

TDC (TDC.CO)

Not Quite Enough Reassurance, Remain Cautious

- Company Update
- Estimate Change

- **Remain cautious, despite attractive yield** — TDC has rebased dividends down to a potentially attractive 9% yield and delivered a confident investor day. However we see further EBITDA, FCF and dividend declines beyond 2013. Our key concerns are the continued worsening gross profit trends, with few details for future net cost savings, combined with no breakdown for what drives the confidence in FCF. Therefore while TDC has a potentially attractive dividend yield, we would wait for signs of improving gross profit trends, cost cutting plans or detail around FCF forecasts. We also see a high chance of a placing from the private equity consortium that still owns 43%. Retain Neutral.
- **We see further risk to FCF beyond 2013** — TDC's gross profit trends have been worsening during 2013, offset by significant opex reductions. In 1Q13 TDC will lap the last significant round of headcount reductions, making EBITDA trends harder if further cost cutting measures are not introduced. At the investor day few specifics were given on cost cutting, only that it would continue at a slower pace. We are concerned that management confidence in the FCF guidance is from expected non-underlying improvements in working capital and cash taxes, rather than confidence in stabilising EBITDA.
- **We expect a dividend cut beyond DKK 3.70 in 2013** — As a consequence of our FCF forecasts, we expect the dividend to be cut further in 2014 to DKK 3.44. We also highlight that leverage at 2.1x 3Q12 is close to the maximum target leverage of <2.2x. Our forecasts have TDC remaining just below the cap at 2.1x for the next few years. If EBITDA fell further than our forecasts, the dividend payout of FCF would need to decrease from 90% to maintain constant leverage.
- **Forecast changes** — We cut our FCF forecasts for 2013E to be in line with new guidance. Contrary to guidance, we don't forecast stabilisation in 2014 and expect a further dividend cut. We also reduce our P&L tax forecasts, so in total we raise our 2012E clean EPS by 5.7%, 2013E 3.9%. We cut 2013E Eq FCF by -11%, 2014E by -17%.

Neutral	2
Price (06 Nov 12)	Dkr38.40
Target price	Dkr38.00
Expected share price return	-1.0%
Expected dividend yield	10.7%
Expected total return	9.6%
Market Cap	Dkr31,680M
	US\$5,435M

Price Performance (RIC: TDC.CO, BB: TDC DC)



TDC (DKK)

Year to 31 Dec	2010A	2011A	2012E	2013E	2014E
Sales (DkrM)	26,167.0	26,304.0	26,184.4	25,825.0	25,702.0
Net Income (DkrM)	2,793.0	3,073.0	3,203.9	2,991.7	2,866.9
Diluted EPS (Dkr)	2.84	3.76	3.97	3.75	3.59
Diluted EPS (Old) (Dkr)	2.84	3.76	3.75	3.61	3.66
PE (x)	13.5	10.2	9.7	10.3	10.7
EV/EBITDA (x)	5.9	5.2	5.3	5.4	5.5
DPS (Dkr)	0.00	4.35	4.60	3.70	3.44
Net Div Yield (%)	0.0	11.3	12.0	9.6	9.0

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TDC.CO: Fiscal year end 31-Dec						Price: Dkr38.40; TP: Dkr38.00; Market Cap: Dkr31,680m; Recomm: Neutral					
Profit & Loss (Dkrm)	2010	2011	2012E	2013E	2014E	Valuation ratios	2010	2011	2012E	2013E	2014E
Sales revenue	26,167	26,304	26,184	25,825	25,702	PE (x)	13.5	10.2	9.7	10.3	10.7
Cost of sales	-12,010	-12,306	-12,747	-12,793	-12,986	PB (x)	1.5	1.4	1.4	1.5	1.5
Gross profit	14,157	13,998	13,438	13,032	12,716	EV/EBITDA (x)	5.9	5.2	5.3	5.4	5.5
Gross Margin (%)	54.1	53.2	51.3	50.5	49.5	FCF yield (%)	9.5	11.8	11.4	10.7	10.0
EBITDA (Adj)	10,337	10,501	10,330	9,990	9,774	Dividend yield (%)	0	11.3	12.0	9.6	9.0
EBITDA Margin (Adj) (%)	39.5	39.9	39.5	38.7	38.0	Payout ratio (%)	0	116	116	99	96
Depreciation	-2,660	-2,703	-2,721	-2,688	-2,667	ROE (%)	12.5	13.0	15.1	11.7	12.2
Amortisation	-2,603	-2,471	-2,365	-2,337	-2,318	Cashflow (Dkrm)	2010	2011	2012E	2013E	2014E
EBIT (Adj)	5,416	5,713	5,324	5,045	4,868	EBITDA	10,772	10,940	10,410	10,070	9,854
EBIT Margin (Adj) (%)	20.7	21.7	20.3	19.5	18.9	Working capital	571	-67	0	150	0
Net interest	-1,591	-1,305	-1,054	-1,056	-1,046	Other	-4,105	-3,696	-3,435	-3,226	-3,094
Associates	3	-25	2	0	0	Operating cashflow	7,238	7,177	6,975	6,994	6,760
Non-op/Except	-1,335	-492	-157	-750	-550	Capex	-3,646	-3,481	-3,451	-3,708	-3,703
Pre-tax profit	2,586	3,944	4,115	3,239	3,273	Net acq/disposals	-286	-260	0	0	0
Tax	-782	-1,131	-839	-810	-818	Other	43	104	760	0	0
Extraord./Min.Int./Pref.div.	1,203	-5	0	0	0	Investing cashflow	-3,889	-3,637	-2,691	-3,708	-3,703
Reported net profit	3,007	2,808	3,276	2,429	2,454	Dividends paid	-70	-1,780	-3,611	-3,315	-2,853
Net Margin (%)	11.5	10.7	12.5	9.4	9.5	Financing cashflow	-20,091	-2,815	-4,361	-3,315	-2,853
Core NPAT	2,793	3,073	3,204	2,992	2,867	Net change in cash	68	658	-76	-29	203
Per share data	2010	2011	2012E	2013E	2014E	Free cashflow to s/holders	3,592	3,696	3,525	3,286	3,057
Reported EPS (Dkr)	3.06	3.44	4.06	3.04	3.07						
Core EPS (Dkr)	2.84	3.76	3.97	3.75	3.59						
DPS (Dkr)	0	4.35	4.60	3.70	3.44						
CFPS (Dkr)	7.37	8.79	8.64	8.76	8.46						
FCFPS (Dkr)	3.66	4.53	4.36	4.11	3.83						
BVPS (Dkr)	25.53	27.24	26.49	25.38	24.88						
Wtd avg ord shares (m)	982	817	808	799	799						
Wtd avg diluted shares (m)	982	817	808	799	799						
Growth rates	2010	2011	2012E	2013E	2014E						
Sales revenue (%)	0.3	0.5	-0.5	-1.4	-0.5						
EBIT (Adj) (%)	-7.8	5.5	-6.8	-5.2	-3.5						
Core NPAT (%)	-14.8	10.0	4.3	-6.6	-4.2						
Core EPS (%)	-14.0	32.3	5.4	-5.6	-4.2						
Balance Sheet (Dkrm)	2010	2011	2012E	2013E	2014E						
Cash & cash equiv.	831	1,489	1,413	1,384	1,587						
Accounts receivables	4,404	4,773	5,318	5,698	6,298						
Inventory	307	281	281	281	281						
Net fixed & other tangibles	23,595	24,360	24,223	24,305	24,405						
Goodwill & intangibles	34,799	33,543	32,125	30,805	29,503						
Financial & other assets	850	719	719	719	719						
Total assets	64,786	65,165	64,078	63,192	62,793						
Accounts payable	6,141	6,914	6,914	6,914	6,914						
Short-term debt	216	3,816	3,816	3,816	3,816						
Long-term debt	23,428	19,404	19,404	19,404	19,404						
Provisions & other liab	14,146	12,787	12,787	12,787	12,787						
Total liabilities	43,931	42,921	42,921	42,921	42,921						
Shareholders' equity	20,855	22,244	21,157	20,271	19,872						
Minority interests	0	0	0	0	0						
Total equity	20,855	22,244	21,157	20,271	19,872						
Net debt	22,813	21,731	21,807	21,836	21,633						
Net debt to equity (%)	109.4	97.7	103.1	107.7	108.9						

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

Not Enough Detail for Reassurance

TDC has rebased dividend and FCF expectations downwards. Management said they were very confident this can be sustained through the period 2013-15. However we argue that we do not have enough details to be confident this is a sustainable level for FCF and dividends. In addition, given the worsening trends across the European telecoms sector, we argue the market is not prepared to give the benefit of the doubt to companies with worsening trends, but plans to stabilise in 2-3 years. TDC is a potentially attractive investment at current levels, but we would prefer to wait for signs of stabilising gross profit trends, and more details on opex savings and expected FCF breakdown.

We expect further declines in EBITDA beyond 2013

Little detail on cost cutting explains no exact EBITDA guidance numbers

Little detail on cost cutting — In 3Q12, gross profit fell by -3.9% yoy, partly offset by a -7.0% yoy reduction in opex, leading to a -1.6% decrease in EBITDA. YoY opex reductions are being driven by significant headcount reductions in 1Q11. However TDC has not announced any concrete plans for further headcount reductions. Management said that while gross savings would continue, they would be reinvested going forwards, limiting net savings. This may explain why no exact EBITDA guidance figures were given.

Already the most efficient operator in Europe according to management

Management also said that TDC is now the most efficient telecoms operator in Europe; this limits our confidence that continued cost cutting can be achieved.

Lapping TDC rate makes yoy EBITDA comparisons harder

Lap TDC rate plan — TDC introduced its handset financing plans 'TDC rate' in May 2011, which creates a temporary benefit to EBITDA. Now that we are 12 months past the introduction and this makes yoy EBITDA comparisons harder.

Continued regulatory pressure

Regulatory pressure in 2013 — TDC has guided to DKK -150m pressure from regulatory cuts to regulatory international roaming rates.

Confidence on FCF may come from NWC and cash tax

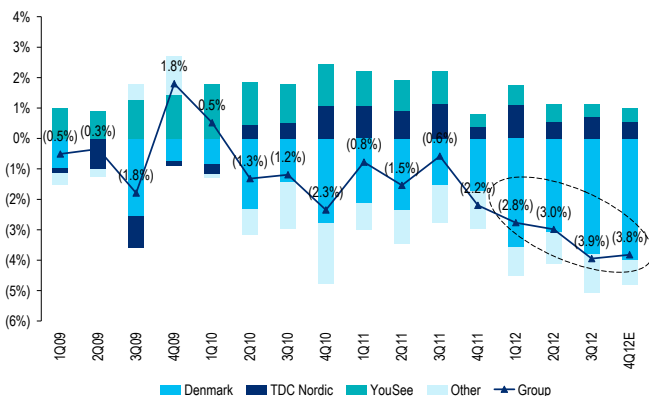
Confidence in FCF comes from NWC and cash tax, in our view

We note the disparity between managements confidence on meeting the FCF guidance numbers, but at the same time giving no breakdown of cash flow items leading to this, specific EBITDA guidance or concrete cost cutting plans. We argue management's confidence on FCF comes from expected improvements in NWC and cash taxes, which we argue are non-underlying.

- **Working Capital** — TDC introduced external financing for handset subsidies in April 2012 for the TDC brand and will expand it for all brands in 4Q12. This removes the negative FCF from handset subsidies. Hence this creates a temporary benefit to FCF, while subsidies are avoided for new customers and TDC is still receiving cash from legacy customers.
- **Cash tax flexibility** — Under Danish tax law, TDC can choose to delay part of a year's tax payment to the following year. In addition, TDC has a tax debt, payments for which it could choose to delay. Lastly, the main reason that cash taxes are higher than P&L taxes is that TDC has DKK c.1.6bn of non tax deductible amortisation of customer relationships, which creates around DKK 400m cash tax in addition to P&L tax. In total, this creates some flexibility over cash taxes, as shown by the volatility between years.

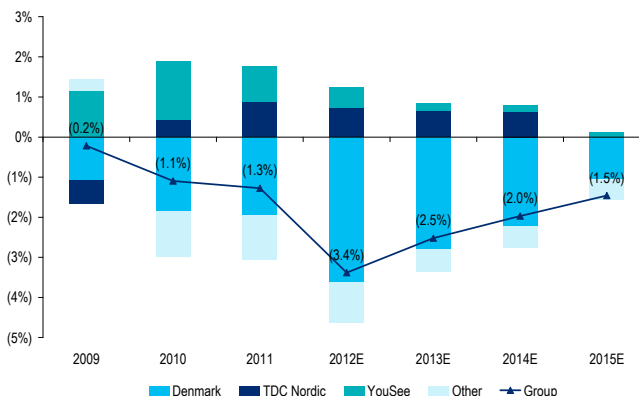
Key Concerns in Charts

Figure 1. Group gross profit growth/(decline) breakdown – Worsening trend through 2013



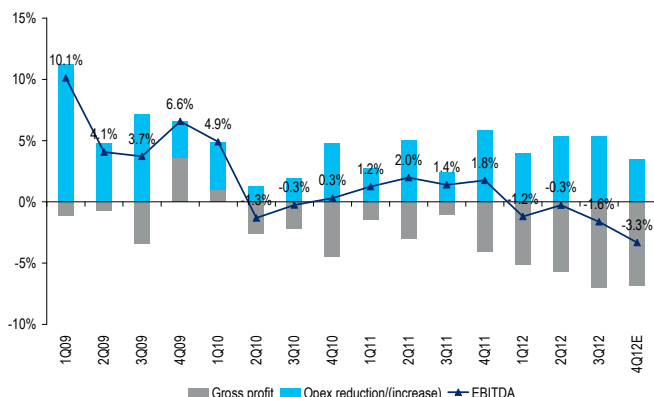
Source: Citi Research, company reports

Figure 2. Group gross profit growth/(decline) breakdown – We expect gross profit to continue to decline, but at a lower rate



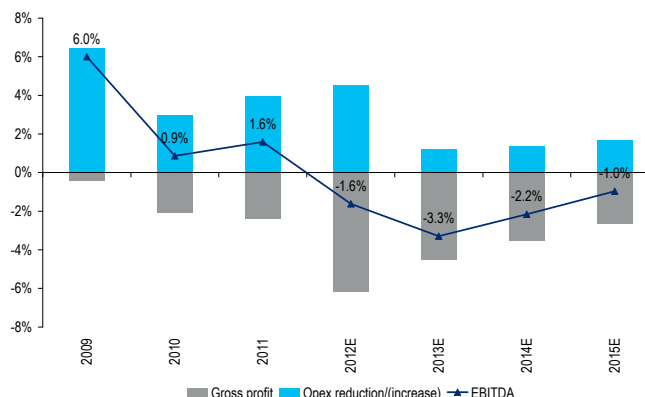
Source: Citi Research, company reports

Figure 3. Group EBITDA growth/(decline) breakdown between opex and gross profit change – Worsening gross profit trends have been offset by increased opex reductions



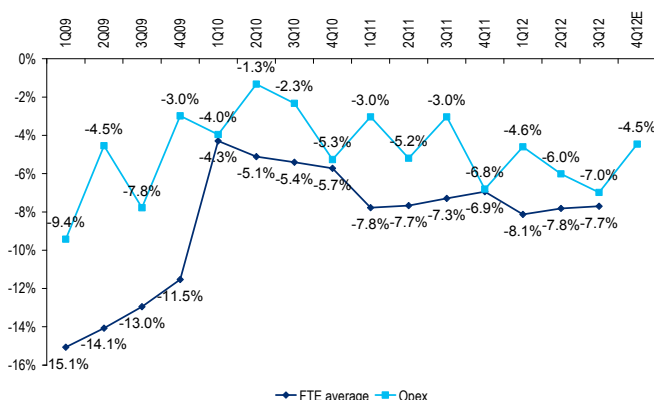
Source: Citi Research, company reports

Figure 4. Group EBITDA growth/(decline) breakdown between opex and gross profit change – We expect lower opex reductions going forwards with only slightly lower gross profit declines



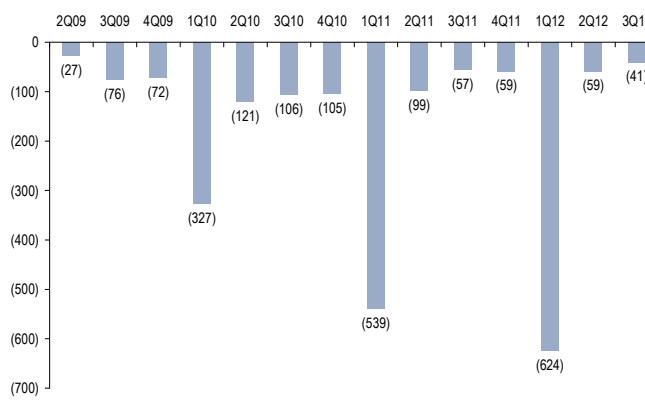
Source: Citi Research, company reports

Figure 5. Group yoy change in average headcount and opex – Significant yoy reductions in headcount have driven opex reductions



Source: Citi Research, company reports

Figure 6. QoQ change in group average headcount – TDC has historically reduced headcount in Q1, TDC currently has no plans for any significant headcount reductions



Source: Citi Research, company reports

FCF and Dividends in Detail

We expect EBITDA to continue declining as gross profit declines are only partly offset by lower opex reductions. We expect cash taxes to fall significantly as TDC pushes out payments where possible. We expect capex to increase to the guided DKK 3.7bn in 2013 and remain there. We expect a positive working capital movement in 2013 due to the full year impact of external financing for handset subsidies.

As a result, we forecast DKK 4.4bn FCF pre special items for 2012, which is enough to pay a DKK 4.60/share dividend on the old dividend policy. Then for 2013 we forecast DKK 3.3bn FCF post special items, which is in line with the guidance for a DKK 3.70/share dividend. However we argue these FCF figures are in part met by NWC and the timing of cash taxes, and therefore do not represent a sustainable level. We therefore forecast a further fall in FCF post special items to DKK 3.1bn in 2014 and a DKK 3.44/share dividend.

Figure 7. Cash Flow Summary

	2010	2011	2012E	2013E	2014E	2015E	2016E
Revenue growth/(decline)	0.3%	0.5%	(0.5%)	(1.4%)	(0.5%)	(0.8%)	(0.8%)
Gross profit growth/(decline)	(1.1%)	(1.3%)	(3.4%)	(2.5%)	(2.0%)	(1.5%)	(1.4%)
Opex (reduction)/increase	(3.2%)	(4.5%)	(5.5%)	(1.5%)	(1.7%)	(2.1%)	(1.6%)
EBITDA growth	0.9%	1.6%	(1.6%)	(3.3%)	(2.2%)	(1.0%)	(1.3%)
EBITDA (excl special items and pension)	10,337	10,501	10,330	9,990	9,774	9,679	9,553
Interest paid, net	(1,422)	(645)	(1,054)	(1,056)	(1,046)	(1,029)	(1,011)
Corporate income tax paid	(1,500)	(1,715)	(1,239)	(1,210)	(1,318)	(1,333)	(1,353)
Pension contributions	(169)	(157)	(145)	(130)	(100)	(75)	(50)
Capex	(3,646)	(3,481)	(3,451)	(3,708)	(3,703)	(3,672)	(3,641)
Eq FCF (excl WC and special items)	3,600	4,503	4,442	3,886	3,607	3,570	3,498
Change in working capital	777	(14)	0	150	0	0	0
Other	138	0	0	0	0	0	0
Eq FCF (pre special)	4,515	4,489	4,442	4,036	3,607	3,570	3,498
Cash flow related to special items	(785)	(793)	(917)	(750)	(550)	(450)	(300)
Eq FCF (post special)	3,730	3,696	3,525	3,286	3,057	3,120	3,198
Eq FCF per share		4.53	4.36	4.11	3.83	3.91	4.00
Dividend share		4.35	4.60	3.70	3.44	3.52	3.60
Payout of FCF		96%	105%	90%	90%	90%	90%
Net debt/EBITDA		1.9	2.0	2.1	2.1	2.1	2.1

YoY Delta

EBITDA (excl special items and pension)	164	(171)	(341)	(216)	(95)	(126)
Interest paid, net	777	(409)	(1)	10	17	18
Corporate income tax paid	(215)	476	29	(108)	(15)	(20)
Pension contributions	12	12	15	30	25	25
Capex	165	30	(257)	4	31	31
Eq FCF (excl WC and special items)	903	(61)	(555)	(280)	(36)	(72)
Change in working capital	(791)	14	150	(150)	0	0
Other	(138)	0	0	0	0	0
Eq FCF (pre special)	(26)	(47)	(405)	(430)	(36)	(72)
Cash flow related to special items	(8)	(124)	167	200	100	150
Eq FCF (post special)	(34)	(171)	(238)	(230)	64	78

Source: Citi Research, company reports

Forecast Changes

We reduce our mobile revenue forecasts due to the continued service revenue decline of -13% in 3Q12. While consumer mobile is showing some signs of stabilising, business mobile is now worsening. In addition, we reduce other revenue and slightly increase fixed revenue. Overall we reduce our 2012 revenue forecast by -1.0%, 2013 -1.2%.

We leave our 2012 and 2013 EBITDA forecasts broadly unchanged. We forecast DKK 10.3bn 2012 EBITDA, in line with the bottom end of the guidance range of DKK 10.3-10.5bn. For 2013 we forecast EBITDA falling to DKK 10bn (-3.3% yoy); TDC guides to a slight decrease in 2013, with no figure given. In 2014 we now forecast a further -2.2% yoy fall.

Below EBITDA we reduce net interest and tax. We increase our 2012 clean EPS forecast by 5.7%, 2013E 3.9%.

For FCF, we increase our 2013E capex and beyond in line with new guidance. We reduce our cash tax forecast and increase our special item cash costs. In total we increase our FCF (post special items) by 8% for 2012E, then reduce 2013E by -11%, 2014E -17%.

Figure 8. New Forecasts (DKK in Millions)

	New forecasts			Diff		
	2012	2013	2014	2012	2013	2013
Revenue						
Mobile	8,765	8,368	8,182	(0.8%)	(2.4%)	(5.3%)
Fixed	8,059	7,575	7,216	0.3%	0.9%	1.2%
Other	490	490	490	(15.5%)	(15.5%)	(15.5%)
TV	655	804	898	(4.0%)	(4.8%)	(4.6%)
Total Denmark	17,969	17,237	16,786	(0.9%)	(1.5%)	(2.9%)
Denmark cable (YouSee)	4,534	4,594	4,642	1.3%	1.3%	1.3%
Other Nordic	4,895	5,190	5,466	(1.5%)	(1.0%)	(0.7%)
Other	287	283	281	(0.7%)	(1.0%)	(1.8%)
Total	26,184	25,825	25,702	(1.0%)	(1.2%)	(2.1%)
EBITDA						
Denmark Total (excl cable)	8,266	7,860	7,587	0.6%	(0.2%)	(2.5%)
Denmark cable (YouSee)	1,655	1,677	1,694	(0.1%)	(0.1%)	(0.1%)
Other Nordic	710	753	793	(1.5%)	(1.0%)	(0.7%)
Other	(310)	(310)	(310)	0.0%	0.0%	0.0%
Total (excl pension)	10,330	9,990	9,774	0.4%	(0.2%)	(2.0%)
Pension	80	80	80			
Total (incl pension)	10,410	10,070	9,854	0.4%	(0.2%)	(2.0%)
D&A	(5,086)	(5,025)	(4,986)	(0.4%)	(0.5%)	0.3%
EBIT	5,324	5,045	4,868	1.1%	(0.0%)	(4.2%)
JVs	762	0	0			
Net financials	(1,054)	(1,056)	(1,046)	(2.7%)	(1.5%)	(0.5%)
PBT (clean)	4,272	3,989	3,823	2.1%	0.4%	(5.1%)
Income tax (excl special items)	(1,068)	(997)	(956)	(7.1%)	(8.7%)	(13.8%)
Net Income, continuing, excl special	3,204	2,992	2,867	5.7%	3.9%	(1.9%)
Net Income	3,276	2,429	2,454	5.2%	(8.6%)	(9.1%)
EPS (DKK)	4.06	3.04	3.07	5.2%	(8.6%)	(9.1%)
EPS clean	3.97	3.75	3.59	5.7%	3.9%	(1.9%)
Net debt	21,089	21,118	20,915	(2.7%)	(1.5%)	(0.5%)
Eq FCF (post special)	3,525	3,286	3,057	8.1%	(11.1%)	(17.1%)

Source: Citi Research

TDC

Company description

TDC is the telecoms incumbent in Denmark, with a c.40% market share in mobile, c.75% for fixed-line telephony and c.65% fixed broadband. TDC also owns the largest cable TV operator in Denmark YouSee. TDC has a small international division, TDC Nordic, which focuses on the business segment in the other Nordic countries.

Investment strategy

We rate TDC Neutral. TDC offers a high dividend yield with a relatively stable macro environment, but we argue this is offset by risk to operations. In mobile, we see back book pricing pressure as well as potential further price cuts. Fixed trends remain some of the weakest in Europe, and we do not believe TV growth can continue to offset this. New wholesale cable access regulation could increase competition from a low level. Lastly the private equity consortium still holds c.40%, we therefore see placement risk.

Valuation

Our valuation of TDC and DKr38 target price are based on a DCF with a WACC of 8.4% and -1.0% perpetuity growth rate.

Risks

95% of TDC's EV on our numbers is from Denmark. Despite recent mobile price competition, the Danish telecoms market remains relatively stable compared to other markets. There could be potential for shareholder returns beyond the current dividend policy, although we see this as unlikely. To the downside, we could see continued price cuts in the market; however, if the market stabilises, then the high dividend yield looks increasingly attractive. The private equity consortium still holds c.40% of TDC. We therefore see significant risk of a placement. 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

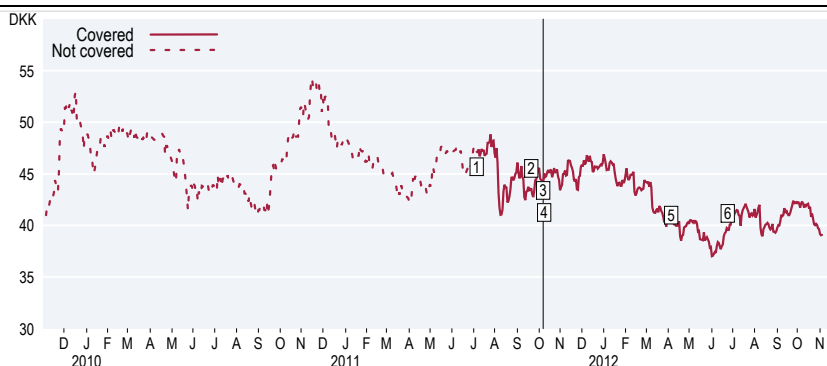
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IMPORTANT DISCLOSURES

TDC (TDC.CO)

Ratings and Target Price History Fundamental Research

Analyst: Laurie Fitzjohn-Sykes, CFA
Covered since July 7 2011



	Date	Rating	Target Price	Closing Price
1	6-Jul-11	*2L	*46.00	47.14
2	21-Sep-11	2L	*43.50	43.60

* Indicates change

	Date	Rating	Target Price	Closing Price
3	7-Oct-11	Stock rating system changed		
4	8-Oct-11	*2	43.50	44.07

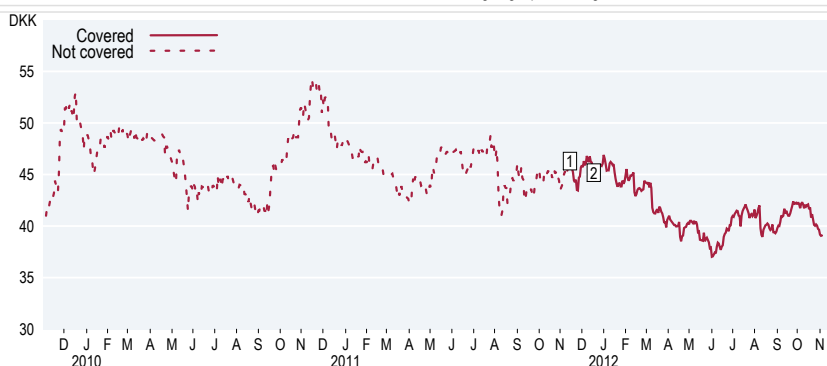
	Date	Rating	Target Price	Closing Price
5	5-Apr-12	2	*40.00	40.63
6	25-Jun-12	2	*38.00	39.66

Rating/target price changes above reflect Eastern Standard Time

TDC (TDC.CO)

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

Analyst: Laurie Fitzjohn-Sykes, CFA
Covered since July 7 2011



	Date	Rating	Target Price	Closing Price
1	15-Nov-11	*ADD LP	-	46.25

* Indicates change

	Date	Rating	Target Price	Closing Price
2	19-Dec-11	*REM LP	-	45.27

Rating/target price changes above reflect Eastern Standard Time

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Data current as of 4 Oct 2012

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% of companies in each rating category that are investment banking clients

12 Month Rating			Relative Rating		
Buy	Hold	Sell	Buy	Hold	Sell
51%	38%	11%	7%	85%	7%
50%	47%	45%	59%	47%	50%

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