM Participações is the third largest mobile operator in terms of subscriber base and the second in terms of revenues in Brazil. TIM provides telecommunication services nationwide using GSM technology. TIM is a subsidiary of Telecom Italia group.

	12/2009	12/2010E	12/2011E	12/2012E
EBITDA / revenue	0.2x	0.2x	0.3x	0.3x
Net profit / EBITDA	0.0x	0.1x	0.0x	0.1x
EBITDA / net interest	7.7x	-12.4x	14.2x	34.9x
Net debt / EBITDA	0.7x	0.5x	0.2x	-0.0x
Net debt / (net debt + equity)	0.2x	0.2x	0.1x	-0.1x

Source: Company reports and BTG Pactual estimates. Valuations: based on the last share price of that year(E) based on share price as of 18 January 2011