



TELECOM ITALIA CAPITAL S.A.

CUSIP: 87927VAQ1

Credit Rating Report

TELECOM ITALIA CAPITAL S.A. is a subsidiary of TELECOM ITALIA S.P.A. This section details the Moody's ratings for CUSIP 87927VAQ1.

Moody's Long-Term Rating
as of 02/11/2013

Baa3

Watch Status TELECOM ITALIA CAPITAL S.A. 08/08/2013

Upgrade **Downgrade** Uncertain Not on Watch

Moody's uses Watch Status to indicate that a rating is under review for possible change in the short-term.

Long-Term Rating TELECOM ITALIA CAPITAL S.A. 02/11/2013

Investment Grade Non-Investment Grade

Obligations rated Baa are subject to moderate credit risk. They are considered medium-grade and as such may possess certain speculative characteristics.

TELECOM ITALIA S.P.A.

Credit Rating Report

This section details the Moody's ratings for TELECOM ITALIA S.P.A.

Moody's Long-Term Rating
as of 02/11/2013

Baa3

Watch Status TELECOM ITALIA S.P.A. 08/08/2013

Upgrade **Downgrade** Uncertain Multiple Not on Watch

Moody's uses Watch Status to indicate that a rating is under review for possible change in the short-term.

Long-Term Rating TELECOM ITALIA S.P.A. 02/11/2013

Investment Grade Non-Investment Grade

Issuers or issues rated Baa represent average creditworthiness relative to other US municipal or tax-exempt issuers or issues.

Moody's Rating Outlook TELECOM ITALIA S.P.A. 08/08/2013

Positive Negative Stable Developing **Under Review** No Outlook Withdrawn

A Moody's Rating Outlook is an opinion regarding the likely direction of a rating over the medium term.

Key Indicators TELECOM ITALIA S.P.A.

	2007	2006
RCF/Adjusted Debt	14,41%	16,46%
FCF/Adjusted Debt	1,39%	1,28%
Total Debt/EBITDA	3.4x	3.2x
(FFO+Interest Exp)/Interest Expense	4.3x	4.6x
(EBITDA-Capex)/Interest Expense	2.5x	2.9x

Corporate Profile

Telecom Italia Group (Telecom Italia, consisting of Telecom Italia S.p.A. and its subsidiaries, Baa3 on review for downgrade) is the leading integrated telecommunications provider in Italy, delivering a full range of services and products, including telephony, data exchange, interactive content and information and communications technology solutions. It is also the operator of one of the three national TV networks. The group reported some 13.6 million fixed-network physical access telephone lines and 31.7 million mobile telephone lines in Italy as of June 2013. The group is also one of the top telecoms players in Argentina, with 19.3 mobile customers, and in the Brazilian mobile market, operating through its subsidiary Telecom Italia Mobile (TIM) Brasil, which had 72.2 million mobile telephone lines as of June 2013. Telecom Italia's major shareholder is a consortium (Telco S.p.A.) composed of Telefónica S.A. (Baa2 negative), the insurance company Generali, and the banks Mediobanca and Intesa Sanpaolo. This consortium held a 22.4% stake in Telecom Italia as of 31 December 2012 and is governed by a shareholder agreement. We view this shareholder group as being stable and having a long term investment strategy. Telco S.p.A. has some EUR3.4 billion of debt to finance the shareholding in Telecom Italia. This debt is not accounted for in Telecom Italia's adjusted debt figures, but is serviced from the group's dividends.

Moody's Opinion: TELECOM ITALIA S.P.A. as of 08/09/2013

Rating Drivers

- Weak operating results reflect challenges to deliver performance targets
- Management remains committed to deleveraging and maintaining financial discipline, but fewer internal options available and may not be sufficient to offset increased business risk and sustain the current rating
- Large size and scale and some geographical diversification with strong positions and growth potential in Brazil and Argentina
- Network separation expected to be broadly neutral to the rating, but better regulatory conditions are anticipated
- Solid liquidity management

SUMMARY RATING RATIONALE

Telecom Italia's ratings are currently under review for downgrade reflecting the deterioration in Telecom Italia's domestic revenues and EBITDA, as shown in its Q2 2013 results, as well as a failure to achieve some of its committed operating performance targets. The deterioration is driven by the worsening economy, higher unemployment, adverse regulatory effects and more intense competition in Italy, and Telecom Italia's inability to meet its domestic and group EBITDA targets has raised concerns. This negative development is despite the group having partially mitigated the effects of a very tough market. As a result, Telecom Italia is likely to struggle to achieve its reported net

**TELECOM ITALIA S.P.A.****Credit Rating Report****SUMMARY RATING RATIONALE** ...continued from page 1

financial position target of under EUR27 billion by year end.

Telecom Italia's Baa3 rating is supported by the company's (1) scale; (2) integrated telecoms business model, with strong market positions in both the fixed and mobile segments; (3) geographical diversification, mainly as a result of its presence in Brazil and Argentina; (4) continued commitment to debt reduction and financial discipline; and (5) high operating margins, ongoing operational expenditure (opex) reductions and strong liquidity.

The Baa3 rating also factors in (1) the deterioration in Telecom Italia's operating performance, including an expected further EBITDA decline this year; (2) management's plan to partially offset the weakened performance with a lower debt level; and (3) the company's outlook for the 2013-15 period.

DETAILED RATING CONSIDERATIONS**WEAK OPERATING RESULTS REFLECT CHALLENGES TO DELIVER PERFORMANCE TARGETS**

We note that Telecom Italia will continue to face substantial challenges in 2013, including the ongoing recession in Italy, adverse regulation and rising levels of competition, all of which have served to erode the company's domestic revenues and EBITDA. Telecom Italia suffered a fall in revenue of around 7.0% during H1 2013 (on a reported basis compared with the same period of 2012), mainly driven by the 10.4% decline in domestic market.

The Italian fixed-line voice market has also been influenced by the development of mobile operators, which attract voice traffic through their mobility advantage but are subject to cannibalisation by the increasing penetration of alternative communication solutions (messaging, emailing, chats and social networks). As a result of increasing competition and the more challenging operating environment, we anticipate continued overall downward pressure on Telecom Italia's fixed-line operations.

In the mobile segment, we expect the company's domestic mobile revenues to continue to decline as a result of ongoing competitive pressure and the need to reprice. We anticipate that the decline might reverse in the second half of this year, as mobile termination rate (MTR) cuts are completed, and because we expect less aggressive price cuts by Vodafone (A3 review for downgrade), Wind (B1 negative) and 3-Italia (not rated). However, we also believe that the more negative prospects for the Italian macroeconomic environment might also weigh on Telecom Italia's revenues in the second half. While we expect 2013 to be a challenging year for Telecom Italia, we also expect its revenues to stabilise in 2014 - although some uncertainty remains as we have recently revised downwards our macroeconomic assumptions for Italy in 2014 - and the company to achieve some growth in 2015. This growth will be supported by the company's initiatives to monetise underlying demand for smartphones and broadband-related services as LTE/4G and fibre to the home (FTTH) are rolled out.

In order to offset pressures on its domestic operations, we would expect Telecom Italia to continue to cut operating expenditures (opex), and enhance both its fixed and mobile service offerings through competitive pricing and bundled offers. The company will continue to benefit from its growing business in Brazil and Argentina, although we note that the repatriation of dividends from Argentina is very uncertain in light of current foreign currency controls.

While stronger marketing and commercial efforts will dent Telecom Italia's EBITDA margins (reduced to 38.1% during H1 2013 from 39.6% in H1 2012), based on its track record we expect the company to sustain fairly strong margins because of its focus on delivering opex cuts and the lack of handset subsidies.

Telecom Italia's management confirmed that the group's revenue trend for 2013 would remain stable. However, it readjusted its EBITDA guidance to a mid-single-digit decline for 2013 at group level and a high-single-digit decline for domestic operations. The company's management is facing difficulties in forecasting highly volatile domestic mobile revenues in a very challenging market, as reflected by its readjustment of its EBITDA guidance less than three months after its previous guidance commitments.

MANAGEMENT REMAINS COMMITTED TO DELEVERAGING AND MAINTAINING FINANCIAL DISCIPLINE BUT FEWER INTERNAL OPTIONS AVAILABLE AND MAY NOT BE SUFFICIENT TO OFFSET INCREASED BUSINESS RISK AND SUSTAIN THE CURRENT RATING

The group has prioritised deleveraging over shareholder remuneration to reduce its debt at a rate of approximately EUR2 billion per year over the next couple of years. We recognise the range of actions initiated by management with a view to underpinning the group's capital structure and enhancing its financial flexibility. The debt reduction plan includes a reported net financial position of less than EUR27 billion by year-end 2013 (from EUR28.3 billion as of 31 December 2012).

Telecom Italia has cut its dividend to around EUR450 million per annum in 2013-2015, from EUR1.0 billion in 2012 and EUR1.3 billion in 2011. The dividend reduction supports Telecom Italia's objective of cutting its net debt level and increasing free cash flow to improve its financial flexibility.

**DETAILED RATING CONSIDERATIONS** ...continued from page 2

In addition, Telecom Italia announced on 13 March 2013 a EUR750 million hybrid bond issue, together with an additional EUR2.2 billion to be issued over the next 18-24 months from February 2013, to alleviate some pressure on the company's leverage. We assigned a substantial equity credit to the recent hybrid bond and noted that the proposed issuance of the hybrid debt was in line with Telecom Italia's financial policies. This was in the context of a challenging operating environment in which Telecom Italia's performance will remain weak, affected by regulation, fierce competition and the adverse macroeconomic conditions in Italy as well as in other countries in which the group operates.

Telecom Italia's earlier cut in dividends and hybrid issuance will most likely not be sufficient to offset the negative effect on its cash flow of a weaker-than-expected performance and the operating challenges ahead. These strategies also leave the company with fewer internal options to protect its financial profile in the event of a further sustained deterioration in its operating performance.

We remain concerned that Telecom Italia is facing stronger headwinds than previously expected in its efforts to improve its financial ratios. Given the challenging operating conditions in Italy, and limited options to strengthen the company's balance sheet, management may find it difficult to meet its updated deleveraging commitment of a reported net financial position/EBITDA of below 2.0x in the next 24 months.

SCALE AND GEOGRAPHICAL DIVERSIFICATION ARE KEY TO OFFSET EXPOSURE TO THE DOMESTIC MARKET

Telecom Italia's rating reflects its large scale (last-twelve-months' revenues in excess of EUR28.5 billion as of June 2013) and the diversification benefits associated with its strong positions in Brazil and Argentina, which contribute to revenue growth at the group level despite currently limited cash up-streaming.

We would expect the Latin American segment to be the main contributor to Telecom Italia's consolidated revenue and EBITDA growth, given the significant expansion we anticipate in the Brazilian market in the short to medium term and in spite of the expected slowdown in GDP growth for this year (refer to Moody's updated macro economic outlook, dated 13 May 2013

http://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_153268).

Telecom Italia's exposure to Brazil, although growing, is still reasonably modest: for the first half of this year, TIM Brasil's operations accounted for approximately 26.3% of group revenues (compared with 25.2% in the same period the previous year) and 17.6% of reported EBITDA (compared with 16.9%). In Brazil, the combination of increasing mobile coverage and smartphones penetration will allow significantly higher growth rates compared with that of mature markets, such as Europe.

For the first half of the year, Argentina represented around 13.8% of total group sales and 10.3% of total group EBITDA. We note that although Telecom Argentina is fully accounted for under the global consolidation method, Telecom Italia has an economic interest in the company of only 22.7%. While this appears to be sufficient for Telecom Italia to effectively control Telecom Argentina, we would not expect any cash up-streaming in the medium term. In addition, Telecom Italia's leverage ratio benefits from the full consolidation of its business in Argentina. Furthermore, the repatriation of dividends from Argentina remains very uncertain in light of current foreign currency controls, which could justify ignoring this subsidiary for ratio calculation purposes. On that basis, Telecom Italia's leverage would be around 0.3x higher. This is one of the reasons why we are more demanding in terms of the credit metrics that we expect the company to report in order to maintain the current rating.

NETWORK SEPARATION NEUTRAL TO THE RATING BUT EXPECTED TO IMPROVE REGULATORY CONDITIONS

On 30 May 2013, Telecom Italia announced the separation of its access network, with its aim being to establish this as a separate company. The assets and resources for developing and managing the passive access network (both copper and fibre) and the active components of the fibre, consisting of OLT (Optical Line Termination) and cabinet, will be spun off to the new company. The new structure will guarantee all operators (OLOs and Telecom Italia) access to the fixed-line network.

We think such a deal would be credit neutral to the rating at best. In addition, we think the separation would weaken Telecom Italia's position as the incumbent operator in the Italian market, by opening up the network and giving equal access to all competitors using the same processes and procedures with full transparency.

The factor that differentiates Telecom Italia from competitors' i.e., its position as an incumbent operator that owns the network infrastructure, would be lost as a result of such a deal. We would expect Telecom Italia to go ahead with the separation only if it improved regulatory conditions. This could be done by either creating a separate division to be 100% owned by Telecom Italia, or by creating a new company and agreeing to bring in a third party, such as Cassa Depositi e Prestiti (Baa2 negative), as an additional shareholder (this has been referred to by CEO Mr. Bernabe on several occasions, including during the Q1 results presentation). Cassa Depositi e Prestiti is a government-related issuer (GRI), 70% owned by the government, with which it has a strong financial and operational link, as reflected in its public policy function.

**TELECOM ITALIA S.P.A.****Credit Rating Report****DETAILED RATING CONSIDERATIONS** ...continued from page 3

The latter option would imply a substantial amount of cash (a minority stake could be sold according to management's comments during its Q1 results presentation), which we would expect to be up-streamed and used to reduce debt at the Telecom Italia level. Although this would be credit positive, we would expect it to be offset by the dilution in cash flow resulting from the dividend payment to Cassa Depositi e Prestiti.

Liquidity Profile

We consider Telecom Italia's liquidity profile to be solid, based on its free cash flow generation, available cash resources and committed credit lines, and an extended debt maturity profile. Telecom Italia's debt maturities are fairly evenly spread out and back-loaded, with around 50% of liabilities due beyond 2016. However, should the Italian government's creditworthiness weaken in the future, this would likely result in increasingly challenging bank and capital market conditions, which could eventually restrict Telecom Italia's ability to access liquidity. We acknowledge the company's currently ample access to liquidity due to its current cash position of more than EUR6.1 billion and EUR6.5 billion in available bank funding, which support its debt maturities through 2015. In addition, we take comfort from Telecom Italia's diversified sources of funding, as well as from the fact that a significant portion of its committed lines are with international banks.

We further note that there is no significant structural subordination of creditors at the Telecom Italia level, given the group's policy of avoiding external debt at the operating subsidiary level. In addition, the group's operations in Brazil and Argentina fund themselves on a non-recourse basis.

Rating Outlook

Telecom Italia's ratings are on review for downgrade. During the rating review, we will assess the negative effect on the company of the continuing tougher-than-expected domestic mobile business in 2013, which has been aggravated by intensified competitive pressure and adverse regulation. An important consideration will be the extent to which management can compensate for the increased risk by implementing measures to strengthen the balance sheet and reduce financial risk. We will also assess if these measures would be sufficient and timely enough to fully offset the company's increased business risk. In addition, we will assess the extent to which Telecom Italia will be able to meet its commitments to reduce group debt and maintain ratios within current rating limits, given that operating cash flow will likely continue to deteriorate at a faster-than-expected pace. Although the group's international diversification partially mitigates the domestic pressure on revenues, limited cash up-streaming and the expected lower growth rates at its Brazilian subsidiary TIM Brazil could challenge Telecom Italia's ability to meet group financial guidance.

What Could Change the Rating UP

The ratings are on review for downgrade and we do not currently anticipate upward rating pressure. However, prior to the current review process being initiated, we had indicated that we could consider a stabilisation of the outlook if the company delivered improved financial metrics on the back of a supportive operating environment, including a net adjusted debt/EBITDA comfortably below 2.8x. We had also noted that upward pressure could result over time if Telecom Italia's net adjusted debt/EBITDA were to improve to below 2.5x.

What Could Change the Rating DOWN

Prior to initiating the review, we had indicated that downward pressure on the rating could potentially result if (1) Telecom Italia were to deviate from management's announced debt reduction plan, which includes a reported net financial position of less than EUR27 billion by year-end 2013; and (2) the company's overall financial metrics do not gradually improve in line with their plan, which includes positive low-single-digit revenue and a positive EBITDA compound annual growth rate through 2015. More specifically, we had noted that a rating downgrade could result if the company failed to sustainably reduce its net adjusted debt/EBITDA ratio to below 2.8x.

Other Considerations**METHODOLOGY GRID**

The grid-indicated rating of Baa2 is one notch above Telecom Italia's actual rating of Baa3. The difference reflects increasing business and operational risks that are not offset by the company's credit metrics, which remain weak for the grid's indicated rating level.

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Rating Definitions

Long-Term Obligation Ratings

Moody's long-term obligation ratings are opinions of the relative credit risk of fixed-income obligations with an original maturity of one year or more. They address the possibility that a financial obligation will not be honored as promised. Such ratings reflect both the likelihood of default and any financial loss suffered in the event of default.

- Aaa** Obligations rated Aaa are judged to be of the highest quality, with minimal credit risk.
- Aa** Obligations rated Aa are judged to be of high quality and are subject to very low credit risk.
- A** Obligations rated A are considered upper-medium grade and are subject to low credit risk.
- Baa** Obligations rated Baa are subject to moderate credit risk. They are considered medium-grade and as such may possess certain speculative characteristics.
- Ba** Obligations rated Ba are judged to have speculative elements and are subject to substantial credit risk.
- B** Obligations rated B are considered speculative and are subject to high credit risk.
- Caa** Obligations rated Caa are judged to be of poor standing and are subject to very high credit risk.
- Ca** Obligations rated Ca are highly speculative and are likely in, or very near, default, with some prospect of recovery of principal and interest.
- C** Obligations rated C are the lowest rated class of bonds and are typically in default, with little prospect for recovery of principal or interest.

Note: Moody's appends numerical modifiers 1, 2, and 3 to each generic rating classification from Aa through Caa. The modifier 1 indicates that the obligation ranks in the higher end of its generic rating category; the modifier 2 indicates a mid-range ranking; and the modifier 3 indicates a ranking in the lower end of that generic rating category.

Rating Outlooks

A Moody's rating outlook is an opinion regarding the likely direction of a rating over the medium term. Where assigned, rating outlooks fall into the following four categories: Positive (POS), Negative (NEG), Stable (STA), and Developing (DEV -- contingent upon an event). In the few instances where an issuer has multiple outlooks of differing directions, an "(m)" modifier (indicating multiple, differing outlooks) will be displayed, and Moody's written research will describe any differences and provide the rationale for these differences. A RUR (Rating(s) Under Review) designation indicates that the issuer has one or more ratings under review for possible change, and thus overrides the outlook designation. When an outlook has not been assigned to an eligible entity, NOO (No Outlook) may be displayed.

Watchlist

Moody's uses the Watchlist to indicate that a rating is under review for possible change in the short-term. A rating can be placed on review for possible upgrade (UPG), on review for possible downgrade (DNG), or more rarely with direction uncertain (UNC). A credit is removed from the Watchlist when the rating is upgraded, downgraded or confirmed.

Provisional Ratings

As a service to the market and typically at the request of an issuer, Moody's will assign a provisional rating when it is highly likely that the rating will become final after all documents are received, or an obligation is issued into the market. A provisional rating is denoted by placing a (P) in front of the rating. Such ratings may also be assigned to shelf registrations under SEC rule 415.



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