



QUARTERLY INSIGHTS

HOLD ASSET MANAGEMENT – THE CENTRAL-EUROPEAN VALUE-BASED EQUITY SPECIALIST

DIGI Communications

A MISUNDERSTOOD OWNER-OPERATED BUSINESS IN CENTRAL EASTERN EUROPE

Q4 - 2021

We love owner operated businesses, where we - as a minority investor - can partner with someone to run the business whose wealth depends on the value creation of the company. We cannot think of a better incentive setup than this. Unfortunately, other investors also hold similar views. As a result, it is often difficult to come across such companies with compelling valuations and valuation is the primary driver for our investments. Should we find an attractively valued owner operated business, we are very interested. DIGI is such a company. This paper will elaborate on why we think so.

DIGI is a Romanian telecommunications company. It is the clear market leader in Romanian fixed business with a very modern, fully fiber network, which covers 85-90% of Romanian households. It is the third/fourth largest mobile player in the country. Up until its very recent transaction, which we will detail below, DIGI was the second largest Hungarian fixed telco provider and was entering the Hungarian mobile market with its own greenfield network. The company is also a low-cost challenger in Spain with a successful MVNO (utilizing Telefonica's network) and recently started to build a fiber network there as well. Finally, they bought mobile frequencies in the recent Portugal mobile auction to enter that market as well.

CEE focused sell side analysts – while acknowledging that it is one of the cheapest telco operator on multiples regionally (see table below) – did not find the shares particularly undervalued recently. We think they miss the point and it should have become very clear after its recent exit from Hungary.



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EV/EBITDA '22 (ESTIMATE)

Cyfrowy Polsat	6.5
Orange Polska	5.4
O2 Czech	6.3
Magyar Telekom	4.0
Hrvatski Telekom	4.0
OTE	6.2
Average	5.4
DIGI (pre HU exit)	4.3

SOURCE: BLOOMBERG, HOLD ASSET MANAGEMENT

HUNGARIAN MARKET EXIT – MOMENT OF TRUTH?

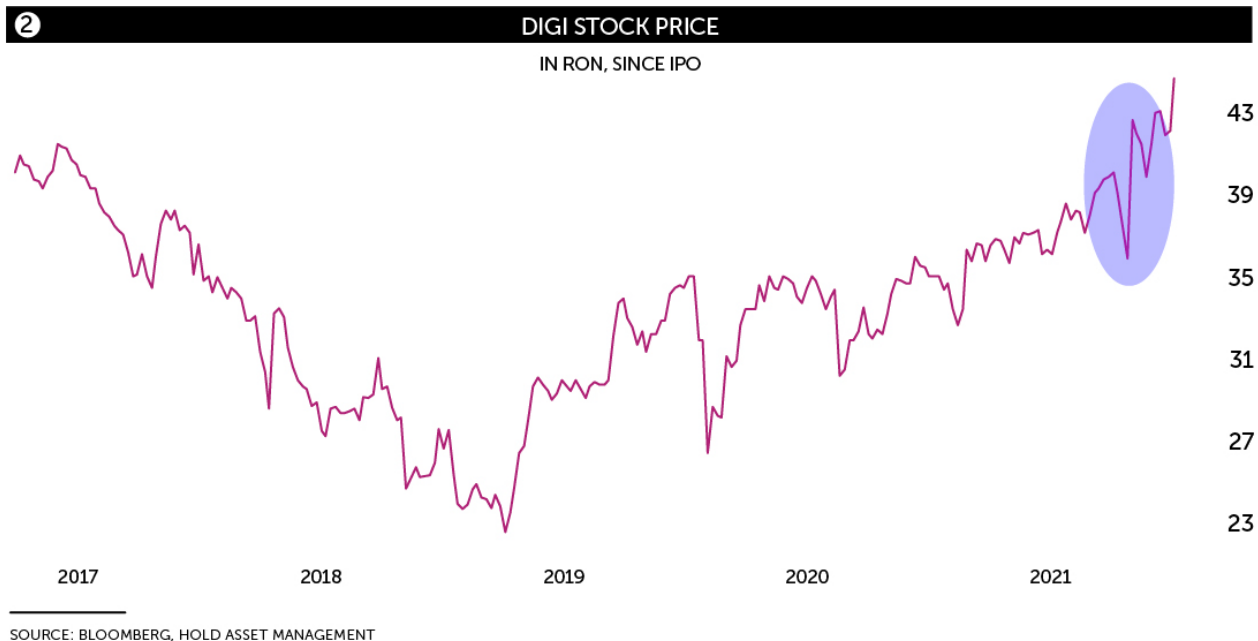
Last March DIGI has announced it has reached a preliminary agreement to sell its Hungarian operation to 4iG. We became immediately very excited upon reading the news because we were certain that it will reveal the real value of its Hungarian assets which the market failed to realize. The market did not see the full value for two reasons: one is that the mobile operation was at start-up phase and was hiding the true profitability of the fixed business. Secondly, the fixed business was also a modern fiber network as the one in Romania, where the market failed to appreciate its value, comparing it to other CEE telco multiples whose network was inferior. We were also expecting that DIGI - being an owner operated business without selling pressure - will not sell its Hungarian assets below its fair value.

After the news of the preliminary agreement came out without disclosing the price, four CEE telco sell side analysts have written about their price expectations. Estimates ranged between EUR 215-350MM. We thought they were quite wrong. They based their calculation on low CEE telco multiples and on an EBITDA depressed by start-up costs. On 30th of November, the final agreement has been published. The price for the Hungarian operation **was EUR 625MM**. More than double what analysts on average have been expecting. Should have been a very big surprise for them. Above all, it has important implications.

- The miss on the value of the Hungarian operation means that they undervalued DIGI on average by EUR 347MM. Which is huge, taking into consideration that the company had a market capitalization of EUR 684MM before the news! Analysts will need to adjust their DIGI valuation on average by 45% just on this news alone! Some of them already started. However DIGI shares jumped on this great outcome by only around 20% so far.
- Majority of DIGI's value comes from its Romanian fiber network. The same type of network that analysts have misvalued by half in Hungary. Needless to say analysts need to reconsider the inputs in their models for the Romanian network.



- It also reveals an important aspect of the owner. It is evident that he is keen on value creation, not on building a business empire. He was perfectly happy to sell when the price was right. The market is discounting DIGI for its strategy that it reinvests 100% of its cash generation into the business growth, instead of paying high dividends, which is not the norm in the telco sector. Now markets should give more benefit of doubt to the management that it is doing it for value creation.



So what was the mistake the analysts have made when misvaluing DIGI's Hungarian business? Mostly, they failed to realize that a modern fiber network is worth a much higher multiple than the one of an average CEE telco peer, which is a blend of an inferior fixed network and a mobile business. Copper based networks need significant CAPEX spending in subsequent years to upgrade them to fiber to be able to tackle current internet speed expectations of the clients. So they are worth much less. Although CEE peers have also modernized part of their fixed networks, these were partial upgrades.

Furthermore, a mobile business also deserves a lower multiple. While with a fiber fixed network, the lines have unlimited capacity and extremely long (100 years) useful lives, the same cannot be said for the mobile ones. One needs to renew the mobile network every fifteen years to be up to date to the current generation (now 5G) with high CAPEX and also need to renew mobile frequencies in every 15-20 years, which is very costly. EBITDA of a fiber network is worth much more than an EBITDA of a mobile network because a much higher portion of the EBITDA will remain as an actual cash flow in the long term. According to Wood Securities, Western European fiber infrastructure transactions were valued at an average of 16.7x EV/EBITDA in the last ten years. Simply put, CEE telcos are not appropriate peers for DIGI's valuation.



WHAT WAS THE MULTIPLE ON DIGI'S HUNGARIAN EXIT?

We do not have a definite answer to that but can provide an educated guess. DIGI Hungary had basically three parts. (1) Their core fiber network, which is the most valuable part. (2) Invitel, a fixed network but in need of modernization, which they acquired few years ago for EUR 135MM and not upgraded yet, and (3) the mobile network they built for an estimated EUR 150MM but has insufficient frequencies for a quality service. We guess the mobile part – due to the frequency problem - should have been priced at a discount to investment cost, maybe at around EUR 100MM. In this case, the core fiber network was priced at around EUR 350-400MM, **resulting in 7-8x** of the 50MM EBITDA (pre IFRS 16) it generated before the mobile startup costs started to appear. This multiple was not a big surprise for us. We were valuing DIGI's fiber networks (both Hungarian and Romanian) at 7 x EBITDA based on our CF valuation, which takes into account the lower CAPEX need.

LET'S GO BACK TO ROMANIA

As we mentioned the majority of DIGI's EBITDA of EUR 357MM in the last four quarters comes from Romania. Mobile and fixed network numbers are not reported separately, but we know that an overwhelming majority of this comes from the fiber network as the mobile part of the business was started later, it is less mature and just started to be EBITDA positive around three years ago. Our estimate is around EUR 300MM for the fiber EBITDA. If we would use the Hungarian exit multiple on this part of the business (after deducting an annual EUR 60MM content CAPEX for comparability), **Romanian fiber network could worth around EUR 1,700MM versus the EUR 1,500MM current EV of the whole company after the Hungarian exit.** Market seems to undervalue the Romanian cable operation to the extent of EUR 200MM and assigns the remaining businesses – namely the Romanian mobile segment with at least EUR 300MM investments so far in our estimate and the Spanish operations with around EUR 50-60MM annual EBITDA – with no value.

FURTHER GROWTH OPPORTUNITIES IN ROMANIA

We often hear from some market participants that a lack of further growth opportunities for DIGI in Romania could be a reason for lower valuation. We also disagree on this for two reasons: mobile opportunities and repricing.

DIGI is quickly rolling out its fiber network in Romania, adding around 500K lines and 300K clients annually. Must admit, it is likely that this will slow down or stop altogether in a few years' time due to high penetration, but on the mobile side DIGI has much room to improve. It is only the third/fourth largest market player with around 15% of market share, while it has 60% market share in the fixed business. It has plenty of opportunity to bundle and cross-sell, which is the trend globally. Furthermore, the fourth largest player, Telekom Romania owned by the Greek OTE is a



struggling operator and has been up for sale for several years now. It separated and sold the fixed part of the business recently to Orange. It is hard to see who would buy its mobile business in Romania, which has one of the lowest pricing in Europe and strong competitors. DIGI can continue to acquire their clients with bundled cheap offerings. Lastly, 5G will benefit convergent players. It will need a dense antenna network, where it is an advantage, if you have a dense fiber network nearby, where the operator can offload traffic. DIGI is clearly a leader in this sense in Romania. We think in the long term DIGI should grow to challenge the market leaders in mobile, which would mean doubling its mobile market share. It would not only mean mobile revenue growth, but also margin improvement due to better scale.

Additionally DIGI has a very important growth driver in Romania: **repricing**. DIGI generates an ARPU (average revenue per user) of around EUR 5 in fixed fiber internet and a similar ARPU in their mobile operation with most clients have unlimited usage in their tariff. These are very low prices by European standards. It is the right strategy for the company until it builds out its nationwide network and strengthens its market share. But at some point, it would make sense to increase prices, converging to CEE prices, which are on average around double of this EUR 5 level, both on the mobile and the fixed broadband side. The price increase would be very beneficial for the EBITDA generation as costs are mostly fixed. A 10% repricing would lead to 20-25% EBITDA growth. DIGI is the lowest cost operator in Romania with low offerings, resulting in being a price setter. Clearly customers are price takers as communication is an integral part of our lives and telco spending is not a meaningful part of incomes, which have doubled in EUR terms in the last ten years. Repricing is not among the short term plans of DIGI. However, we give price increases a higher likelihood in the midterm, especially in a case inflation becoming a sustained problem.

THOUGHTS ON VALUE CREATION

An owner-operated business deserves a higher valuation only if it delivers higher returns (ROIC). Unfortunately DIGI is not a clear cut case, contributing to a general neglect of investors. On the headline level, its ROIC was on average around 9% in the last 3 years, similar to its WACC. However there are reasons to think why this is not the full picture.

- DIGI grows fast, which contributes to below midterm ROIC. It leads to underutilized assets (new lines), elevated marketing expenses (currently in Spain) and high customer acquisition costs. If DIGI would slow down, it would improve its ROIC.
- DIGI depreciate its investments too fast. A clear sign of this is that in the 2020 annual report, it has restated its fixed assets by EUR 325MM. This revaluation almost equals to the last 3 years' NOPLAT! Remember the long term nature of its fiber network.
- Finally, there is ample room for repricing in the midterm as stated above. The 10% price increase we mentioned would lead to around 1,5x higher ROIC!



All in all, we think that DIGI is creating value through its growth, it is just not so visible in the reported numbers for the above reasons. Owner-operated companies are rare in the telco sector hence more valuable as long term capital allocation decisions are the most important aspect of value creation in this sector.

THE "OWNER DISCOUNT"

Analysts are routinely assigning discount to their DIGI valuation for its owner (Mr. Zoltán Tészári). The reason is that he is extremely reserved, not appearing publicly and has super voting (10x votes) shares. The first is really an uncommon aspect of DIGI. HOLD has been an investor in the company since its IPO in 2017 and has never spoken to him. Must add that if a management is of any indication of its owner then what we can add here is that DIGI has a very down to earth management, working hard but communicates cautiously. Nothing promotional. We like their approach.

As per the super voting shares, it is something that theoretically really deserves a discount but not so much in DIGI's case. The reason is that Mr. Tészári has around a 52% economic stake in the company, even without taking into account the extra votes he still has a controlling stake. It is not the case that he controls the company with a small economic stake. To the contrary, he has a huge incentive to create value for DIGI. We think that DIGI shares are the large majority of his fortune. In our view, the Hungarian exit has showed his focus on value creation. He built this company from the ground up and outcompeted the incumbent telco operator during the past twenty years with constant reinvestments.

SPAIN AND PORTUGAL

Touching upon the remaining part of the business, this is admittedly the harder part to value. DIGI entered the Spanish mobile market as a virtual operator, eyeing the large, two million strong Romanian diaspora in Spain. It clearly outgrew initial plans. With little investments, they created a business which now has close to 3 million customers, still growing very fast and generates around EUR 50MM EBITDA. As they do not have a network in Spain, CAPEX need is very low so this EBITDA is close to CF. Seeing the success of their cheap offering and supporting regulation, DIGI has also stepped into the fixed line business, partly renting available fiber infrastructure, partly building out their own network. It is a new chapter in their strategy book, a much more investment heavy one, which they plan to continue for many years.

DIGI is of the view that there is significant room for a lean telco operator targeting the cost sensitive clients in some Western European countries. The company's entry in the Portugal market is a further step on this road. Admittedly, it is a riskier strategy in our view. We know plenty of good CEE businesses which failed to recreate their successes in Western Europe. So far, they have invested around 15% of its EV in Portugal but will continue to grow this amount. We think that being an owner-operated business, DIGI will be cautious to risk too much.



CONCLUSION

In our view, the market and analysts clearly underestimate DIGI's value. Valuing the Romanian fiber network at 7xEBITDA, giving reasonable value to the Romanian mobile business and to the Spanish operation can lead to **around 60% upside** from the current market price (without a management discount – which we think it does not deserve). And let's not forget the company has the **very valuable repricing option...**

Disclosure: funds and accounts managed by HOLD Asset Management have significant position in DIGI Communications shares.