

# **CASO PRÁCTICO**

# **TELÉFONICA INTERNACIONAL, S.A.**

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## **1. ONE COMPANY'S EXPERIENCE OF INTERNATIONALIZATION.**

It was 4.30 on a cold February afternoon in 1994. The Extraordinary Board meeting convened by TELEFÓNICA INTERNACIONAL, S.A. (TISA) at its Madrid head office was about to begin. TISA's top management and partners were assembled there, and it was evident that Ignacio Santillana, the Chief Executive Officer, was going to play a decisive role.

The main objective of the meeting was to determine the Company's future expansion strategy: to become the main telecommunications operator in Latin America.

The future privatization of the two main Peruvian telephony operators had aroused great interest among the large international companies in the telecommunications sector.

TISA was preparing a bid which would have to compete with the likes of such large operators as American ATT, British CABLE & WIRELESS or French FRANCE TELECOM.

Laid out on the meeting room table were the final reports containing the calculations and analyses done during the bidding process, the result of several months' intensive work.

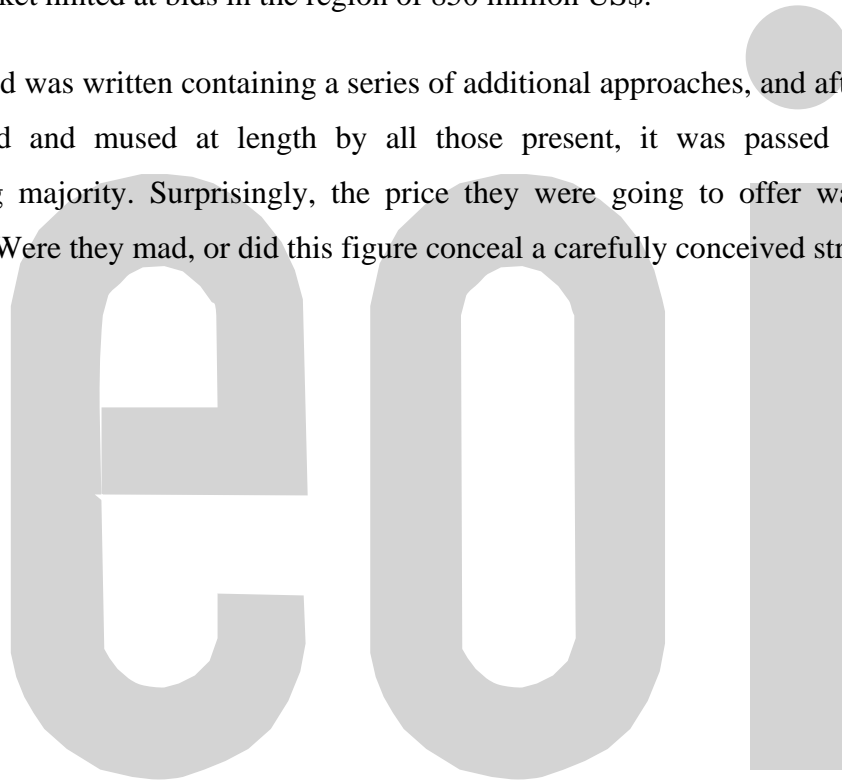
Beneath all these figures was one underlying one, the most important, and it was being discussed: the price that the consortium headed by TISA was going to offer to the Peruvian Government.

At first it was thought that the best alternative was to submit a bid where the price matched the economic appraisal of the Peruvian companies in question. This valuation, by the management team, followed the line of economic and financial strategy pursued up to then in earlier privatization in Chile or Argentina.

Furthermore, this bid was in line with the valuations that the consultant hired by the Peruvian government had estimated as feasible; placing the companies analyzed in a 700 to 900-million US\$ bracket.

Suddenly, the meeting was interrupted by an international call for Mr. Santillana, a long-distance call from New York, informing him of the price that the American operators would probably offer. The American expert consultants and the rumors going round the market hinted at bids in the region of 850 million US\$.

Thus a new bid was written containing a series of additional approaches, and after it had been analyzed and mused at length by all those present, it was passed with an overwhelming majority. Surprisingly, the price they were going to offer was 2,002 million US\$. Were they mad, or did this figure conceal a carefully conceived strategy?



## 2. THE INTERNATIONALIZATION OF TELEFÓNICA.

### 2.1. Background.

TELEFÓNICA DE ESPAÑA, the parent company, is not only a telecommunications service firm with over sixty years' experience (founded in 1924), and a world leader in data transmission public network technologies, but it also has a large group of firms specializing in information technologies and other broad fields, such as R&D, manufacturing, engineering, installations, computing, marketing and maintenance.

This group of firms aims to meet the main Firm's demand and has witnessed a series of developments and changes in the course of its existence. It has acquired a high degree of experience and some of its firms have become important internationally.

The group was formed in 1985 and in 1986 it was rationalized by maximizing profits and optimizing resources.

By way of reference, the following are some examples: AMPER in the manufacturing group, ENTEL in the computing group, CETESA and TELFISA in the marketing or financial group, SINTEL and TELEFÓNICA SISTEMAS in the engineering and installations group and, finally, TISA set up to promote TELEFÓNICA's activity in world markets.

SINTEL is one of the companies, which was created with a definite international vocation. Its activity focused on the installation of equipment and laying of lines and cables for telecommunications. TISA was conceived to export telecommunications and telephony equipment and services.

During the early years of these two companies (1985-1988) and as the share capital, net worth and result magnitudes illustrate (Table 1) SINTEL had a more prominent role in the telecommunications business scenario, while TISA had a modest role in TELEFÓNICA, as a trader of telephony and telecommunications equipme.

**TABLE 1: TISA AND SINTEL'S MAIN MAGNITUDE TRENDS (\*)**

	TELEFÓNICA DE ESPAÑA'S DIRECT INVESTMENT		SHARE CAPITAL		TELEFÓNICA'S BOOK VALUE		ASSIGNABLE NET (**) WORTH O/BALANCE		ASSIGNABLE ACCOUNTING RESULT	
	TISA	SINTEL	TISA	SINTEL	TISA	SINTEL	TISA	SINTEL	TISA	SINTEL
1986	100%	100%	200	1,100	200	2,992	204	2,620	4	42
1987	100%	100%	200	1,100	204	2,935	218	3,142	19	543
1988	100%	100%	200	1,100	204	2,935	225	4,056	4	915
1989	100%	100%	2,946	1,100	890	2,935	916	5,548	4	1,496
1990	100%	100%	11,196	1,100	11,200	2,935	10,352	6,529	-873	1,504
1991	76%	100%	79,900	1,100	34,212	2,935	40,487	7,461	5,683	1,466
1992	76%	100%	79,900	1,100	50,227	2,935	79,061	7,426	7,175	344
1993	76%	100%	79,900	1,100	60,904	2,935	119,521	5,181	16,469	-2,272
1994	76%	100%	119,009	1,100	90,713	2,935	171,123	3,621	19,375	-1,269

(\*) From the point of view of direct investment in the parent company. In millions of pesetas.

(\*\*) On-balance capital, reserves and assignable results

Source: Telefónica de España

**TABLE 1: TELEFÓNICA INTERNACIONAL'S FIGURES**

	1990	1991	1992	1993	1994
Total Assets (mill. Pts.)	68,098	116,901	168,826	232,197	1,005,190
Latent goodwill (mill. Pts.) (!)	-4,704	71,591	134,666	590,635	102,301
Latent goodwill (% o/ acquisition cost)	-	90	122	427	29
Lines installed	2,933,799	3,148,000	6,185,580	7,173,868	8,574,278
Lines in service	2,511,819	2,779,000	5,051,013	5,813,377	7,370,491
Cellular telephony subscribers	9,353	18,979	59,534	160,384	314,312

(1) Total difference between market value and acquisition cost of the listed firms where TISA has a stake.

Source: Expansión 09/05/96

At that time, the policy developed by TELEFÓNICA, at the hands of the chairman then, Luis Solana, had been based on what is known as Holding Industrial Circulante<sup>1</sup> setting up new firms, both in Spain and abroad, in collaboration with leading industrial companies, and then after an adequate level of development had been reached because

<sup>1</sup> Circulating Industrial Holding

*Holding Industrial Circulante* is a dynamic and flexible concept referring to financial investment in firms. This general philosophy aims to achieve the following objectives:

- To group firms with closely related activities at the same decision level in order to optimise the joint exploitation of resources, technologies, markets and distribution channels.
- To face a sales plan of firms in order to release financial resources and thereby, tackle new business areas.
- To design a strategic plan for new activities in order to participate in new projects strengthening TELEFÓNICA's competitive position and leadership in technology.



of TELEFÓNICA'S capacity to attract demand, the shares were sold. The aim was to collaborate using a Spanish policy of creating firms and promoting technology and research, and yet still have a stake in the parent companies of the large European groups in the sector.

At that time, for example, the agreement was signed for the setting up of TELUR, the first mixed Spanish-Soviet firm (TELEFÓNICA and AMPER represented 49%), and the first joint venture in the telecommunications sector in the USSR for the manufacture of telephones, and which was unsuccessful.

However, in 1990 a series of events took place which affected both the operator and the national and international environment and which caused the parent Company to take a firm and prompt decision to internationalize its business via its subsidiary TISA.

These events are described below.

## **2.2. Reasons for Internationalization.**

### **2.2.1. Liberalization of Telecommunications.**

The liberalization of telecommunications in Spain began at the end of 1987 with the passage of the Ley de Ordenación de las Telecomunicaciones (Telecommunications Regulation Act), amended in December 1992. This Act together with the Plan Nacional de Telecomunicaciones (National Telecommunications Plan) 1991-2002 and the Contract between TELEFÓNICA and the Spanish Government, renewed at the end of 1991, established a new and more competitive environment.

As well as liberalizing terminals and value-added services, the Act also liberalized certain mobile services, such as closed group radio messaging and radiotelephony. The services for renting circuits and data transmission were liberalized from 1993 and the same thing would happen with cellular telephony in 1994.

All this liberalizing process is in accordance with the standards set forth in the European Community Directives. Thus, TELEFÓNICA, which has always been the sole operator of basic voice services, will have to compete with other operators from 1998 in its own market.

### 2.2.2. Internationalization of Government Policy.

In the late 1980s and early 1990s, with high rates of interest and a steep appreciation of the peseta, the exports were notably affected while Spanish investments abroad increased considerably.

The Government, in order to make Spanish firms more competitive, influenced among other things, by Spain's recent entry into the EEC, gave firm support to those firms wanting to venture abroad either by exporting their products or internationalizing their investments.

Nevertheless, there was strong opposition from the Government to the internationalization of TELEFÓNICA because it thought that the service that the company was offering nationally was inadequate. Thus, although there was interest in Government circles, there was no general agreement on this matter.

### 2.2.3. TELEFONICA's flotation.

The financial internationalization of TELEFÓNICA took place before its direct investment in foreign firms. Proof of this were the large volumes of currency debt it contracted, and the listing of its shares on the main foreign stock exchanges.

The Spanish capital market could not meet the immense financial requirements of the company in a sector, such as telecommunications, which is capital intensive, and was at a stage of great investment in relation to the funds generated. A limited domestic

market, pay-back periods which were too short for the average lives of the assets to be financed and the high brokerage charges in relation to other markets, caused TELEFÓNICA's directors to venture abroad for financial resources.

Spain's entry into the European Community improved the country's risk rating. TELEFÓNICA's listing on the London, Paris, Frankfurt and Tokyo stock exchanges in 1985, and especially on the New York stock exchange in 1987 boosted the Company's drive to attract funds. It also gained access to a wide and varied supply of instruments for which there was no market or investment base in Spain.

It thus increased its equity base and the Company's visibility and image, leading to better valuation of the firm's assets.

#### 2.2.4. Internal changes in the Company.

When Cándido Velázquez became chairman of TELEFÓNICA (1988), he decided to change the focus of foreign investment policy, because he was concerned about the apparent incoherent nature of this policy up to then. For this new period he appointed Ignacio Santillana, from the parent Company's Finance Management, Chief Executive Officer of TISA, to change the image and base of TISA's operations. The idea was to replace the industrial projection of the previous stage with an investment policy in foreign operators, based on strict profitability criteria, management quality and exploitation of operational synergies.

The strategic policy of the new chairman was based on three points:

- Modernizing and extending the national network.
- Improved quality and attention to traditional and new service demand.
- International expansion policy focusing primarily on Latin America and Europe.

### 2.2.5. Situation of the Spanish telephony market and future prospects.

The diversification approach that TELEFÓNICA began to implement occurred just at that moment when problems with service quality and waiting lists in Spain were increasing and becoming worse every day because of the demand boom and the deterioration of out-of-date equipment. It is because of this that TELEFÓNICA's expansion to other countries began to be increasingly criticized. However, the Spanish market's boom in demand for telephone services at that time would surely come to a halt one day, and in fact it was already beginning to wane. The 630 thousand million-peseta<sup>2</sup> investment by the company in 1990 would begin to decline in the following years.

The fall in demand for lines throughout 1990 reduced the waiting lists above the forecasts and also caused TELEFÓNICA to cancel some of the purchasing contracts for equipment from suppliers in the sector.

The Company directors also knew that, at a given moment, they would begin to lose their share in the Spanish market as a result of liberalisation in the telecommunications world.

TELEFÓNICA responded to the scene described above by positioning itself in strategic places outside Spanish territory. This would give the Company a much stronger position in negotiations with suppliers of equipment and at the same time, it would open up new export horizons for the Spanish telecommunications industry, controlled largely by TELEFÓNICA (Table 2).

<sup>2</sup> Official Exchange Rates pesetas per US\$, 1990-1997:

	1990	1991	1992	1993	1994	1995	1996	1997
<b>31/12</b>	95.80	96.80	115.10	143.20	131.58	121.67	129.57	152.31
<b>Average</b>	101.96	103.95	102.57	127.69	133.92	124.66	126.57	146.41

**TABLE 2: THE TOP TEN EXPORT COMPANIES TO TELEFÓNICA INTERNACIONAL**

FIRM	AMOUNT(*)	FIRM	AMOUNT(*)
Ericsson	135	ATT	39
Alcatel Standard	122	Abengoa	35
Sintel	113	Cables de Comunicación	27
Amper	46	ITT	26
Radiotrónica	43	Otros	252
Dragados y Construcciones	42	<b>Total</b>	<b>880</b>

(\*) Millions of US\$

Source: Expansión 10/02/96

**TABLE 2: PURCHASE FROM SPANISH FIRMS (millions of US\$)**

COMPANY	1992	1993	1994	TOTAL
TASA (Argentina)	300	505.6	520	<b>1,325.6</b>
CTC (Chile)	34.8	55.1	44	<b>133.9</b>
CANTV (Venezuela)	20	20	25	<b>6.5</b>
Telefónica Rumanía	-	0.4	36	<b>36.4</b>
<b>TOTAL</b>	<b>354.8</b>	<b>581.1</b>	<b>625</b>	<b>1,560.9</b>

Source: Telefónica de España

### **3. TELEFÓNICA INTERNACIONAL S.A.**

It was then when it began to give TISA a more prominent role.

This company, which was created as a small subsidiary, 100% controlled by TELEFÓNICA, has become the center for foreign investment operations. Its main activity, from 1990, has been the appraisal of investment operations in the telecommunications sector, analyzing investments and capital shares and looking for the most appropriate financing channels. This policy was aimed at investments in foreign operators and not at investments in plant and equipment. This was a marked change from the company's former international strategy.

In 1991, in order to promote its expansion abroad, share capital was increased to 79,900 million pesetas. Patrimonio del Estado became one of its shareholders and the parent company's direct investment was reduced to 76%.

#### **3.1. TISA's organization and structure.**

The number of people in the organization is not very many (approximately 50 people in 1989 and 80 in 1995), bearing in mind the large volume of business that it manages, mainly in Latin America. The key to not many staff lies in the company's foreign strategy: to sell TELEFÓNICA's telecommunications management experience and know-how skills. Management support consists of helping and backing the country's operators who, with their own staff, do the necessary work to offer telecommunications service in the conditions of service and quality determined and controlled by TISA.

TELEFÓNICA also has large teams of highly qualified managers and technicians, capable of travelling immediately to the country and taking control of the operators as soon as the contracts are signed. These groups undertake all the activities that the operators develop, guiding them towards more effective and productive management, providing the most appropriate solutions to each of the areas, in order to put the

company back on its feet in the time and with the quality demanded by TISA. All these changes have a profound impact on the culture of the firm that TISA is going to manage.

The structure is organized in teams covering three main areas of work: the telecommunications area devoted to network and equipment planning, the investment appraisal area formed by financial analysts, and the legal area consisting of international law experts.

One of the keys to TISA's success is that it was conceived as a firm separate from the Parent company. It could be regarded as a special and successful case in the sector, since no other European operator has acted like this (the only parallel might be the British company CABLE & WIRELESS).

The first years were difficult, due to the centralist culture of the parent company, where it was unusual for a subsidiary's director to co-ordinate and organise the parent company's directors. In this respect, Cándido Velázquez, when he became TELEFÓNICA's chairman and within his decentralizing policy, gave TISA his total support, granting it a great deal of autonomy in its management and also giving it the chance of using the necessary staff in the parent company for its management.

Thus TISA has had a lot of freedom in decision-making processes for its international expansion, and it has shown agility and flexibility in the different liberalization and/or privatization processes, and a greater capacity for negotiation and management.

## **3.2. Foreign investment policy.**

### **3.2.1. Investment criteria.**

The criteria on which its strategic policy is based could be summarized as follows:

- Consideration of the competitive advantages that TELEFÓNICA can provide for improving the management of the operator that it has bought.

TELEFÓNICA has proven experience in the management of large investment programs for extending and modernizing telecommunications networks (e.g. in Spain more than a million lines a year were installed in 6 years). It also has a large competitive advantage because it adapts its know-how to the telecommunication requirements of the countries wherever it goes.

Furthermore, it can also use the operational synergies of the different Companies in the group. The particularly relevant ones are those related to international traffic, common network management systems and a greater capacity to negotiate with suppliers.

- The management of foreign companies cannot imply any economic sacrifice for TELEFÓNICA.

Thus the return on any investment must be more than resource cost and cover risk expectations. For every possible operation a very detailed valuation is carried out.

- Participation in privatization of basic telephony and, as a result of this, it can take advantage of its privileged position participating in the international market of advanced services, targeted mainly at cellular telephony, advanced mobile services, and international voice and data transmission networks.
- Acquisition of shares in foreign operators and the strengthening of TELEFONICA's position for establishing global strategic alliances in order to achieve notable participation in the development and exploitation of large capacity international telecommunication networks.



### 3.2.2. Partner Selection.

Ignacio Santillana from the beginning strove to admit new partners into TISA, for example financial institutions, to make the internationalization process of the company sound.

Back in 1990, the banks and saving banks on TELEFÓNICA's Board of Directors (CENTRAL, BBV, BANESTO, HISPANO AMERICANO, SANTANDER, CAJA POSTAL, CAJA DE MADRID and LA CAIXA) had been given the opportunity of acquiring a stake in the firm, but there had not been much response. At that time, they thought there were not many guarantees for profitability and the country risk was very high.

Consequently, the alternative it chose was to look for financial aid from foreign banks and firms to go to the privatization, and to form part of larger consortiums.

In this respect, TELEFÓNICA's strategy has been to have the majority holding in the consortiums participating in the privatization or at least be sure of the management.

Generally, in the liberalization in Latin American countries a block of minority shares is privatized. The majority shares belong to the State and the workers. However, even in these circumstances TELEFÓNICA is still in control because the companies are very undercapitalized. Since the purchasing group promises to inject large amounts of money in the local operator in the form of capital and investment, the operator's share prices increase dramatically.

In its search for local partners, TISA develops a very detailed selection process. First of all, it looks for powerful business groups in the country, with recognized prestige and public recognition, who are economically sound and have not been involved in any kind of corruption scandal. Secondly, it looks for large local financial groups, such as pension funds.

All these will provide advice about the functioning of the country’s political and financial environment and will help implement the most effective strategy, which the directors and workers of the company being invested in, can readily understand and accept.

### 3.2.3. Market selection.

The main objective is countries with high growth potential, which have a low GDP but signs of rapid improvement, with a large dormant consumer market and low-penetration indices in the different telecommunications services.

In this respect, since the late 1980s Latin American countries have undergone a series of profound reforms, which have led to considerable improvement in their economic indices (Table 3).

**TABLE 3: BUSINESS POTENTIAL IN LATIN AMERICA**

GDP GROWTH (%)	1990-93	1994-96 FORECAST
Argentina	6.0%	4.5%
Colombia	3.3%	4.9%
Chile	6.5%	5.0%
Mexico	3.6%	4.0%
Peru	2.3% (6.5% in 1993)	4.4%
Southeast Asia	6.3%	7.3%
Japan	2.7%	1.9%
USA	1.2%	3.3%
European Union (average)	1.5%	2.2%

INFLATION (%)	1990	1991	1992	1993	94-96 FORECAST
Argentina	1,343.0%	84.0%	17.5%	7.4%	6.0%
Chile	27.3%	18.7%	12.7%	12.2%	10.0%
Colombia	32.4%	26.8%	25.1%	22.6%	18.0%
Mexico	29.9%	18.8%	11.9%	8.0%	7.0%
Peru	7,650.0%	139.2%	56.7%	39.5%	20.8%
Venezuela	36.5%	31.0%	31.9%	45.9%	38.8%

Source: Bank of America. March 1994

It is expected that the GDP growth trend will continue to be 4.5% compared with 3% in the USA, or 2% in Japan or the European Community.

Moreover, we must not forget the risks involved in investing in countries with these characteristics:

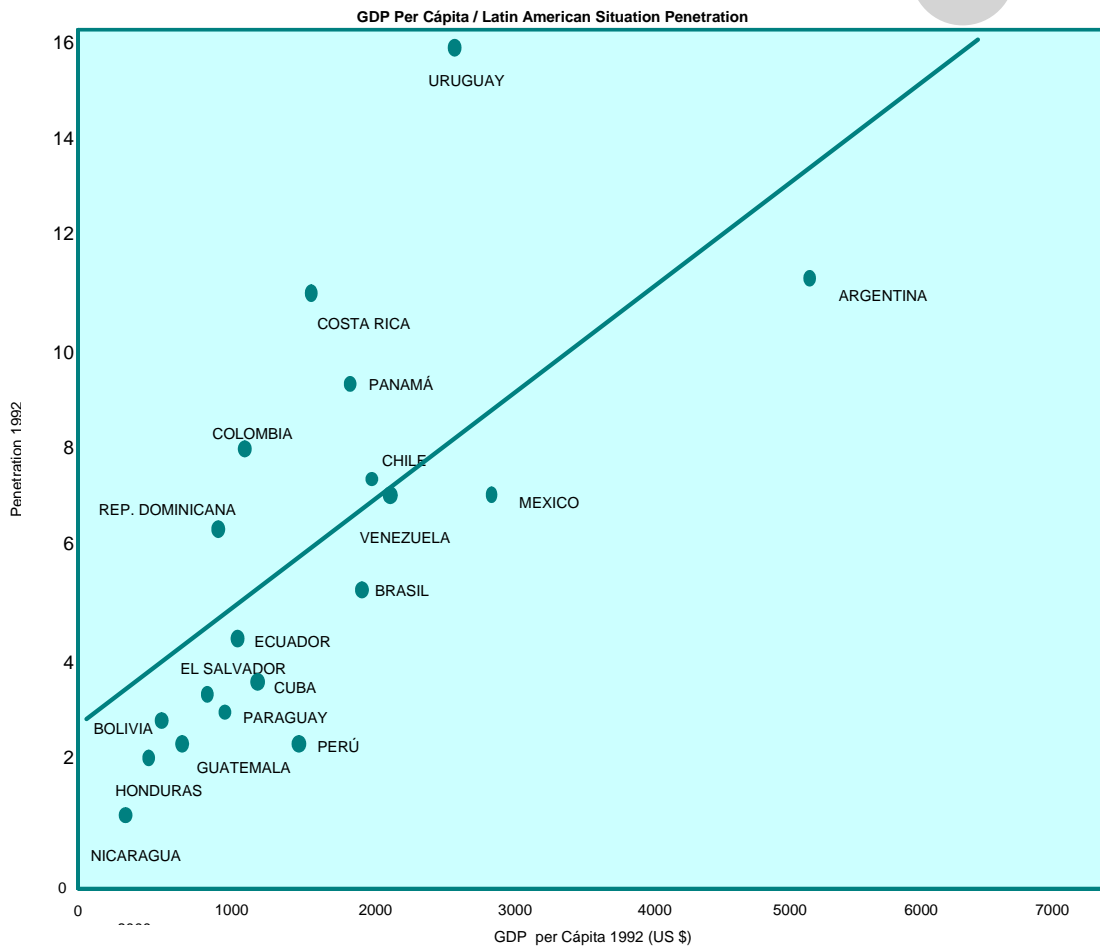
- Political risks: paralysis of the liberalisation processes or danger of expropriation.
- Economic risks: devaluation or periods of hyperinflation.
- Stable legal framework: necessary to protect foreign investment, as well as repatriation policies, dividends, etc.

It should be stressed that telecommunications are directly linked to a country's growth and development. Countries with higher income per capita are those with higher telephone service penetration indices (between 40 and 60 telephones for every 100 inhabitants) giving an idea of some market saturation (compared, for example, with 7.4 telephones for every 100 inhabitants in Chile in 1989).

One of the most commonly used methods in the telecommunications sector for estimating a country's potential telephone demand is linear regression between a

country's income, measured as GDP per capita and telephone density, measured by the number of lines for every 100 inhabitants. According to a sample of 100 countries in the five continents, most Latin American countries are below this line of regression, which means that their level of telephone density is lower than it should be for the level of income per inhabitant (Table 4).

**TABLE 4: LATIN AMERICA'S TELECOMMUNICATIONS POTENTIAL**



This situation is the consequence of insufficient investment in adequate infrastructures and maintenance, because of serious problems with financing the large deficits in these

countries, together with management capacity problems to meet development in the telecommunications sector.

All these deficiencies explain why privatization programs and structural reforms have appeared, creating business opportunities for foreign operators.

In the future, TELEFÓNICA is thinking of going to North African countries, such as Morocco or Tunisia, which are attractive markets. However, they are impenetrable for the moment.

#### 3.2.4. Privatization process and TISA's course of action.

The starting point of any privatization process takes place way ahead of the official announcement by the country privatizing.

Usually the companies put up for sale are those which have been a monopoly for a long time. The first steps towards their privatization involve the passage by the respective governments of those legislative measures and constitutional changes necessary for liberalizing and deregulating the sector. The essential bases are thereby established for creating an environment of free competition and sufficient confidence to attract foreign investors.

For this TISA works with several interlocutors in each country, who are usually, first of all, lawyers' offices or business practices offering legal services. These interlocutors are in permanent contact with the official institutions responsible for the privatization processes and they constantly update any information, which may be useful for the company interested in buying.

Secondly, TISA works with merchant banks. These are financial institutions providing information about the companies to be sold and their general characteristics.

Additionally, TISA does a laborious technical, economic and legal study of the new emerging opportunities in Latin America, via its new businesses department and with work teams generally headed by a telecommunications expert.

At the next stage of the process, the government of the country privatizing writes a draft of the liberalization procedure which is to take place and which includes, among other things, the prerequisites for admittance to the purchase as well as the award procedure. This report is sent to all those operators interested so that they can analyze it and then query and comment on anything they are not sure about.

For this task it is the merchant banks which have a more active role as intermediaries between the operators and governments.

Then the due-diligence period begins when all those foreign companies wanting to participate in the privatization have the opportunity of evaluating the firm. A thorough analysis of the technical and administrative and financial areas is done before offering a price. A set period is assigned to each firm to analyze the balance sheets, the earlier audits, the human resources (e.g. pension plans, trade unions), the subscriber data, the telecommunications networks, the switch centers, the international traffic agreements, dividend policies, technologies, etc.

For this examination, a room is fitted out, the data room, where the work groups are given the reports and files necessary to do their studies and analyses.

For this task work teams are created in TISA and a leader is appointed, who in turn appoints and co-ordinates a group of experts in different areas (human resources, network, international communications, sales, etc.). This team has the mission of writing a weekly or fortnightly progress report of all the process. The report is submitted to TISA's Management Board and in the final stages, it contains approximate valuation figures.

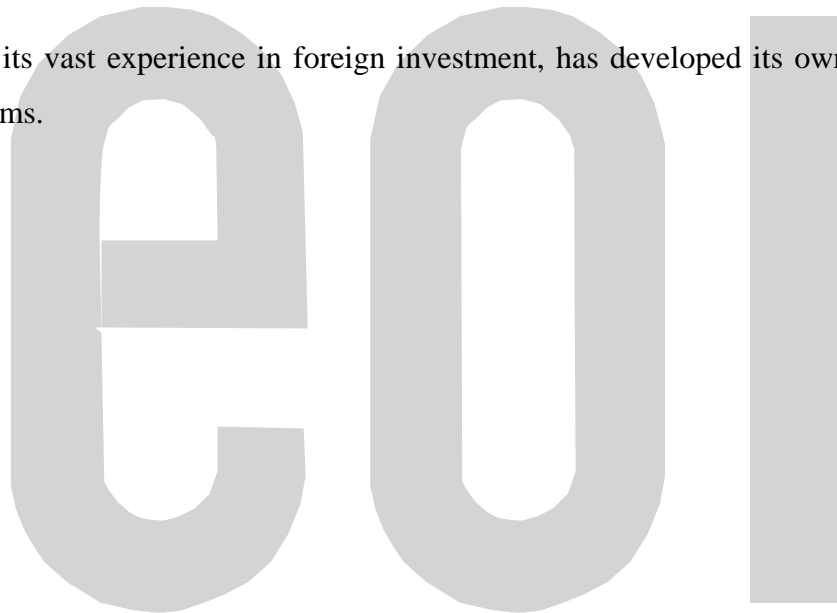
Meanwhile another work group from the investment area does a macroeconomic study of the country.

After the Spanish company has done its own stocktaking, it hires an international auditor to validate and contrast their data and analyses. It also contacts a merchant bank to issue its fairness opinion, in other words, an objective opinion or valuation by an independent organization of the real price of the company to be privatized.

From then on a series of continual valuations are done at the same time by TISA and the institutions mentioned earlier to determine the price bracket of the valuation.

For the determination of the price a series of standard international economic and financial parameters are used such as, for example, the price line, management and profitability ratios, etc which are later adjusted by internal agreements.

TISA, due to its vast experience in foreign investment, has developed its own models for valuing firms.



## **4. INTERNATIONAL INVESTMENTS.**

### **4.1. Chile (1990).**

TELEFÓNICA's international expansion began in 1989 with the purchase of a 10% block of shares in the national and international long-distance monopoly ENTEL-CHILE, auctioned by the Chilean Government on the Santiago stock exchange. This acquisition was done in accordance with a regulation on foreign investments with the issue of Chilean foreign debt certificates. However, the main investment did not occur until 1990 with the acquisition of 44% of COMPAÑÍA DE TELEFÓNOS DE CHILE (CTC), which managed the local telephony business almost exclusively and a 20% increase in ENTEL-CHILE's stake holdings.

In the case of CTC, TISA purchased shares from BOND CORPORATION CHILE, S.A. It so happens that in 1987 both BOND CO. (property of an Australian financier) and TELEFÓNICA competed for the privatization of the Chilean operator. They both offered a similar price, and it was finally awarded to the American company because in its bid it promised to disburse the capital in 1 year while TISA preferred to see the results of the following 5 years before disbursing any amount. After two years, BOND CO. was in a liquidity squeeze and had to sell its shares to its initial competitor.

TELEFÓNICA invested around 40,000 million pesetas in the purchase of CTC and the financing was completed with the granting of 130 million US\$ worth of credit from the World Bank to finance the expansion programs. This was because the resources generated by the firm plus those that could be obtained on the national financial market were insufficient to meet all the investment requirements.

In 1990, too, shares were placed on the New York stock exchange, and CTC thus became the first Latin American firm to be listed on the most important stock exchange center in the world, and gain the backing of the international finance community.

The company began to carry out an ambitious Plan de Desarrollo (Development Plan)



(1990-1996) which meant investing over 400,000 million pesos, installing over one million new lines, increasing the number of lines in service for every 100 inhabitants to 12 and the number of telephones to 16.

This Plan called for strict action policies, which were well defined by its promoters:

- The investments would be approved whenever the rate of return was greater than the cost of capital. This rate should also cover investment risk expectations.
- As a financial restraint on the Plan de Empresa (Firm's Plan), the maximum level of debt would be determined by a debt-to-equity ratio equal to 1.25 times.
- The dividend policy that it agreed to pursue was to restrict the dividend distribution to a maximum during the initial years so as to generate enough internal resources to meet the necessary investments, thereby maintaining financial soundness.

Well, in 1994, some of the objectives envisaged in the Plan had been achieved (e.g. the number of lines for every 100 inhabitants was 12). During this period the operating revenue increased considerably every year, except for 1994 when it increased just 1%. The same thing occurred with the operating result, which after a sharp upward trend to 1993, in 1994 fell below 1993's.

One of the reasons, which best explains this fall was the increase in the asset depreciation ratio to adjust to their useful life. However, the main reason was due to a change in the long-distance service market with the introduction of the multi-carrier system, as explained below.

### *Liberalization of the telecommunications sector in Chile.*

In 1990, the national and international long-distance service market was dominated by ENTEL-CHILE, and CTC covered 18% of long-distance national traffic. At that time CTC requested the concession to develop and operate its own optical fiber

communications network and satellite links, which meant introducing a multi-carrier system. This would enable free competition among long-distance market operators, and also lead to deregulation of the market.

This request was studied by the Comisión Resolutiva de la Fiscalía Nacional Económica (Commission for Resolutions on Legal, Economic and Tax matters) at the petition of the Supreme Court of Justice, and it was the object of much discussion and debate for several years. In 1994, when the legislation changed, the market was opened up to competition, and the multi-carrier system was established in the long-distance market. This led, first of all, to a reduction in line-connection costs and secondly, a fierce price war, which consequently affected the providing companies' profit-and-loss accounts.

There are two ways of using the multi-carrier system:

- For every call customers (or subscribers) select the operator that they want to use.
- The consumers subscribe to the service offered by one specific operator.

The authorisation of CTC to act as the long-distance operator in Chile was one of the reasons why TELEFÓNICA decided to put up for sale its 20% stake in ENTEL-CHILE. The new deregulation, which meant competition between CTC and ENTEL-CHILE could cause a conflict of interests in the future, given TELEFÓNICA's condition as shareholder in both operators.

This problematic situation was studied by different legal institutions, and TELEFÓNICA finally decided to sell its stake in ENTEL that very year.

At the end of 1994, CTC had over 9,300 employees and managed 1.7 million subscriber lines. It is also a highly diversified firm operating in the local telephony, cellular mobile telephony, data, cable TV and national and international long-distance service market.

(See Table 5 showing CTC and ENTEL'S operation and financial data trends)

**TABLE 5: COMPAÑÍA DE TELÉFONOS DE CHILE, S.A. – (C.T.C.)**

OPERATING DATA					
	Dec. 1990	Dec. 1991	Dec. 1992	Dec. 1993	Dec. 1994
No. of lines installed	1,018,568	1,162,539	1,379,530	1,646,637	1,737,109
No. of lines in service	811,811	996,738	1,213,216	1,437,138	1,545,074
Lines in service per 100 inhab.	6.6	8.0	9.2	11.4	12.1
Line digitalisation (%)	64.0	70.6	76.0	100.0	100.0
No. of employees	7,530	7,994	8,005	8,133	7,424
FINANCIAL DATA					
Results(1) (Mill. Of Chilean pesos)	Dec. 1990	Dec. 1991	Dec. 1992	Dec. 1993	Dec. 1994
Operating income	168,837	265,613	336,720	401,920	406,857
Net result	48,787	67,084	85,689	97,770	90,790
Cash Flow operations	72,791	117,463	166,134	187,399	143,665
BALANCE SHEET	Dec. 1990	Dec. 1991	Dec. 1992	Dec. 1993	Dec. 1994
	M US\$	M US\$	M US\$	M US\$	M US\$
	(*)	(**)	(***)	(****)	(*****)
Total assets	1,624.3	1,688.1	2,118.6	2,569.5	3,186.9
Equity	891.6	867.7	1,050.6	1,195.6	1,474.9

(1) The 1992 to 1994 data are from CTC's 1994 report. The 1991 and 1990 data are from the 1993 and 1992 Annual Reports respect.

(\*) Exchange rate 31.12.90: 1 US\$ = 337.09 pesos

(\*\*) Exchange rate 31.12.91: 1 US\$ = 374.51 pesos

(\*\*\*) Exchange rate 31.12.92: 1 US\$ = 382.12 pesos

(\*\*\*\*) Exchange rate 31.12.93: 1 US\$ = 428.47 pesos

(\*\*\*\*\*) Exchange rate 31.12.94: 1 US\$ = 402.92 pesos

**TABLE 5: ENTEL CHILE**

OPERATING DATA			
	Dec. 1990	Dec. 1991	Dec. 1992
International Traffic (minutes)	106,621,115	131,517,093	133,359,316
No. of employees	1,547	1,582	1,590
FINANCIAL DATA			
Results(1)	Dec. 1990	Dec. 1991	Dec. 1992
Operating income	177.2	180.0	229.2
Net result	72.2	72.2	91.7
Cash Flow operations	88.9	90.2	120.8
	Dec. 1990	Dec. 1991	Dec. 1992
BALANCE SHEET	M US\$	M US\$	M US\$
	(*)	(**)	(***)
Total assets	304.8	299.7	362.4
Equity	186.2	185.5	231.2

(\*) Exchange rate 31.12.90: 1 US\$ = 337.09 pesos

(\*\*) Exchange rate 31.12.91: 1 US\$ = 374.51 pesos

(\*\*\*) Exchange rate 31.12.92: 1 US\$ = 382.12 pesos

Source: Telefónica Internacional

## 4.2. Argentina (1990).

TELEFÓNICA's presence in Argentina came about as the result of its participation in the privatisation of EMPRESA NACIONAL DE TELECOMUNICACIONES DE ARGENTINA, whose area of action was divided into two zones, north and south.

The privatization of ENTEL was first posed in 1987 and was the reason for

TELEFÓNICA venturing abroad. A preliminary agreement had been signed with the former chairman Raúl Alfonsín.

At first, the investment amounted to 3,000 million pesetas, which meant it was able to acquire 10% of the operator in the south (TELCO SUR), and management of the firm. The majority partner was CITICORP, which provided the rest of the money necessary to pay for the Argentine Company. (114 million US\$ in cash and 2.700 million US\$ in Argentine debt certificates).

Later revalorization of the Argentine firm (TASA) cost TELEFÓNICA dear when it tried to increase its stake. It had to pay 5,000 million pesetas for an additional 2% of COINTEL, the consortium with a majority holding in TASA (TELEFÓNICA DE ARGENTINA S.A.), and then acquisition of a further 19% cost 31,000 million pesetas.

When the firm was purchased, it was in a sorrowful state, and the investments necessary were valued at 1,000 US\$ for each line to be installed, and it was expected to install between 1.5 and 2 million lines in 5 years. The royalties that TELEFÓNICA planned to charge for its management work (management fee) would allow the investment to be recouped in approximately 3 years.

The management plan envisaged financing the suppliers with supply contracts and increasing self-financing, thanks to the sharp rises in tariffs authorized by the Argentine Government. The Buenos Aires Stock Exchange was also waiting for almost a third of the shares owned by the State to be floated on the stock exchange.

During the early months, TELEFÓNICA tried to adjust and rationalize the firm's economic structure and correct management deficiencies or bad practices. It also made a tremendous effort to discover the operator's real situation with audits, which had never existed before and with a monthly monitoring of the firm. The number of staff was dramatically reduced, from 23,000 to 17,000 employees, and the bureaucratic nature of the work began to be changed. The management methods normal to Spain were introduced and the necessary investments were made in plant and equipment.

TISA showed its management capacity in a crisis situation. It completely changed the chaotic company that it had inherited and established the bases of its growth. In 1992, TASA earned 25,700 million pesetas, representing 89% growth, far outstripping TELECOM, the operator in the northern zone controlled by a Franco-Italian group. This improvement was also seen in the revalorization of its listed securities at the end of 1992, with 247% latent goodwill on their acquisition cost.

In 1994, at the end of its financial year, TASA managed over 3 million lines and had a profit of 226 million US\$, 18% more than in 1993.

(See Table 6 showing TASA's operating and financial data trends).



**TABLE 5: TELEFÓNICA ARGENTINA – (TASA)**

OPERATING DATA					
	Dec. 1990	Dec. 1991	Dec. 1992	Dec. 1993	Dec. 1994
No. of lines installed	1,943,760	1,984,973	2,463,247		
No. of lines in service	1,705,254	1,782,355	2,058,797	2,595,929	2,718,809
Lines in service per 100 inhab.	10.3	12.7	12.9	15.0	17.1
No. of employees	21,003	17,458	19,228		
FINANCIAL DATA					
Results (1)	Nov.90/ Sep.91 M US\$ (*)	Oct.91/ Sep.92 M US\$(**)	Oct./Jun.94 M US\$	Oct./Jun.95 M US\$	
Operating income	1,119	1,615	1,917	2,054	
Net result	117	221	307	353	
Cash Flow operations	325	486			
BALANCE SHEET	Sep. 1991 M US\$ (*)	Sep. 1992 M US\$(**)	Jun. 1994 M US\$	Jun. 1995 M US\$	
Total assets	2,849	3,246.4	4,400	5,168	
Equity	2,335.8	2,546.3			

(1) The 1992 to 1994 data are from CTC's 1994 report. The 1991 and 1990 data are from the 1993 and 1992 Annual Reports respect.

(\*) Exchange rate 31.12.91: 1 US\$ = 9.910 Australes

(\*\*) Exchange rate 31.12.92: 1 US\$ = 9.990 Australes

Source: Telefónica Internacional

### **4.3. Venezuela (1991).**

TISA entered Venezuela in December 1991 with a 302 million-US\$ investment. In this instance, it had 16% stake holdings in VENWORLD TELECOM, the owner of 40% of the Venezuelan company (CANTV).

In 1991, the company owned just 1.8 million lines and in 1994, it had 2.8 million. It went from earning 320 million US\$ in 1992 to a profit of 370 million US\$ in 1993 and it had losses of 44 million US\$ in 1994, due to a 60% devaluation of the bolivar and the resulting effect on debt.

### **4.4. Puerto Rico and the North-American market (1992).**

TISA acquired 79% of TELEFÓNICA LARGA DISTANCIA INC. (TLD) in December 1992 for 142 million US\$. TLD provides long-distance telephony land services in Puerto Rico.

The purchase of TLD, the result of the splitting of the long-distance division from the old public Puerto Rico operator, is TISA's boldest operation, since with this it achieved a foothold in the US market and also a strategic point in Caribbean communications.

This company maintains approximately 80% of its traffic with the United States, competing with giants such as ATT, MCI and SPRINT, and the rest of its traffic is with Latin American and European countries.

Although in the beginning the North American Telecommunications Administration imposed restrictions on TLD, it obtained a net profit of one million US\$ in 1994.

TELEFÓNICA has thus gained direct access to the United States via TLD and it does not rule out other ways of gaining access to this market of 30 million Spanish speakers. It has even thought of having alliances with one or several regional telecommunications companies (Bells), considering that its target market is mainly concentrated in just 7



states in the country.

#### **4.5. Other countries.**

TISA has also made exceptional and isolated investments in cellular telephony in Rumania and in radio search and integral solutions in Portugal.



## 5. PERU'S DECISION.

One of the main reasons of pride for Peru's current Government is the fact that it began the most ambitious privatization program in Latin America in 1992: the Fujimori Economic Reform Plan. This Plan transferred nearly all public-sector assets to the private sector.

The Peruvian Government's announcement of the privatization, envisaged for 1994, of 35% of EMPRESA NACIONAL DE TELECOMUNICACIONES (ENTEL) and COMPAÑÍA PERUANA DE TELÉFONOS (CPT) interested TISA right from the outset. With this privatization it would be able to consolidate the expansion strategy it had begun in Latin America in 1990. (see Appendix of TISA's organizational structure)

Prior to this announcement, TISA had already done studies of the country and knew that, with the arrival of Alberto Fujimori to the presidency in 1990, Peru had started a drastic economic stabilization and liberalization plan. The result was that in recent years Peru had recovered control of its economy and had become an attractive destination for foreign investment in Latin America.

Peru had recovered its stability and security, terrorism had been brought under control and by sheer hard work it had managed to become part of the international financial system once more. If in the 5-year period (1985-1990) foreign investment had barely reached 124 million US\$, between 1990 and 1994 it reached 4,000 million US\$.

The GDP growth rate expected for 1994 was around 13% (one of the highest on the planet) and for 1995, 6%. The expected inflation rate for 1994 was 20%, well below 1990's 7,650%, with expectations of between 9% and 11% for 1995.

At the beginning of 1994, Peru had 22.8 million inhabitants and telecommunications penetration was 2.7 lines for every 100 inhabitants, way behind the average 12 in Latin American countries.

Faced with this situation, the Spanish company decided to go to the bid. Back in 1993

TISA had obtained the pre-qualification to compete in the privatization of ENTEL PERU. TISA's admittance by the privatizing committee meant it was able to submit bids in the sale-process for ENTEL PERU, which was 100% state-owned.

Similarly, TISA received the go ahead from the privatizing committee to participate in the sale of the block that the State had in COMPAÑÍA PERUANA DE TELÉFONOS (CPT), another firm in the Peruvian telecommunications sector, but with private capital among its shareholders.

TISA thus set about evaluating and analyzing all the relevant aspects of the privatization. The result would be the valuation of the Peruvian companies in question and the final price that the Spanish company would be willing to pay for managing the Peruvian operators. This would then be submitted as the definitive bid to the Peruvian Government.

## **5.1. Concession characteristics.**

The concession contracts would be signed with the Peruvian Government and they would be for 20 years and renewable for another 20; the first 5 would be exclusive in nature.

Up to the end of 1998, the winning company would be the only one under license to manage the local and long-distance telephony service in Peru, and in return it would guarantee certain standard services and extend and modernize the basic telephony network. Cellular telephony, data transmission, radio search, cable television and public telephones were therefore exempt from this exclusivity.

The concession terms concerning the line-installation program, the tariff framework and service quality were very explicit up to 1998.

### **5.1.1. Line-installation program.**

The concession called for the installation of 1.2 million lines during 1994-1998, over

150% of the total number of lines at the end of 1993 (673,021).

Furthermore, it was also necessary to install 19,000 public telephones and provide a telephone service before 1999 to all the towns with over 500 inhabitants.

### 5.1.2. Tariff framework.

The concession contract guaranteed that for the first five years, tariffs would be adjusted to inflation every three months.

Up until then in Peru, like in many other Latin American countries, governments were in the habit of not increasing tariffs as an inflationary measure. The prices of monthly fixed services were also kept low (line and telephone rental charges) so that the population could gain access to them, but conversely, line connection and long-distance call prices were astronomically high.

Well, the concession agreement should correct the cross-subsidies so that at the end of 1998 the prices of the respective services would be normal and competitive compared with tariffs in other countries.

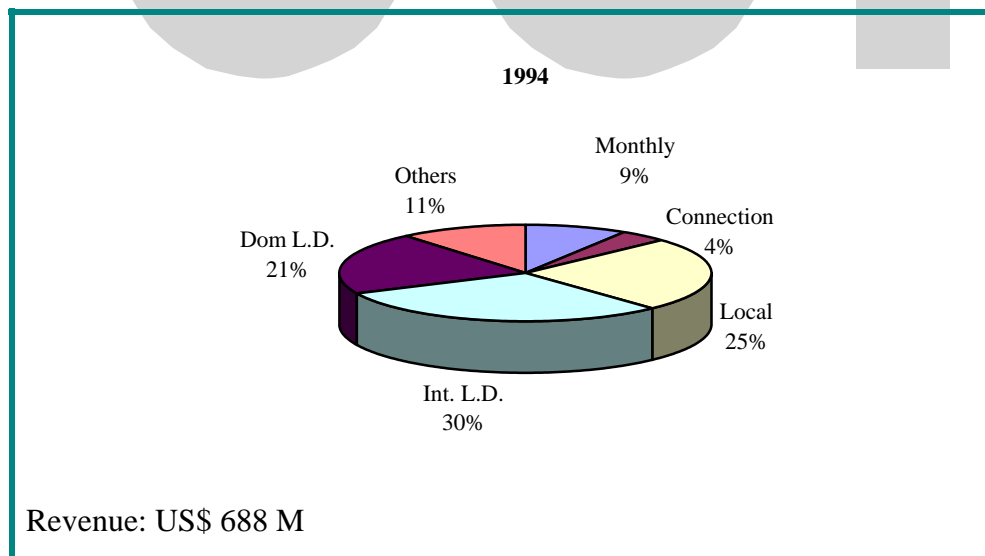
This would alter the revenue composition considerably. The revenue from long-distance calls would fall and the revenue from fixed monthly tariffs would rise. This was important because with the advent of competition in 1998, both national and international long-distance calls would be affected more than local calls, which are usually the ones with lower tariffs and higher fixed costs (Table 7).

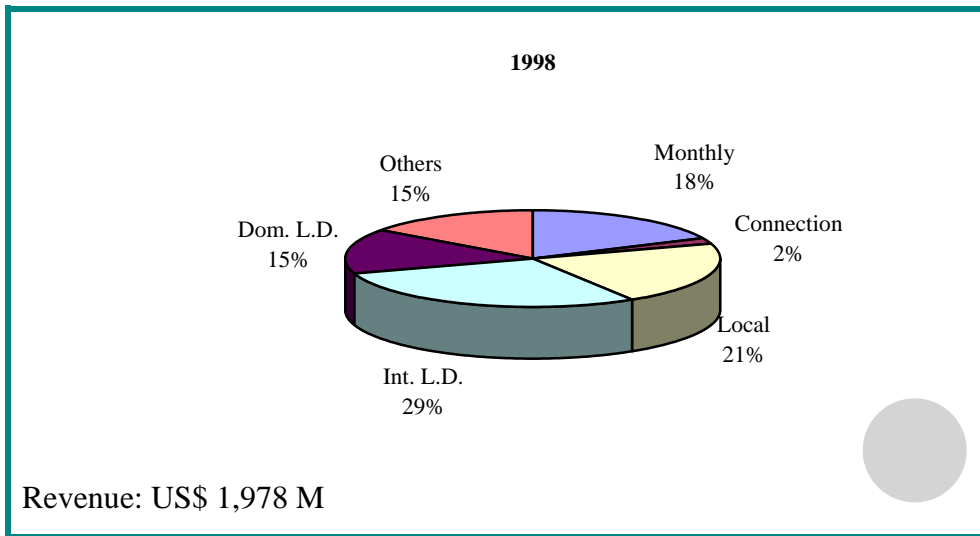
**TABLE 7: REVENUE COMPOSITION BEARING IN MIND THE CHANGE IN TARIFFS**  
(indexed at 100 in 1994)

	1994	1995 F(*)	1996 F	1997 F	1998 F
Connection tariff (residential)	100	86	73	59	46
Connection tariff (commercial)	100	77	59	41	23
Monthly Tariff (residential)	100	128	170	231	291
Monthly Tariff (commercial)	100	119	135	140	147
Local calls	100	97	94	89	83
Domestic long-distance calls	100	90	80	72	65
International long distance calls	100	91	80	69	58

(\*) F: Forecast

Source: Acuerdo de concesión-OSIPTEL (Organización para la Supervisión de Inversiones Privadas en Telecomunicaciones).





Source J.P. Morgan

The charge for installing a line, as stipulated in the concession, would fall every year so that the sooner the lines in service were installed, the greater the revenue they would obtain from the installation charge.

Furthermore, the sooner a customer had a line, the sooner revenue would be obtained from monthly rental charges and there would be greater opportunities for reaping revenue not only from basic telephony service, but also from value-added services.

### 5.1.3. Service quality.

A series of objectives relating to service operation were specified and they had to be accomplished by the winning operator if the quality of the telecommunications service were to be improved. For example, in 1998 80% of the requests for telephones had to be met in less than 90 days, there was a maximum number of faults permitted for every 100 telephones, and assistance from the operator had to be in less than 10 seconds. (Table 8)

**TABLE 8. SERVICE QUALITY: OBJECTIVES (%)**

LIMA AND CALLAO	1994	1995	1996	1997	1998
Line faults	52	48	44	40	37
Same day repairs	55	57	62	69	75
Assistance operator in 10 secs.	67	69	73	77	81
First-attempt calls:					
- Local	45	47	55	57	59
- Domestic long distance	35	39	43	47	51
- International long distance	40	43	46	49	52
REST OF PERU	1994	1995	1996	1997	1998
Line faults	50	48	45	42	38
Same day repairs	65	67	69	72	75
Assistance operator in 10 secs.	70	73	76	80	83
First-attempt calls:					
- Local	58	60	62	64	66
- Domestic long distance	40	42	44	46	49
- International long distance	45	47	50	52	55

Source: Concession contract (Baring Securities)

To give an idea of the size of the commitment that they were taking on, suffice it to say, that at the moment of privatization there were 300,000 requests for telephones and the

average waiting time was nine years.

Moreover, a series of financial sanctions were specified in the event of not discharging some of the obligations, with fines of between US\$ 25,000 and US\$ 500,000 for each annual percentage point of deviation.

## **5.2. Technological situation of the Peruvian companies.**

Peru, the same as its neighboring countries, had obsolete infrastructures and serious maintenance problems. This was due to an inadequate investment policy, because of serious problems with financing the large deficit which dogged its economy, and because of the political and economic disorder which shook the country in the late 1980s and early 1990s.

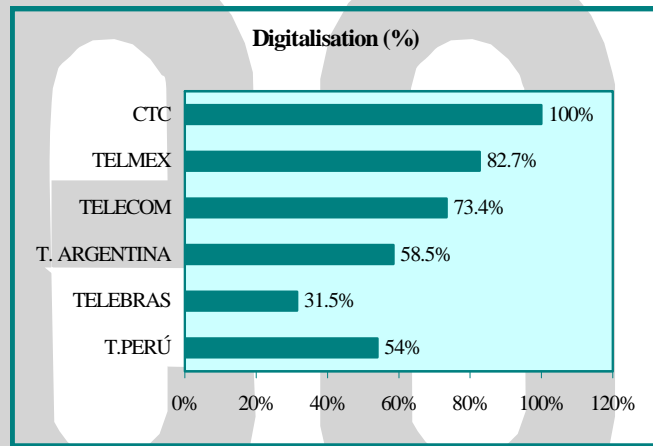
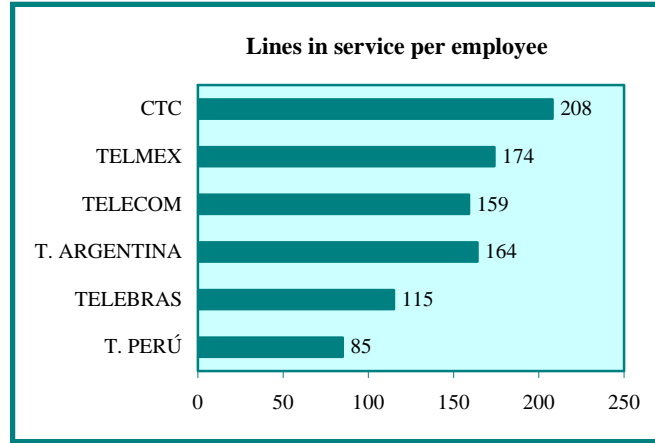
TISA would have to concentrate its investment efforts on extending the network with digital technology and replacing the old analogue telephone exchanges with digital ones.

The digital system allows voice, text and data applications to be transmitted simultaneously in the same network. Thus by increasing digitalization, maintenance costs fall, service revenue increases and service quality improves.

The company expected to achieve 54% digitalization during 1994, a percentage, which was low if it were compared with Chile's CTC (100%) or Mexico's TELEMEX (83%) (Table 9).



**TABLE 9: EFFICIENCY**



### 5.3. Partners.

The Spanish company went to this privatization in a consortium. TISA had the majority (85%) and the other partners were Peruvian firms: CERVECERÍAS BACKUS Y JOHNSTON (5%), the construction company GRAÑA Y MONTERO (5%) and BANCO WIESSE (5%).

#### **5.4. Competitors.**

As well as the Spanish operator, another five international companies in the telecommunications sector obtained the pre-qualification to compete in the privatization processes of ENTEL and CPT. The multinationals, which qualified for the privatization, were AMERICAN TELEGRAPH & TELEPHONE (ATT), FRANCE TELECOM, CABLE & WIRELESS, GTE, SOUTHWESTERN BELL, and KOREA TELECOM.

#### **5.5. Management team.**

TISA is the international investor with more experience in the region, because of its important management successes in Chile and Argentina.

The expertise of its management team has improved the quality of management considerably in different countries, each with their own idiosyncrasies. This has led to an increase in the number of lines in service, better productivity and ratios, such as digitalization, which have resulted in higher returns on investment.

#### **5.6. Staff analysis.**

The number of employees at the end of 1993 totaled 12,088 and the number of lines in service 671,000. The ratio used in the sector, an indicator of operator productivity, is the number of lines in service per employee, and in 1993 it was 56, which indicated that there were too many employees for the number of existing lines if compared with the other neighboring countries.

TISA decided to reduce 25% of the staff during 1994, increasing the ratio significantly to 85 and it compared this ratio with that of other Latin American operators (Table 9), and observed that this level was still very low. Therefore, in its action plan the number

of annual layoffs kept changing to meet the envisaged increase in lines in service and in 1998 TISA achieved an operating ratio which was sufficiently competitive. (Table 10)

**TABLE 10. OPERATING INDICATORS TREND**

	1991	1992	1993	1994	1995	1996	1997	1998
Lines installed (thousands)	668	696	758	875	1,232	1,528	1,762	1,930
Lines in service (thousands)	594	614	671	759	1,105	1,370	1,613	1,800
Digitalisation	26%	29%	37%	54%	73%	83%	90%	96%
Employees	14,200	12,700	12,000	8,900	8,500	8,000	7,500	7,300
Lines in service/employee	42	48	56	85	130	171	215	247

Source: J.P.Morgan

Moreover, the staff plan aimed to improve the quality of the technical staff via training programs for graduates from the country’s engineering schools, which would mean that the best would be selected to stay with the company.

The ability to reduce and also increase the number of staff became one of the challenges for the directors of the consortium headed by TISA if they won the privatization.

It should be noted that about 60% of the employees were trade union members and that salaries were low in Peru.

## 5.7. Financial analysis.

In 1993, TISA's balance sheet structure showed a high level of solvency with equity, consisting of capital and reserves, equivalent to 75% of total liabilities, which meant it was still possible to face greater debt and, therefore, face new international business expansion opportunities.

**TABLE 11: PROFIT AND LOSS ACCOUNT**

(Constant US \$)	1994 (*)	1995 F(**)	1996 F	1997 F	1998 F
International long distance	209	282	379	471	571
Domestic long distance	141	187	235	267	288
Connection charge	30	178	112	79	44
Monthly fees	62	104	174	261	359
Local services	173	241	320	377	414
Cellular	20	30	44	62	84
Directory	16	23	28	34	38
Others	37	59	88	129	180
<b>Operating revenue</b>	<b>688</b>	<b>1,104</b>	<b>1,380</b>	<b>1,680</b>	<b>1,978</b>
% Growth	22.4%	60.5%	25.0%	21.7%	17.7%
Related costs and salaries	(234)	<u>(192)</u>	(190)	(186)	(183)
Other operating expenses	(218)	(341)	(418)	(505)	(598)
Depreciation	(69)	(106)	(165)	(208)	(248)
<b>Operating expenses</b>	<b>(521)</b>	<b>(639)</b>	<b>(773)</b>	<b>(899)</b>	<b>(1,029)</b>
% Growth	7.6%	22.6%	21.0%	16.3%	14.5%

(Constant US \$)	1994 (*)	1995 F(**)	1996 F	1997 F	1998 F
<b>Operating profit</b>	<b>167</b>	<b>465</b>	<b>607</b>	<b>781</b>	<b>949</b>
% Margin	24.3%	42.1%	44.0%	46.5%	48.0%
% Growth	113.6%	178.4%	30.5%	28.7%	21.5%
EBITDA	237	571	772	989	1198
Net interests Revenue (Expense)	5	16	1	10	33
Profit (Loss) due to inflation adjustments	(38)	(16)	4	(4)	(23)
Other Revenues (Expenses)	2	6	7	8	10
Voluntary retirement programme	(73)	(11)	(15)	(16)	(7)
<b>Profit before tax</b>	<b>63</b>	<b>460</b>	<b>604</b>	<b>779</b>	<b>962</b>
% Margin	9.2%	41.7%	43.8%	46.4%	48.6%
Employee profit sharing	(7)	(46)	(60)	(78)	(96)
% Tax rate	11.1%	10.0%	9.9%	10.0%	10.0%
Tax o/ Profit	(28)	(138)	(181)	(234)	(289)
% Tax rate	44.4%	30.0%	30.0%	30.0%	30.0%
<b>Net Profit</b>	<b>28</b>	<b>276</b>	<b>363</b>	<b>467</b>	<b>577</b>
% Margin	4.1%	25.0%	26.3%	27.8%	29.2%
% Growth		885.7%	31.5%	28.7%	23.6%

(\*) Based on the financial consolidation of CPT and ENTEL's statements

(\*\*) F: Forecast

Source: J.P. Morgan

TISA experts, using the data obtained in earlier analyses, did a study of the profitability expected from the investment in Peru in accordance with the revenue and expenditure estimates (Table 11).

### 5.7.1. Revenue.

Telephone revenue not only depends on the number of lines and the tariff structure, mentioned earlier, but also on line usage. Line usage should fall if telephones were installed in those areas where family income is lower, but the expansion that TELEFÓNICA planned up to 1998 would mainly cover middle-upper income groups.

Furthermore, the hypothesis was that in the long term the tariff revenue for calls would tend to fall due to competition from new market entrants, while demand expectation for telecommunication services would tend to rise due to the country's economic growth. As a result of these two trends, revenue from traffic would increase in the same proportion as the number of lines.

The revenue structure would also include changes in its composition due to the correction of the cross-subsidies.

The operating revenue envisaged for 1998 over 1994's, in constant terms, would mean a 188% increase, with an annual average increase of 30% for this period.

### 5.7.2. Expenditure.

According to the analysis, staff expenditure would fall sharply because of the plan for reducing the number of employees envisaged for 1994-1998. However, the redundancy payments had to be considered, which would basically affect 1994; their total cost was estimated at 80 million US\$.

The largest disbursement would be the investment in fixed assets, basically due to the

line-installation plan (1.2 million) up to 1998, which would mean a total of approximately 2,000 million US\$ in 5 years (4,200 million US\$ in 10 years). The direct consequence would be that the depreciation cost of these fixed assets would increase considerably, bearing in mind that most of the equipment was amortized in 10 years.

As regards fees, there would be three types:

- It was stipulated that the Peruvian operators would pay 2% of their revenue in fees to the Government.
- TISA would also receive a quarterly fee. The transfer of technical capacity would be equivalent to 1% of the revenue billed by the companies (an exception would be in the first year from the date of signing the contract when there would be an additional fee of 1.5%).
- The management and control fee that TISA envisaged receiving, would be equivalent to 9% of the operating profit (not considering depreciation, intangible asset depreciation, supplies, financial cost, taxes and rates, or royalties established in the concession contracts).<sup>3</sup>

The agreement regarding the management fees could be extended up to a maximum of 20 years.

Taxes would also be another large item of expenditure. Corporation taxes were estimated to be 30% of profit.

In accordance with Peruvian Law, the employees would be entitled to 10% of the pre-tax profit as company shares.

The figure for operating expenses envisaged for 1998 over the 1994 figure, in constant terms, would mean a 98% increase, with an annual average increase of 16% during this period.

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<sup>3</sup> TISA had signed contracts on the transfer of technical capacity and management for five years. These contracts could be automatically renewed for a further five years up to a maximum of twenty from the date of the contract.

### 5.7.3. Profitability.

Profitability, measured as the net profit over income, would increase from 4% in 1994 to an average 28% during the other years up to 1998. If we measure it as net profit over capital (R.O.E.), the percentage increases from 1994 are considerable and progressive (Table 12).

**TABLE 12: PROFITABILITY**

%	OPERATING PROFIT			NET PROFIT			R.O.E. (AVERAGE)		
	1994	1995	1996	1994	1995	1996	1994	1995	1996
T.ARGENTINA	25.9	27.4	27.4	18.7	19.3	19.7	13.4	14.3	14.3
TELEBRAS (BRASIL)	8.7	7.5	17.1	8.5	0.7	6.5	3.0	0.2	2.7
CTC (CHILE)	27.0	32.8	35.3	24.7	25.3	25.0	16.6	14.6	15.4
TELEMEX (Mexico)	42.5	35.1	50.2	26.9	23.9	31.0	14.2	12.9	16.2
T. PERU	24.4	42.1	44.0	4.2	25.0	26.2	2.3	18.2	19.9

Source: Baring Securities (except JP Morgan for Telefonica Peru)

### 5.7.4. Valuation.

In accordance with the profit forecast, TISA began to value the Peruvian companies by calculating the cash flow present value that the firms could generate in the future.

In order to quantify the expected cash flows, it had to bear in mind the following variables and assumptions:

- All the concession contract obligations would be discharged during 1994-1998.



- The Sol/US\$ exchange rates would be variable up to 1998 and then constant.
- Traffic would increase in the same proportion as the number of lines.
- Tariffs would be adjusted to local inflation.
- Tariffs would be reduced in 1999 due to competition from new market entrants.
- From 1995 75% of net profit would be distributed as dividends.
- Macroeconomic scenario. (Table 13)

**TABLE 13: ECONOMIC HYPOTHESES**

	1994	1995 F(*)	1996 F	1997 F	1998 F
Population (mill.)	23.1	23.5	24.0	24.4	24.8
GDP (US\$ bn (10 <sup>9</sup> ))	50.0	59.0	63.5	66.7	72.1
GDP/capita (US\$)	2,165	2,511	2,646	2,734	2,907
GDP Growth (%)	13.0%	8.0%	6.0%	5.0%	5.0%
Inflation	10.5%	10.8%	9.5%	8.5%	7.0%
Exchange rate Sol/US\$	2.18	2.32	2.48	2.61	2.71
US\$ LIBOR (%)	4.7%	6.0%	6.0%	6.0%	6.0%

(\*) Forecast

Source: Baring Securities

With these premises, a flow-of-funds chart was designed for a 10-year period. The table would give the operation, financial and investment activity cash flow and the net cash flows for each year (Table 14 shows the first five years).

**TABLE 14: CASH FLOW STATEMENT**

(Constant US \$ M)	1994	1995 F(*)	1996 F	1997 F	1998 F
Net income	28	276	363	467	577
Depreciation	69	106	165	208	248
Change in working capital (not including financial debt)	(7)	5	(13)	(17)	(19)
<b>Operating cash flow</b>	<b>90</b>	<b>387</b>	<b>515</b>	<b>658</b>	<b>806</b>
Net capital expenditures (capex)	(213)	(739)	(437)	(421)	(386)
Other items	31	0	0	0	0
<b>Investment cash flow</b>	<b>(182)</b>	<b>(739)</b>	<b>(437)</b>	<b>(421)</b>	<b>(386)</b>
Financial loans	(177)	(23)	(6)	(9)	(12)
Pensions liabilities	(85)	8	3	3	3
Ordinary shares + Paid-in capital	654	0	0	0	0
Reserve	39	0	0	0	0
Others	(1)	0	0	0	0
Dividends	0	(22)	(55)	(72)	(94)
<b>Financing cash flow</b>	<b>430</b>	<b>(37)</b>	<b>(58)</b>	<b>(78)</b>	<b>(103)</b>
<b>Net change in funds</b>	<b>338</b>	<b>(389)</b>	<b>20</b>	<b>159</b>	<b>317</b>
Cash at begin year	59	397	8	28	187
Cash at year-end	397	8	28	187	504

(\*) Based on the financial consolidation of CPT and ENTEL's statements

Source: J.P.Morgan

Thus by updating the final values and using the discount rates analysed earlier, the Peruvian companies' value was obtained in accordance with their capacity to generate funds and their level of associated risk.

For its analysis and valuation, TISA considered different discount rates, which included the investor's possible perceptions in relation to country risk. Several sensitivity analyses were thus done using rates varying between 10% and 20%. Considering the high risk that Peru posed, even in 1994, for an investment project of this size (e.g. there were still problems with the Sendero Luminoso terrorist group and, among other things, considerable political risk), it was estimated that an 18% discount rate was optimum for covering investment risk expectations.

The value obtained using this procedure would be the price that in theory the consortium headed by TISA should have offered as the definitive bid to the Peruvian Government.

However, on occasions a firm's price can differ considerably from its calculated value, since there are certain factors, measurable and non-measurable, which play an important role in the determination of this price.

The figure that was finally offered was 2,002 million US\$.

### **5.8. Financing scheme.**

To finance this operation, TISA planned to increase share capital by 35,000 million pesetas, which according to its calculations, would mean that it could contract an additional debt of 82,000 million pesetas.

The sale of non-strategic assets (economic shares with no voting rights, of one of the Latin American firms in which TISA had a stake) would be added to these contributions. A further 58,000 million-peseta gain was thus envisaged. The rest would come from contributions from other operators, consortium partners, strategic partners, and the consortium's debt.

All in all, these operations meant a total disbursement of 2,002 million US\$ (Table 15).

**TABLE 15: FINANCING SCHEME OF THE PERU’S PROJECT**

TELEFÓNICA INTERNACIONAL’S CONTRIBUTION	
Capital increase	35,000 Mill. Pts.
Sale of shares with no voting rights	58,000 Mill. Pts.
Debt	82,000 Mill. Pts.
<b>Other operators' contribution</b>	20,000 Mill. Pts.
<b>Consortium partners' contribution</b>	42,000 Mill. Pts.
<b>Strategic partners</b>	23,000 Mill. Pts.
<b>Consortium debt</b>	20,000 Mill. Pts.
<b>TOTAL in Pesetas</b>	280,000 Mill. Pts.
Exchange rate Pta/Dollar	140
<b>TOTAL in Dollars</b>	2,000 US\$ M

Source: Expansión

From this amount, the Peruvian State would receive 1,392 million and the remaining 610 million would go into the Peruvian company CPT. The company would be capitalized and receive a large injection of financial resources.

### 5.9. Strategy analysis.

The rupture with the traditional telecommunications model of monopoly, along with the introduction of new technologies and the defense of private initiative and free

competition, have promoted privatization processes in several telephone administrations and the gradual liberalization of services in countries, such as the United Kingdom, Sweden and Chile.

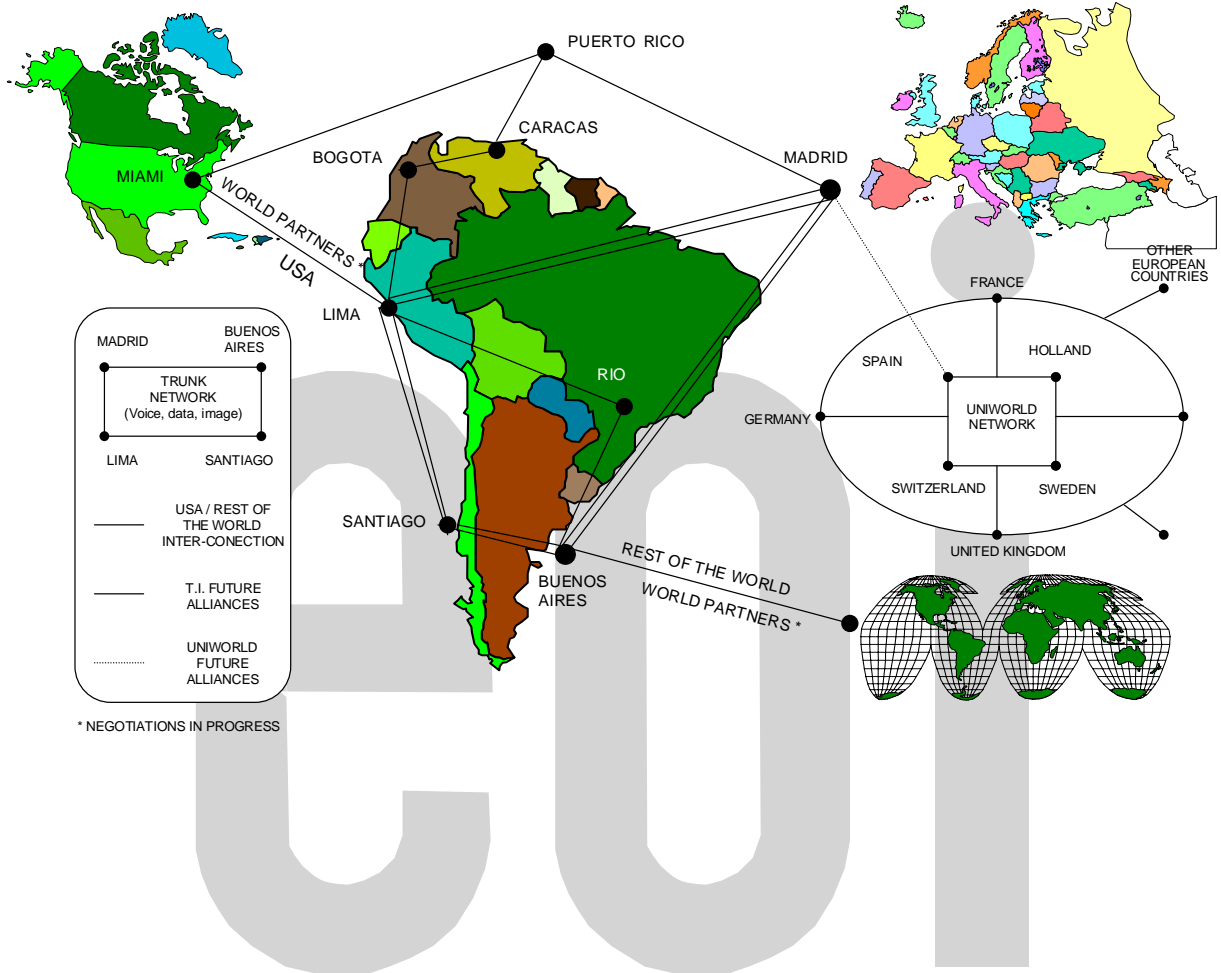
The consequences of this process lead to spectacular alliances between competing or complementary companies in order to become bigger, reduce uncertainties and increase profits.

In this situation, where in the future there will only be a small number of companies in the international telecommunications market, TELEFÓNICA would like to have a prominent role, yet not necessarily the leading one in the foreseeable alliances and international agreements.

In this respect, TISA has concentrated its business opportunities in those markets where there is greater potential for profitability, such as Latin American countries. Its aim is to be a global service operator and not a geographical one.

After TISA's investments in Chile, Argentina or Venezuela, it was immersed in privatization processes in Peru. However, it did not lose sight of those countries whose telephony operators were at different stages of privatization: Mexico, Brazil, Nicaragua, Ecuador, Panama, Uruguay, Paraguay, etc. within the integral strategy of creating a Pan-American network of global services (Table 16).

### PAN-AMERICAN GLOBAL SERVICE NETWORK



## 6. QUESTIONS.

- In your opinion, what were the main reasons for TELEFÓNICA developing an international strategy?
- What strategy has TISA pursued in its venture abroad and what do you think of this strategy?
- Identify what were the most important competitive advantages TISA had when it entered the Latin American market, and the main risks it had to face.
- What do you think are the salient negative and positive aspects of the investments in Chile, Argentina, Venezuela and Puerto Rico?
- Why did it choose Peru?
- Use Table 17 to estimate the cash flows for the following years and do a sensitivity analysis, discounting these cash flows at 10%, 15% and 18% discount rates. The table should be completed with the management fees that TISA would receive in the period.

**TABLE 17: CASH FLOW ESTIMATE AND SENSITIVITY ANALYSIS WITH DIFFERENT RATES**

	1994	1995	1996	1997	1998...
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Cash Flow Peru (1) (US\$ M)

(1) Source: J.P.Morgan

	1994	1995	1996	1997	1998...
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Cash Flow Peru (2)

(in millions of soles)

(2) Source: Baring Securities

	1994	1995	1996	1997	1998...
Management Fee 1%					
(*)					
Management Fee 9%					
(**)					
<b>Total Management Fee (3)</b>					
(in millions of soles)					

(\*) 1% of the revenue except for the first year's 1,5%

(\*\*) 9% of the operating profit excluding depreciation taxes and royalties

	DISCOUNT RATES		
Cash flow present value – Peru			
Management fee present value	10.0%	15.0%	18.0%

- Analyzing the data obtained in this exercise, do you think that the price offered by TELEFÓNICA reflects the true value of the Peruvian countries?

How can you explain the difference between the 2,002 million US\$ offered by TISA and the rest of the valuations?

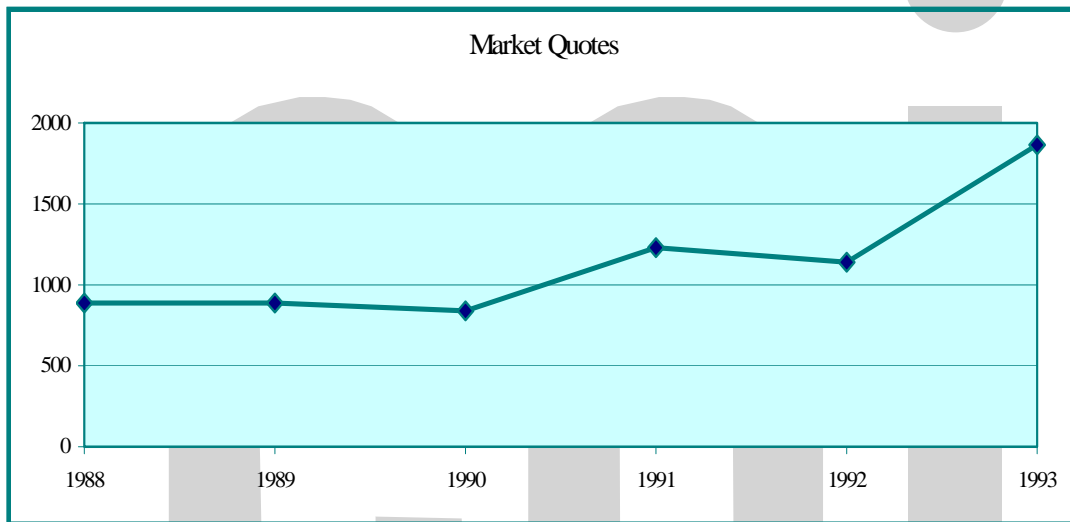
- If it had obtained the concession at that price, what effect would this have had on the financial markets for penalising or not the parent company in its quotations? (See Table 18).



**TABLE 18: GRAPH OF TELEFÓNICA DE ESPAÑA’S MARKET QUOTES**

	1988	1989	1990	1991	1992	1993
Market quotes	888	888	840	1,230	1,1140	1,865
TISA largest investments			Chile Argentina	Venezuela	Puerto Rico	

Source: Telefónica de España’s Annual Report’s



- The merger of the Peruvian companies, among other things, could lead to reduced costs, a possible consolidation of departments, a reduction in administrative procedures (purchasing, marketing, etc.), one management structure and an increase in productivity.

Do you think that the Spanish company considered the opportunity of this merger in its calculations and forecasts?

- Given TISA’s bid price, would it have to go to the national or international financial markets to finance the envisaged expansion plan?

# eoi

**APPENDICES**

## I. Balance sheet.

ASSETS	1994 (*)	1995 F(**)	1996 F	1997 F	1998 F
Cash and investments	398	9	27	187	505
Trade debtors	133	210	262	319	376
Other debtors	42	66	83	101	119
Stocks	38	55	69	84	99
Others	26	29	31	33	35
<b>Current Assets</b>	<b>637</b>	<b>369</b>	<b>472</b>	<b>724</b>	<b>1,134</b>
Property plant and equipment	1,904	2,643	3,080	3,501	3,887
Accumulated depreciation	-994	-1,100	-1,264	-1,472	-1,720
<b>Fixed assets</b>	<b>910</b>	<b>1,543</b>	<b>1,816</b>	<b>2,029</b>	<b>2,167</b>
<b>Total Assets</b>	<b>1,547</b>	<b>1,912</b>	<b>2,288</b>	<b>2,753</b>	<b>3,301</b>
LIABILITIES					
Creditors	43	66	83	101	119
Others creditors	149	254	311	369	425
Provisions for layoffs and pensions	3	11	14	17	20
Long-term debt transfer	24	7	10	13	11
<b>Current liabilities</b>	<b>219</b>	<b>338</b>	<b>418</b>	<b>500</b>	<b>575</b>
<b>Long-term liabilities</b>	<b>67</b>	<b>59</b>	<b>48</b>	<b>35</b>	<b>24</b>
Share capital	1,226	1,226	1,226	1,226	1,226
Undistributed profits	35	289	596	992	1,476
<b>Equity</b>	<b>1,261</b>	<b>1,515</b>	<b>1,822</b>	<b>2,218</b>	<b>2,702</b>
<b>Total liabilities</b>	<b>1,547</b>	<b>1,912</b>	<b>2,288</b>	<b>2,753</b>	<b>3,301</b>

(\*) Based on the financial consolidation of CPT and Entel's statements

(\*\*) F: Forecast

Source: J.P. Morgan

## **II. Company valuation theory.**

### **Introduction.**

Company valuation is understood to be that part of the economy which aims to estimate a specific value or values of a company in accordance with specific hypotheses and objectives using calculations based on technical and economic information.

Valuing a company implies bearing in mind a series of multidimensional features. It measures a living organism affected by microeconomic, theoretical, commercial, and human aspects and the macroeconomic aspects of the environment, in which it is immersed, as well as legal and political ones, etc.

As well as using financial analysis techniques, it is also necessary to consider the capacity and elasticity of the management team to adapt to fluctuating changes in market demand, the level of economic obsolescence and equipment use, the capacity of the commercial and technical teams, brand performance in the market and growth prospects in the sector, etc.

It is not possible to combine all these aspects into one mathematical formulation. This poses a problem of methodology, which is difficult to solve and which is affected by the more or less subjective evaluations of the evaluator.

Therefore, in the development of every methodology there must be perfect harmony between the development of the theory and the databases feeding it in order to obtain useful results for the evaluator.

### **Valuation methods.**

The following classification is based on the information source:

- Valuation methods based on a company's accounting information.

- Valuation methods based on a company's earning information.
- Valuation methods based on share price information.

### **III. Valuation methods based on accounting information.**

#### **Book Value and Net Worth.**

Company valuation can use the accounting information on the balance sheet to estimate an initial value, the book value, which is defined as the difference between current liabilities and assets.

However, the book value is different from net worth, because the book value is calculated from the historical prices which, in general, will not be the same as the market prices.

Net worth or real value is the value of equity when assets and, where appropriate, liabilities are valued at current market prices.

Net worth is also the amount of money a businessman would be left with if he realized all his assets at market prices and satisfied his receivables at market prices.

It should be noted that net worth estimates a company's value as static, and therefore, it does not consider a company's capacity to generate wealth. This may make sense when a company is in liquidation or selling its assets.

### Example

A company's initial balance sheet.

ASSETS		160	LIABILITIES		160
Available		10	Receivable		20
Current		50	Equity		140
Fixed		100			

$$\text{Book Value} = 160 - 20 = 140$$

Balance sheet valued at market prices.

ASSETS		200	LIABILITIES		200
Available		10	Receivable		20
Current		60	Equity		180
Fixed		130	- Equity		140
			- Correcting account (*)		40

(\*) The correcting account includes the difference between the fixed and current assets valued at market prices and the fixed and current assets on the initial balance sheet.

$$\text{Net worth or Real Value} = 200 - 20 = 180$$

There is a method complementing the book value and net worth, which is based on what is known as goodwill. It is based on the fact that as well as valuing the factors which are an integral part of wealth, it is also necessary to value another series of factors, such as customers, brand, management, and methods and innovative techniques, which give

higher earnings than normal.

The update of these future surplus earnings is the economic gain known as goodwill.

#### **IV. Valuation methods based on earning information.**

##### **Present value or capitalized income value.**

Present value or capitalized income value is the value that a company has arising from its expectations to generate economic returns in the future (profits, gains, cash flow, etc).

A company is valued bearing in mind that it is a source for generating surpluses and producing revenue. For the calculation of its value, investment analysis methods are used. The present value formula is the following:

$$V_A = \frac{Q_1}{(1+r)} + \frac{Q_2}{(1+r)^2} + \dots + \frac{Q_n}{(1+r)^n}$$

$V_A$  = Present value of the company

$Q_n$  = Cash flow

$n$  = Time horizon

$r$  = Capitalization rate

In the normal investment analysis technique, the difference between collection and payment is used (cash flow). Sometimes revenue does not coincide with collection because the sales are not always cash. As for expenses, sometimes they do not coincide with the payments because depreciation costs are not annual payments, but one or several payments when the fixed assets are purchased or renewed, and also because purchases are not always cash.

The main characteristic of these methods compared with the methods in the previous section is that they do not value the balance sheet items.

### **The choice of discount or capitalization rate.**

One of the main problems of valuing a company by capitalization is the choice of the update or capitalization rate.

Conceptually the update rate converts future monetary magnitudes into current monetary magnitudes. To some extent it represents the exchange relationship between future cash flow expectations with present collection and payment.

From this concept it is deduced that a higher risk investment will lead to a higher update rate and conversely, for very safe investments a lower rate. If the update is done against a background of high inflation, the corresponding rate will be high. Future cash flow expectations will be converted into present cash flows and they will have less purchasing power. Against a background of low inflation, the opposite will occur.

Another characteristic, which may influence the update rate is liquidity. In fact, when risk and inflation are the same, that investment will be preferred with greater liquidity or capacity to become money. Liquidity can therefore have a positive effect on the choice of update rate, so the greater the liquidity the less the update rate and vice versa.

The discount rate therefore must reflect the risk of the project and the financial structure of the investment . If we consider both the cost of debt and the cost of equity then we have the Weighted Average Cost of Capital (WACC).

### **Time horizon.**

For company valuation the hypothesis of unlimited duration has gradually been abandoned and what is estimated is the duration of the investment or, in other words,



the number of annual cash flows to be updated.

Although there are no fixed rules, most authors seem to think that a useful life of a company is between five and ten years for companies with an economic activity that we could call normal, with a minimum of three to a maximum of twenty, incorporating in the last cash flow the residual value.

Nevertheless the number of years to be considered depend on many variables, and perhaps the most important could be one's confidence in the future, based on the knowledge of the company, the business evolution and the market.

The number of periods can be also increased when an important future event has to be included in the cash flows.

### **Residual value.**

When the number of annual updated cash flows is not very high or, even when it is, a company's activity requires large investments in durable fixed assets and it is necessary to consider a company's residual value at the end of its useful life. In this instance, an additional cash flow must be considered corresponding to a company's residual value at the end of its activity.

$$V = \frac{Q_1}{(1+r)} + \frac{Q_2}{(1+r)^2} + \dots + \frac{Q_n}{(1+r)^n} + \frac{A_n}{(1+r)^n}$$

$A_n$  = A company's residual value at the end of its activity

### ***Free Cash Flow calculation (to be discounted at WACC)***

Cash flows generated by a firm in millions of pesetas.

YEAR	1994	1995	1996	1997	1998	1999	2000...
Net profit							
+ Taxes							
+ Financial expenses							
= EBIT							
- Taxes							
= EBIT (1-t)							
+ Deprec.&Amortization							
+ Provisions							
<b>CF FROM OPERATIONS</b>							
- Capex							
+/- Change Working Capital							
<b>FREE CASH FLOW</b>							

## V. Valuation methods based on share price information.

The stock market value of a company is obtained by multiplying the share price index by the number of shares.

It is not possible to confuse the stock market value with a company's market value, since it is just an indication to bear in mind when estimating market values.

Some share valuation methods are based on the capitalization of earning expectations, either directly or indirectly. For example, the Shapiro model explains the value of a share using future dividends and capital gains. The Modigliari and Miller model estimates a company's stock market value (market value of its shares) capitalizing the net earning at a given rate of interest, or the PER ratio (Price Earning Ratio) which relates the share price to the earning per share.

How is the PER calculated?

Share price = 1,400 m.u.

PER = 7.78

Earning per share = 180 m.u.

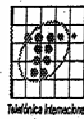
That is to say, if 1,400 m.u. were paid for a share giving 180 m.u. a year, it would take 7.78 years to recoup the capital, and the return on the share would be equal to 12.857%  
= (180/1,400)

*Example (Stock market value using the PER ratio)*

If only the earning per share is known, and the PER of several companies in the sector is for example, 10, the expected stock market value of a share will be:

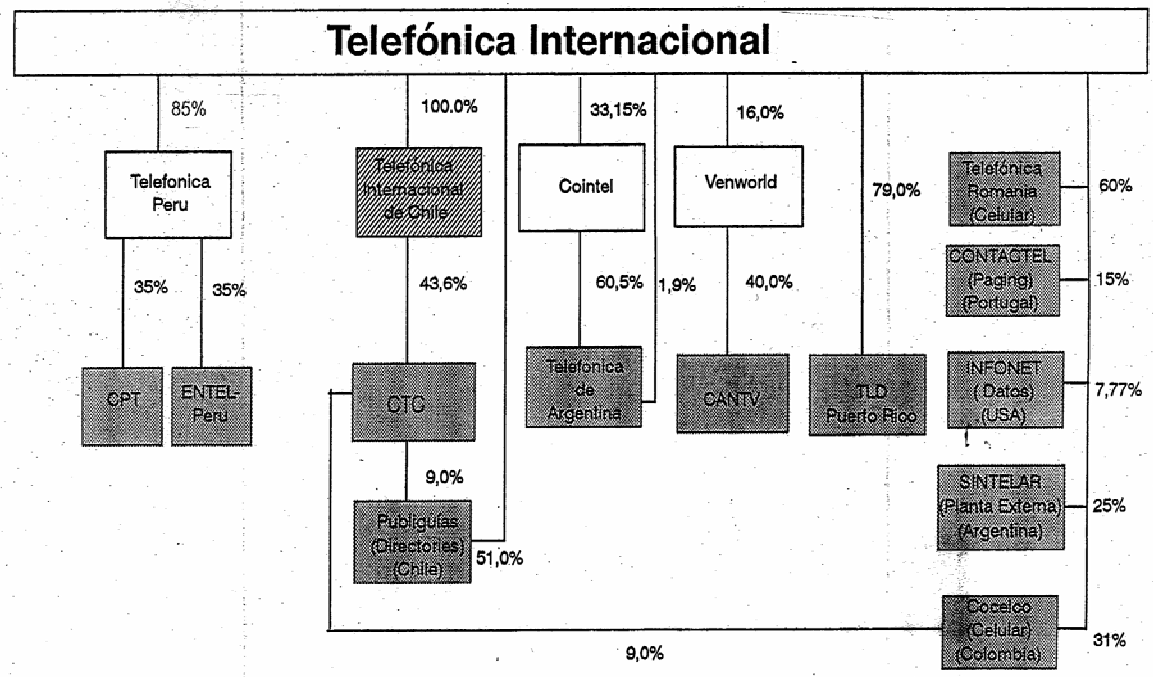
$$V = 10 \times 180 = 1,800 \text{ m.u.}$$

## VI. TISA's Organizational Structure.



### Estructura organizativa de Telefónica Internacional

Consorcios    
  Holdings    
  Compañías Operativas



## VII. Sources.

- “MÉTODOS DE VALORACIÓN DE EMPRESAS” Vicente Caballer Mellado.  
Editorial Pirámide
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