

Wednesday, 06 September 2023

## OVERWEIGHT

Maintain

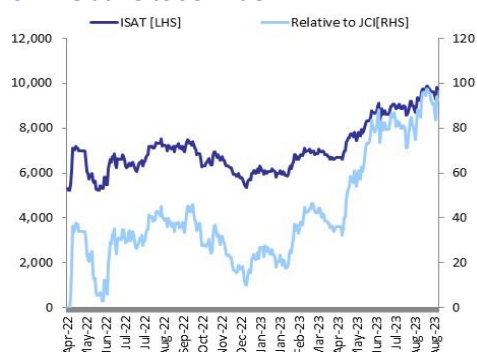
## Telco

### Merger of #3 and #4 players to be potentially beneficial for EXCL and the sector

#### EXCL relative to JCI Index



#### ISAT relative to JCI Index



Source : Bloomberg

We continue to see the merger of #3 and #4 operators to be a sensible option for both players to strengthen their resources and reach. We believe industry changes in recent years should make stronger likelihood for this transaction to happen now. We maintain our OW rating on the sector and reiterate our Buy rating on EXCL and ISAT as our top picks.

**Why has the merger failed in the past?** A potential merger between #3 (EXCL) and #4 (FREN) operators (which resurfaced in a Bloomberg article this week) has been available and sensible option for both players (i.e., better resources and market reach). Despite this, we reckon this has failed to happen since FREN held up on its key bargaining chips namely: sector leadership with 52MHz spectrum (now 62MHz) in attractive bands (800MHz & 2300MHz), a subs base of 28mn in 2020 with 1.9MHz/sub, its uniquely-focused 4G operation (with no legacy business), a large business clientele from within Sinarmas group, and its shareholder's group own reach. These allowed them to bargain on a high valuation basis.

**What has changed? Smartfren 4G advantage may have been eroded.** We believe FREN's operational advantages have now been eroded. The merger of Indosat & Hutch3 eliminated them from the M&A discussions, and FREN is only a good fit now for XL. Moreover, legacy 3G networks have been switched-off suggesting that majority of Indonesian subs have moved to 4G usage, thus eroding FREN's edge in 4G. While in 1H23, FREN still managed to grow its coverage to 45.6k 4G BTS (37.5k in 2020) and subs to 36mn in 2Q23, these failed to drive ARPU growth (which still hovers at ~Rp25k) with revenue Rp2.8tn in 2Q23 growing 9% in the span of 10 quarters. Looking at the Opensignal KPIs (exhibit 4), FREN carries limited network leverage at this point. We think FREN can improve ARPU through better network experience which requires investments in additional sites. The close relationship with affiliate Moratelindo provides FREN with good access to tower sites and fiber backbone. However, the high FREN leverage (at 5x net debt/EBITDA) and low oFCF, limits its capacity for more network rollout and compete in 4G and onwards in 5G as the sector evolves.

**Will it materialize this time? Not merging may soon no longer be an option.** In a recent media event (Aug. 25<sup>th</sup>) the need for business collaboration was raised by both CEOs of XL and FREN. We think this view marked a shift from FREN. Nonetheless, we think an option to merge is justified spanning across business areas from infrastructure to sales. (pls refer to details in exhibit 1). We think both XL and FREN will likely realize that, on standalone basis, the current landscape has allowed Telkomsel and IOH to grow at their expense. We see a likely scenario of a deal parallel to ISAT & Hutch (where both shareholders ended up owning equal stake in the holding company with fair share of seats in BOC & BOD for both and injections from Hutchison Group).

**The merger shall support EXCL's long-term strategy.** We believe that XL's endgame is to lead in the FMC asset light model. XL 2Q23 ARPU sat at Rp42k and with FMC offerings we reckon can add an incremental Rp150-200k for several of its subs accounts in the medium term. The merger scenario will give them more spectrum, more addressable markets and better opex/capex efficiency. Reiterate our Buy rating on EXCL (TP Rp3,900). FREN overridden with debt, can become profitable on the 4G by sharing tower sites, avoid roll out duplications and reach faster profitability, while positioning in the 5G.



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Company	Ticker	Rec	Target Price	Market Cap.	P/E (x)		P/BV (x)		ROE (%)
			(Rp)	(RpBn)	2023F	2024F	2023F	2024F	2024F
XL Axiata	EXCL IJ	BUY	3,900	32,418.4	23.4	15.5	1.2	1.2	7.7
IOH	ISAT IJ	BUY	11,100	78,409.8	23.8	21.6	2.7	2.5	11.8
Telkom	TLKM IJ	BUY	4,435	375,445.8	18.1	15.3	2.9	2.7	18.5

**Two arguments for stronger merger case: 5G and FMC.** We see the sector has pivoted with the advent of a new double revenue play for Indonesian telcos. 5G main use case is the FWA (fixed wireless access) to be offered at affordable prices expecting massive service penetration. Fixed Broadband and FWA can sit on the asset-light strategy foundations, separating infrastructure support from the business marketing to end user, and inline with the spirit of Omnibus Law. Thus, the merger can be a breakthrough for EXCL and FREN in re-arranging their structures for mobile enjoying more network throughput with consolidated spectrum. On the infra side, both EXCL and FREN consumer business can source homepasses and FWA connections from the affiliated infrastructure entities such as Moratelindo and Linknet. We think a merger between XL and FREN will expedite the segregation of EXCL's and Sinarmas entities between consumer and infrastructure businesses.

Moreover, both players will be able to bid more viably together for 5G spectrum which will support further the sales of FWA connections to households to support massive penetration in the coming years.

#### Exhibit 1: Benefits from a potential merger of #3 and #4 players

##### Sales – Revenue area:

###### ➤ **New business:**

XL aims to lead in the FMC asset light model. Apart from Linknet, Sinarmas group can support with the supply of homepasses for fixed broadband and FWA.

###### ➤ **Retail customers:**

Potentially maintain the brands XL, Axis, Smartfren segregating the subscribers accordingly.

EXCL can cross – sell to FREN subscribers with fixed internet products.

###### ➤ **Business customers:**

Sinarmas Group business activities span in many sectors of the Indonesian economy incl. property, commodities. XL will potentially have significant upside amid still limited revenue exposure from these business segments thus far.

###### ➤ **Competition landscape:**

We expect mobile market repair to continue. Oligopoly effects can be more pronounced after a 2<sup>nd</sup> merger that results in 3-player market.

##### Network Infrastructure:

###### ➤ **Capex /opex efficiency:**

Significant upside through capex prioritization and better monetization of new sites to reflect the improved revenue trajectories and profitability

###### ➤ **Frequency spectrum:**

The total spectrum from a combined telco of EXCL & FREN may put them at par with IOH or slightly above (depending on deliberations with Kemkominfo).

A larger telco with better economies of scale can generate larger oFCF. This will put the merged telco in a more credible position among peers to bid in the upcoming spectrum auction for 4G and 5G.

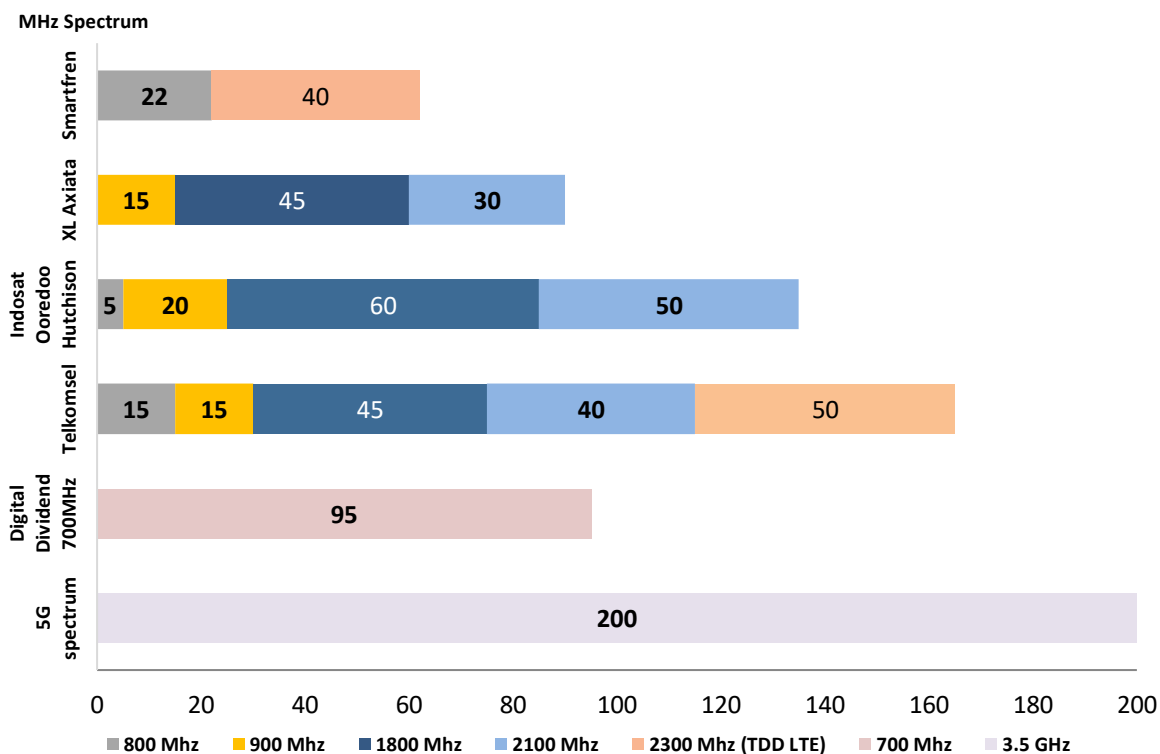
###### ➤ **Tower sites, rollouts**

It has been suggested that FREN coverage differs from its peers. Nonetheless a sizeable upside from sites optimization and relocation should be in the cards.

We expect more coverage in ex-Java for the merged telco as Moratelindo can help branch out the network from West and East Palapa rings.

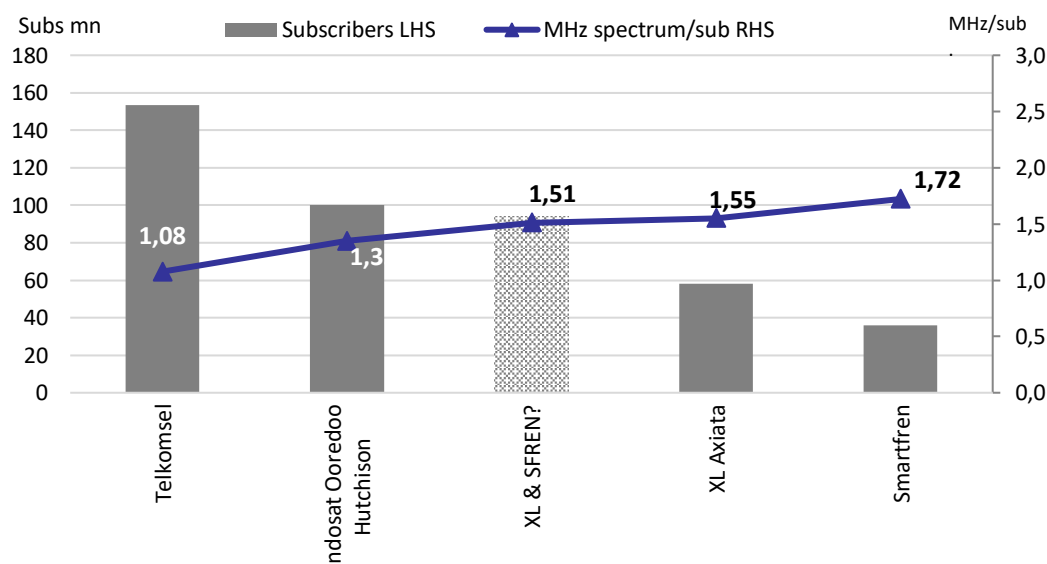
Source: BRIDS

**Exhibit 2: Frequency spectrum allocations and potential ones for telecommunications in Indonesia.**



Source: Telco Operators, media references

**Exhibit 3: Subscriber base of telcos and corresponding spectrum frequency per subscriber**



Source: Telco Operators, media references, BRIDS

Exhibit 4: Opensignal network KPIs and ranking

NATIONWIDE MOBILE NETWORK KPIs (OpenSignal Tests)									
Period	Operator	Download speed: Overall	Upload speed	Video Experience	Voice App. Experience	Gaming experience	Availability 4G (on demand)	4G Coverage experience	Core Consistent Quality
Periodic Change (Feb-May 2023 vs. Aug01-Oct31 2022)									
periodic Δ - last testing period	Indosat Ooredoo	1.6	1.0	15.8	3.3	14.4	0.9	-1.5	-18.2
	XL Axiata	0.3	0.1	8.7	0.6	6.0	0.5	-1.9	-18.7
	Smartfren	3.1	0.2	18.0	0.7	4.5	0.0	-2.8	-15.6
	Telkomsel	4.4	1.3	14.3	1.2	5.7	-0.1	0.1	-23.1
	Hutchison 3	3.6	2.0	20.0	3.8	16.0	0.1	0.1	-13.0
	average	0.8	0.4	1.5	0.3	-2.4	0.1	0.1	7.2
periodic Δ, %	Indosat Ooredoo	11.7	13.7	38.1	4.4	26.1	0.9	-23.4	-22.8
	XL Axiata	1.4	1.3	18.7	0.8	8.9	0.5	-29.2	-24.0
	Smartfren	32.6	11.8	63.4	0.9	7.1	0.0	-54.9	-31.4
	Telkomsel	25.0	15.9	31.0	1.6	8.9	-0.1	1.1	-27.6
	Hutchison 3	30.8	30.8	52.9	5.1	29.3	0.1	2.1	-18.3
	average	20.3	14.7	40.8	2.6	16.1	0.3	-20.9	-24.8
NETWORK RANKING (1-5) 1 being the worst, 5 being the best									
Period: Feb01 - May01 2023		Download speed: Overall	Upload speed	Video Experience	Voice App. Experience	Gaming experience	Availability y 4G (on demand)	4G Coverage experience	4G Coverage experience
Network Performance	Indosat Ooredoo	2	3	3	3	2	2	3	5
	XL Axiata	4	2	2	4	5	2	2	3
	Smartfren	1	1	1	1	1	5	1	1
	Telkomsel	5	5	5	2	3	1	5	4
	Hutchison 3	2	4	4	5	4	2	3	2
Network Improvement	Indosat Ooredoo	2	3	3	4	4	5	3	3
	XL Axiata	1	1	1	1	3	4	2	2
	Smartfren	3	2	4	2	1	2	1	4
	Telkomsel	5	4	2	3	2	1	4	1
	Hutchison 3	4	5	5	5	5	3	5	5

Source: Opensignal, BRIDS

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