

France Telecom (FTE.PA)

Turnaround Easier Said Than Done

- **Remain sellers** — Yesterday's results showed that operating trends are getting worse, but not worse than expected. Management remain cautious on 2013 but still expect a stabilisation of operating cash flows in 2014, driven by more effort on cost cutting. We remain unconvinced that FT can turn around its business due to the very challenging competitive, macro and regulatory environment. We remain Sellers and cut our price target from €8.30 to €7.00 to reflect reduced estimates and a lower perpetuity growth assumption in our DCF analysis.
- **Cut to forecasts** — We have reduced our EPS forecasts by 0.1% for 2013E and 3.0% for 2014E to reflect lower margin assumptions for France. We are slightly below FT's OpFCF target for FY13E of above €7bn (Citi: €6.9bn). We forecast OpFCF to decline by 3.9% yoy in 2014E.
- **Dividend risk** — FT management reiterated their commitment to a flat dividend in 2013 and a reduction in leverage to 2.0x net debt/EBITDA by 2014. We expect the dividend to be cut again to €0.60 per share in 2013 unless FT is prepared to divest some of its assets like mobile towers and use more operating leases.
- **More repricing in French mobile** — FT has repriced about 50% of its customer base at the end of 2012. We expect another price cut in April but remain concerned that we have not yet reached the bottom, in particular if Orange or Bouygues decide to react more aggressively than the market anticipates to SFR's recent price cut.
- **Low return on fixed capex** — The performance of the French fixed business remains disappointing in broadband, especially considering the continuous growth in capex. We expect the performance to improve in 2013 partly helped by regulation (higher ULL rate, increase in line rental) but still expect FT to lose market share. Fibre is doing well but is still too small to have a material impact on performance.
- **Telecoms Conference** — Our 13th Annual European and Emerging Markets Telecoms Conference is being held at the Radisson Mayfair Hotel on the 19th March to the 21st March. Please register your attendance by clicking [here](#).

- Company Update
- Target Price Change
- Estimate Change

Sell	3
Price (20 Feb 13)	€7.56
Target price	€7.00
	from €8.30
Expected share price return	-7.4%
Expected dividend yield	5.3%
Expected total return	-2.1%
Market Cap	€20,026M
	US\$26,809M

Price Performance (RIC: FTE.PA, BB: FTE FP)



France Telecom (EUR)

Year to 31 Dec	2011A	2012A	2013E	2014E	2015E
Sales (€M)	45,277.0	43,515.1	41,838.3	41,134.5	40,748.7
Net Income (€M)	3,895.0	819.8	2,640.5	2,507.9	2,514.3
Diluted EPS (€)	1.47	0.31	1.00	0.95	0.95
Diluted EPS (Old) (€)	1.47	1.24	1.00	0.98	0.95
PE (x)	5.1	24.3	7.6	8.0	8.0
EV/EBITDA (x)	3.3	4.0	3.8	3.8	3.7
DPS (€)	1.40	0.80	0.60	0.60	0.80
Net Div Yield (%)	18.5	10.6	7.9	7.9	10.6

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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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FTE.PA: Fiscal year end 31-Dec						Price: €7.56; TP: €7.00; Market Cap: €20,026m; Recomm: Sell					
Profit & Loss (€m)	2011	2012	2013E	2014E	2015E	Valuation ratios	2011	2012	2013E	2014E	2015E
Sales revenue	45,277	43,515	41,838	41,134	40,749	PE (x)	5.1	24.3	7.6	8.0	8.0
Cost of sales	-36,839	-37,355	-35,692	-35,245	-34,927	PB (x)	0.7	0.8	0.8	0.7	0.7
Gross profit	8,438	6,160	6,147	5,890	5,821	EV/EBITDA (x)	3.3	4.0	3.8	3.8	3.7
Gross Margin (%)	18.6	14.2	14.7	14.3	14.3	FCF yield (%)	31.7	14.8	16.7	16.5	16.2
EBITDA (Adj)	15,129	12,495	12,617	12,274	12,116	Dividend yield (%)	18.5	10.6	7.9	7.9	10.6
EBITDA Margin (Adj) (%)	33.4	28.7	30.2	29.8	29.7	Payout ratio (%)	95	257	60	63	84
Depreciation	-4,253	-3,996	-4,082	-4,028	-3,971	ROE (%)	13.7	3.2	10.5	9.5	9.3
Amortisation	-2,482	-2,333	-2,383	-2,351	-2,318	Cashflow (€m)	2011	2012	2013E	2014E	2015E
EBIT (Adj)	7,948	4,063	6,283	6,035	6,002	EBITDA	15,129	12,495	12,617	12,274	12,116
EBIT Margin (Adj) (%)	17.6	9.3	15.0	14.7	14.7	Working capital	369	-56	0	0	0
Net interest	-1,941	-1,668	-1,798	-1,703	-1,610	Other	-2,619	-2,423	-2,651	-2,931	-2,898
Associates	-97	-263	131	140	175	Operating cashflow	12,879	10,016	9,967	9,343	9,217
Non-op/Except	-441	-1,901	0	0	0	Capex	-6,537	-7,073	-6,614	-6,040	-5,976
Pre-tax profit	5,915	2,335	4,485	4,332	4,391	Net acq/disposals	0	0	0	0	0
Tax	-2,087	-1,231	-1,525	-1,473	-1,493	Other	447	745	0	0	0
Extraord./Min.Int./Pref.div.	67	-284	-320	-351	-384	Investing cashflow	-6,090	-6,328	-6,614	-6,040	-5,976
Reported net profit	3,895	820	2,641	2,508	2,514	Dividends paid	-4,386	-4,215	-1,230	-1,844	-2,152
Net Margin (%)	8.6	1.9	6.3	6.1	6.2	Financing cashflow	-2,860	-5,072	-3,230	-3,844	-4,152
Core NPAT	3,895	820	2,641	2,508	2,514	Net change in cash	3,851	-1,358	124	-541	-910
Per share data	2011	2012	2013E	2014E	2015E	Free cashflow to s/holders	6,342	2,943	3,353	3,303	3,242
Reported EPS (€)	1.47	0.31	1.00	0.95	0.95						
Core EPS (€)	1.47	0.31	1.00	0.95	0.95						
DPS (€)	1.40	0.80	0.60	0.60	0.80						
CFPS (€)	4.87	3.80	3.76	3.53	3.48						
FCFPS (€)	2.40	1.12	1.27	1.25	1.22						
BVPS (€)	10.41	9.18	9.77	10.12	10.37						
Wtd avg ord shares (m)	2,644	2,633	2,649	2,649	2,649						
Wtd avg diluted shares (m)	2,644	2,633	2,649	2,649	2,649						
Growth rates	2011	2012	2013E	2014E	2015E						
Sales revenue (%)	-0.5	-3.9	-3.9	-1.7	-0.9						
EBIT (Adj) (%)	0.9	-48.9	54.7	-4.0	-0.5						
Core NPAT (%)	-23.8	-79.0	222.1	-5.0	0.3						
Core EPS (%)	-23.7	-78.9	220.1	-5.0	0.3						
Balance Sheet (€m)	2011	2012	2013E	2014E	2015E						
Cash & cash equiv.	8,044	8,321	8,495	7,953	7,043						
Accounts receivables	4,905	4,635	4,635	4,635	4,635						
Inventory	631	586	586	586	586						
Net fixed & other tangibles	28,815	28,692	28,841	28,502	28,189						
Goodwill & intangibles	38,683	37,591	37,591	37,591	37,591						
Financial & other assets	15,005	10,155	9,564	9,458	9,428						
Total assets	96,083	89,980	89,711	88,726	87,472						
Accounts payable	8,151	7,697	7,697	7,697	7,697						
Short-term debt	7,462	7,447	7,447	7,447	7,447						
Long-term debt	33,933	31,883	29,883	27,883	25,883						
Provisions & other liab	16,945	16,569	16,569	16,569	16,569						
Total liabilities	66,491	63,596	61,596	59,596	57,596						
Shareholders' equity	27,573	24,306	25,887	26,806	27,466						
Minority interests	2,019	2,078	2,228	2,324	2,410						
Total equity	29,592	26,384	28,115	29,130	29,876						
Net debt	33,351	31,009	28,835	27,377	26,287						
Net debt to equity (%)	112.7	117.5	102.6	94.0	88.0						

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For definitions of the items in this table, please click [here](#).

Forecast Changes

We have reduced our margin estimates for France and increased our estimates for Spain. Overall we have cut our EBITDA estimates by 1.3% in 2013 and 2.1% in 2014. 4Q12 results were broadly in line with our expectations except for net income, which was negatively impacted by high impairment charges.

Figure 1. Forecast Changes (In €m except per share data)

	New 2012	New 2013	New 2014	Old 2012	Old 2013	Old 2014	change % 2012	change % 2013	change % 2014
France	21,431	20,089	19,164	21,415	19,984	19,044	0.1%	0.5%	0.6%
o/w personal	10,686	9,732	9,157	10,663	9,613	9,043	0.2%	1.2%	1.3%
o/w home	12,375	12,045	11,726	12,368	12,040	11,700	0.1%	0.0%	0.2%
Spain	4,027	3,950	4,007	4,006	3,949	4,009	0.5%	0.0%	-0.1%
o/w personal	3,262	3,142	3,172	3,241	3,145	3,174	0.6%	-0.1%	-0.1%
o/w home	765	807	835	764	804	835	0.1%	0.4%	0.0%
Poland	3,381	3,149	3,043	3,299	3,149	3,043	2.5%	0.0%	0.0%
o/w personal	1,787	1,740	1,693	1,750	1,740	1,693	2.1%	0.0%	0.0%
o/w home	1,873	1,715	1,599	1,812	1,715	1,599	3.4%	0.0%	0.0%
RoW	8,281	8,296	8,448	8,279	8,205	8,403	0.0%	1.1%	0.5%
IC&SS	1,623	1,634	1,650	1,624	1,631	1,650	-0.1%	0.2%	0.0%
Enterprise	7,001	6,989	7,052	6,946	6,934	6,996	0.8%	0.8%	0.8%
Elimination (and Other pre-2007)	-2,352	-2,268	-2,230	-2,257	-2,172	-2,137	4.2%	4.4%	4.3%
Total Revenues	43,515	41,838	41,134	43,310	41,681	41,008	0.5%	0.4%	0.3%
France	6,763	6,923	6,541	6,621	6,995	6,557	2.1%	-1.0%	-0.3%
Spain	951	932	938	889	908	915	7.1%	2.7%	2.5%
Poland	1,156	1,110	1,087	1,122	1,110	1,087	3.0%	0.0%	0.0%
RoW	2,893	2,862	2,898	2,955	2,864	2,899	-2.1%	-0.1%	0.0%
Enterprise	1,134	1,083	1,058	1,216	1,207	1,210	-6.7%	-10.2%	-12.6%
IC&SS	-401	-294	-248	-395	-294	-132	1.6%	0.2%	87.6%
EBITDA	12,495	12,617	12,274	12,408	12,790	12,538	0.7%	-1.3%	-2.1%
margin	28.7%	30.2%	29.8%	28.6%	30.7%	30.6%	0.1 ppt	-0.5 ppt	-0.7 ppt
Depreciation and amortisation	-6,329	-6,465	-6,379	-6,400	-6,481	-6,389	-1.1%	-0.2%	-0.2%
Operating Income	4,063	6,283	6,035	5,943	6,437	6,297	-31.6%	-2.4%	-4.2%
Finance Costs net	-1,728	-1,798	-1,703	-1,990	-1,980	-1,880	-13.2%	-9.2%	-9.4%
Profit before Tax	2,335	4,485	4,332	3,954	4,457	4,418	-40.9%	0.6%	-1.9%
Income tax	-1,231	-1,525	-1,473	-1,265	-1,493	-1,480	-2.7%	2.1%	-0.5%
Share of minorities	284	320	351	318	320	351	-10.8%	0.0%	0.0%
NI	820	2,641	2,508	2,370	2,644	2,586	-65.4%	-0.1%	-3.0%
Adjusted EPS	0.31	1.00	0.95	1.24	1.00	0.98	-74.9%	-0.1%	-3.0%
Capex	5,818	5,814	5,740	5,910	5,784	5,716	-1.6%	0.5%	0.4%
Capex to Sales	13.4%	13.9%	14.0%	13.6%	13.9%	13.9%	-0.3 ppt	0.0 ppt	0.0 ppt
Net Debt	30,545	28,835	27,377	30,954	28,807	27,002	-1.3%	0.1%	1.4%
Net debt to EBITDA	2.44x	2.29x	2.23x	2.49x	2.25x	2.15x			
Net debt to EBITDA as defined by FT	2.17x	2.24x	2.18x	2.19x	2.21x	2.11x			
Dividend per share	0.80	0.60	0.60	0.80	0.60	0.60	0.0%	0.0%	0.0%
Operating Cash Flow (Adj EBITDA - Capex)	7,967	6,884	6,614	7,927	7,086	6,902	0.5%	-2.9%	-4.2%

Source: Citi Research

Cut to our price target from €8.30 to €7.00

We have reduced our price target on FT to €7.00 to reflect lower estimates and a lower perpetuity growth rate. Our price target is based on our DCF fair value using an 8.0% WACC and -1.0% perpetuity growth rate.

Figure 2. France Telecom DCF valuation

	€ mn	€/share
Value of years 1-8 cash flows	25,153	9.5
Terminal value	24,840	9.4
Enterprise value	49,993	18.9
Net Debt (2013E)	-28,835	-10.9
Minorities	-4,998	-1.9
Associates	4,799	1.8
Provisions for senior plan, DPTG, TV rights	-572	-0.2
Unfunded pension liabilities and retirement indemnities	-972	-0.4
Tax dispute (50% probability)	-868	-0.3
Equity value	18,548	7.0

Source: Citi Research

We show in the following Figure our Sum of the Parts for FT, which we use as a cross check for our DCF valuation, but not as a base to set our price target.

Figure 3. France Telecom – Sum of the Parts (In €m except per share data)

Asset	Stake	Driver (2013)	EV (€m)	Net debt end 2013E (€m)	FT share of equity	Per Share (€)	As a % of Equity value	As a % of Enterprise value
French Fixed line	100.00%	4.0x EV/EBITDA	16,210	0	16,210	6.12	32%	24%
French Mobile	100.00%	4.0x EV/EBITDA	11,484	0	11,484	4.34	22%	17%
French assets			27,694		27,694	10.45	54%	41%
Spanish Fixed line	99.98%	€300/subscriber	449	0	449	0.17	1%	1%
Spanish Mobile	99.98%	4.5x EV/EBITDA	3,959	0	3,958	1.49	8%	6%
TPSA Poland	49.79%	Listed Value	5,749	-1,700	2,016	0.76	4%	9%
UK	50.00%	DDM - 10%	8,461	-1,228	3,617	1.37	7%	13%
Main Mobile Assets			18,618	-1,700	10,040	3.79	20%	28%
Mobistar	52.91%	Listed Value	1,619	-459	614	0.23	1%	2%
Mobinil	93.92%	1.8x EV/Revenues	2,557	0	2,401	0.91	5%	4%
Mobilrom (Romania)	96.82%	1.5x EV/Revenues	1,359	0	1,316	0.50	3%	2%
Slovakia Mobile	100.00%	1.5x EV/Revenues	1,004	0	1,004	0.38	2%	1%
Jordan	51.00%	1.8x EV/Revenues	847	0	432	0.16	1%	1%
Senegal Mobile	42.33%	1.8x EV/Revenues	1,294	0	548	0.21	1%	2%
Ivory Coast	85.00%	1.5x EV/Revenues	886	0	753	0.28	1%	1%
Dominican Republic	100.00%	1.8x EV/Revenues	845	0	845	0.32	2%	1%
Mali	29.71%	1.8x EV/Revenues	560	0	166	0.06	0%	1%
Cameroon	99.50%	1.8x EV/Revenues	580	0	577	0.22	1%	1%
Moldavia	94.31%	1.5x EV/Revenues	269	0	254	0.10	0%	0%
Kenya	40.00%	1.8x EV/Revenues	170	0	68	0.03	0%	0%
Madagascar	71.80%	1.5x EV/Revenues	106	0	76	0.03	0%	0%
Botswana	43.70%	1.8x EV/Revenues	186	0	81	0.03	0%	0%
Other	65.00%	1.8x EV/Revenues	788	0	512	0.19	1%	1%
RoW Assets			13,071	-459	9,648	3.64	19%	19%
Enterprise	100.00%	3.5x EV/EBITDA	3,792	0	3,792	1.43	7%	6%
IC&SS	100.00%	3.5x EV/EBITDA	-1,029	0	-1,029	-0.39	-2%	-2%
Sonaecom	20.00%	Listed Value	113		113	0.04	0%	0%
Orange Austria	35.00%		1,250	-964	100	0.04	0%	2%
Tunisia	49.00%		96		96	0.04	0%	0%
Meditel (Morocco)	40.00%		2,140	-540	640	0.24	1%	3%
Korek (Iraq)	20.00%		1,429	-554	175	0.07	0%	2%
Dailymotion	49.00%		59		59	0.02	0%	0%
Total Assets			67,231	-2,159	51,327	19.38	100%	100%
Provisions for senior plan, DPTG, TV rights					-572	-0.22		
NPV of tax assets					600	0.23		
Unfunded pension liabilities					-972	-0.37		
Equity component of TDIRA					-425	-0.16		
Tax dispute (50% probability)					-868	-0.33		
Debt adjustment for minorities and other				2,159		0.81		
Net debt (2013E)				-28,835		-10.89		
Equity Value	number of shares		2,649			8.46		

Source: Citi Research

France Telecom

Company description

France Telecom (FT) is one of the world's leading telecom operators, with revenues of over €45bn. Through its Orange brand, FT is the French and Polish incumbent provider and owns mobile and ULL assets in the UK, Switzerland and Spain. FT is one of the largest providers to corporate customers.

Investment strategy

We rate France Telecom Sell. We see downside risk due to poor earnings momentum and market share loss and mobile repricing associated with a new mobile entrant in France. We expect FT's domestic ROCE of 18% in 2011 on our estimates to fall to 13% in 2013.

Valuation

Our valuation of FT and €7.0 target price are based on our 25-year DCF, which fades the ROCE close to the cost of capital in the longer term. We use a WACC of 8.0% and -1.0% perpetuity growth rate from year 25.

Risks

On the positive side, we see four reasons why FT's share price could outperform. These include: a better performance from RoW assets after the recent slowdown in growth especially in Africa, stabilising French DSL market share, a turnaround of Orange UK and better than expected headcount reduction. On the downside, corporate pricing remains under pressure and may deteriorate faster than we anticipate. The risk of higher market share loss and ARPU decline from a fourth mobile entrant is high. There is still a risk that regulation and austerity measures continue to hit domestic wireline and mobile revenues. If the impact of these risk factors is more or less negative than we anticipate, then the share price could fail to reach or rise above our target price.

Appendix A-1

Analyst Certification

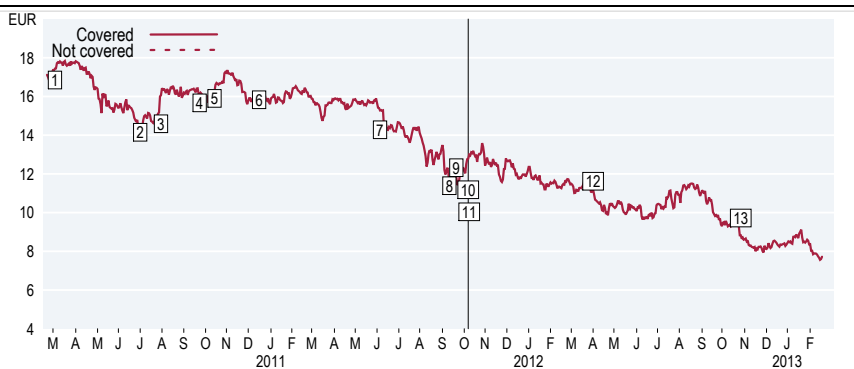
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France Telecom (FTE.PA)

Ratings and Target Price History Fundamental Research

Analyst: Dimitri Y Kallianiotis, CFA



	Date	Rating	Target Price	Closing Price
1	3-Mar-10	*2M	17.00	17.44
2	1-Jul-10	2M	*16.00	14.15
3	30-Jul-10	2M	*16.50	16.07
4	23-Sep-10	2M	*17.00	16.09
5	14-Oct-10	*2L	17.00	16.27

* Indicates change

	Date	Rating	Target Price	Closing Price
6	16-Dec-10	*1L	17.00	16.04
7	6-Jun-11	*2L	*15.50	15.28
8	12-Sep-11	2L	*13.60	11.39
9	21-Sep-11	*2M	*12.00	11.84
10	7-Oct-11	Stock rating system changed		

	Date	Rating	Target Price	Closing Price
11	8-Oct-11	*2	12.00	12.78
12	2-Apr-12	*3	*9.10	11.19
13	26-Oct-12	3	*8.30	8.83

Rating/target price changes above reflect Eastern Standard Time

France Telecom (FTE.PA)

Ratings and Target Price History Best Ideas Research Relative Call (3 Month)

Analyst: Dimitri Y Kallianiotis, CFA



	Date	Rating	Target Price	Closing Price
1	11-Feb-11	*ADD MP	-	16.24

* Indicates change

	Date	Rating	Target Price	Closing Price
2	14-Jun-11	*REM MP	-	14.59

	Date	Rating	Target Price	Closing Price
3	14-May-12	*ADD LP	-	10.15

Rating/target price changes above reflect Eastern Standard Time

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12 Month Rating

Relative Rating

Data current as of 31 Dec 2012

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