

BT Sport Survey

A Sporting Chance for BT

- **Bespoke survey shows Sport a bigger positive for BT than market recognises** — Citi's bespoke survey of 1,365 UK household decision makers asked 10 questions designed to establish interest levels in BT Sport across a broad range of demographics and existing suppliers. The survey showed that a quarter of households are interested in BT Sport and 13% are prepared to switch broadband supplier or pay to get it on top of those with BT broadband already who can get it for free.
- **BT: Upgrade to Buy** — We upgrade BT to Buy with a target price of 365p ex div, increased due to stronger long term growth assumptions and higher estimates, providing 21% ETR. We expect a combination of cost savings, progress at Global Services and in mobile, momentum in consumer triple play and longer-term prospects of faster dividend growth (dependent on reaching a BBB+ rating) to drive the stock.
- **Sky in the Corridor of Uncertainty: Stay Buy, remove from Focus List** — The survey suggests that upwards of 1m Sky subs could take BT Sport, a big number but not materially different from our initial estimate. More positively, the survey suggests Sky has upwards of 4m potential triple-play converters (from its existing base) and we note the near-term potential for it to grow the sub-base as VMED customers move to the BT/Sky 'straddle'. We adjust estimates for the O2 UK broadband deal which is accretive from FY15. Ultimately we think Sky will deliver near-term earnings/cash returns and, with the group now at a market multiple, stay Buyers but remove from Citi Focus List Europe.
- **Liberty: Retain Buy** — While the survey results suggest BT Sport will inject incremental risk to the Virgin results, we think the overall impact to Liberty stock is likely to be muted by three factors: 1) the UK market represents 37% of Liberty's 2014 revenues and 36% of its EBIT; 2) Virgin still benefits from a superior broadband offer; and 3) consensus has already incorporated some of this risk into its valuation.
- **TalkTalk: Downgrade to Sell** — Our survey broadly bears out management's line that its customers are less interested in BT Sport but that is not the same as saying it has no exposure. Based on the survey, around 28% of TalkTalk's broadband customers have Sky TV and among those that do not 9% say that they would switch or pay to get BT Sport. Losing even half of those equate to around 130k customers. We downgrade our estimates consistent with guidance for higher TV costs and slower net cost savings and reduce our forecasts for broadband customers. As a result we see downside to consensus and downgrade the stock to Sell with a 200p ex div target price.

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Company	Ticker	Rating		Target Price		Current Year Earnings Estimates	
		Old	New	Old	New	Old	New
B Sky B	BSY.L	1	1	£9.50	£9.50	p57.8	p58.1
BT Grp	BT.L	2	1	£3.00	£3.65	p25.7	p25.9
TalkTalk Tele	TALK.L	2	3	-	£2.00	p17.0	p12.7

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

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Contents

A Sporting Chance for BT	3
Key Takeaways from the Survey	3
What is behind BT's thinking?	9
On The Survey	10
Survey Results	13
Citi BT Sport Consumer Survey Results	14
Company Sections	21
BT Group PLC (BT.L)	22
Forecast revisions	23
Valuation	26
British Sky Broadcasting Group PLC (BSY.L)	28
Why are We Still Buyers?	29
Examining Sensitivities on BT Sport	32
Changes to Forecasts	35
TalkTalk Telecom Group PLC (TALK.L)	39
Forecast revisions	40
Operational progress	41
TV offer summarised	42
Valuation	43
Financial forecasts	44
BT Group PLC	47
British Sky Broadcasting Group PLC	47
TalkTalk Telecom Group PLC	48
Liberty Global Inc.	49
Appendix A-1	50

A Sporting Chance for BT

Our bespoke survey of 1,365 UK household decision makers into the market prospects for BT Sport produced a stronger result for BT than we had expected with a quarter of households interested and 13% prepared to either switch broadband supplier or take a paid subscription to get it.

We upgrade BT to Buy with a target price of 365p ex div. We expect a combination of cost savings, progress at Global Services and in mobile, momentum in consumer triple play and longer-term prospects of faster dividend growth to drive the stock.

TalkTalk we downgrade to Sell with a 200p ex div target price. While our survey broadly bears out management's line that its customers are relatively less interested in BT Sport, that is not the same as saying it has no exposure. We expect it to lose some broadband momentum and downgrade our estimates consistent with guidance for higher TV costs and slower net cost savings.

For Sky we stay Buyers but remove it from the Focus List. Our survey suggests around 1m customers potentially at risk from BT but upwards of 4m potential triple-play converters (from its existing base) and the potential to grow the sub-base as competitors' customers move to the BT/Sky 'straddle'.

Liberty Global we rate Buy and while the survey results suggest BT Sport will inject incremental risk to the Virgin results, we think the overall impact to Liberty stock is likely to be muted by its diversity, Virgin's superior broadband offer and time for the stock to react to the news to date. Nonetheless, the survey suggests that with about 1M subs that could be at risk the risks are about 20% higher than we suggested previously. That increases our downside from \$3-4 per share to \$4-5 per Liberty share depending on the tactics Liberty uses to mitigate the losses.

Key Takeaways from the Survey

Overall 25% of the consumers surveyed express an interest in BT Sport including 52% of Sky Sports subscribers and 32% of Sky TV customers. The 25% overall figure includes customers with no pay TV today as well as some who claimed no interest initially (perhaps due to concerns over price) but later in the survey said that they would be prepared to switch broadband supplier or pay a £12/month subscription for the channels. Among the broadband customer bases the figures are 28% for Sky customers, 25% for Virgin and 22% for TalkTalk. Looking at only those who are prepared to switch broadband provider (11%) or pay for a subscription (10%) reduces the interested group by around half because these groups substantially overlap and come to 13% in combination. This survey was taken before BT's high profile, celebrity-endorsed marketing campaign properly kicked off and that may have a further impact from here.

BT looks to us set to benefit in a number of ways from the combination of BT Sport, YouView and its basic TV channels. The TV offer should reduce the rate at which BT broadband customers who also take Sky TV churn (around 43% of BT's consumer broadband base, or 2.2m, according to our survey - the largest proportion of any of the competitors except Sky itself - Figure 1). Of these, our survey shows that around one tenth have Sky Sports and one third are interested in BT Sport.

The survey points to around 1m broadband customers with Sky who might be prepared to switch/pay for the BT Sport channels. Almost all have Sky TV and so could take the pay option.

Around 1.5m at other operators may be prepared to switch or pay for BT Sport, around half at Virgin Media (~10% with Sky TV), the bulk of the remainder with TalkTalk (~60% with Sky TV).

A further 1m who do not have pay TV currently are also prospective customers.

BT Sport may make it tougher for BSkyB to penetrate BT's broadband base but easier to penetrate that of Talk Talk and Virgin Media.

Sky's offer of free broadband for those of its customers that "add a product" may be partly aimed at keeping the offer sharp for this group of customers, along with those at other competitors. Our survey suggests there are around 1m broadband customers at Sky who are interested and prepared to either switch broadband supplier or pay for the BT Sport channels. Not surprisingly nearly all of these have Sky TV, according to the survey, and so could take the pay option.

In addition the survey points to around another 1.5m at the other operators who say they are prepared to switch or pay. Around half are at Virgin Media and only around 10% of them have Sky TV and so would have to either switch pay-TV supplier to Sky or switch both TV and broadband to either Sky or the Sky/BT straddle. The bulk of the remainder is with TalkTalk and nearly 60% of them have Sky TV and so could take the pay option without changing TV or broadband supplier. A further 1m who do not currently have pay TV are also prospective customers, and one other option is those with an inactive Sky set top box who can receive BT Sport over satellite without the need for a live Sky TV account.

Taking the additional information from the survey into account we believe our previous forecasts for broadband and direct and indirect BT Sport subscribers were too low. We change our forecasts as follows:

- Retail broadband net additions to 690k from 520k in FY14;
- Retail fibre net additions to 1.01m from 0.96m in FY14;
- BT Sport indirect customers at March 2014 of 900k vs 600k;
- BT Sport direct customers at March 2014 of 830k vs 780k.

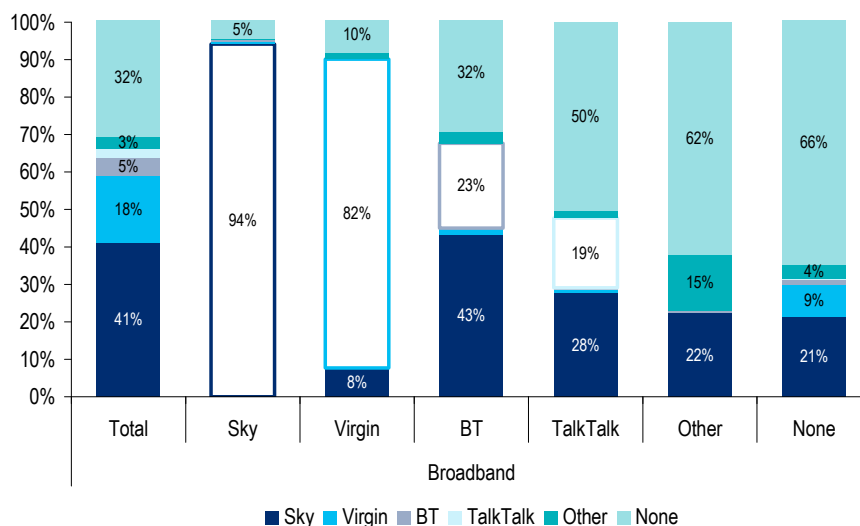
In combination these changes add around 1% to BT's group revenue and 2% to EBITDA in a full year (about half that in FY14).

Ironically, while Sky will in our view find it harder to recruit BT broadband customers to its triple play and will likely feel pricing pressure on its basic TV tier, it could also see some offsetting benefit by targeting the TV customers of those competitors without BT Sport, notably Virgin Media.

Key implications of the survey are:

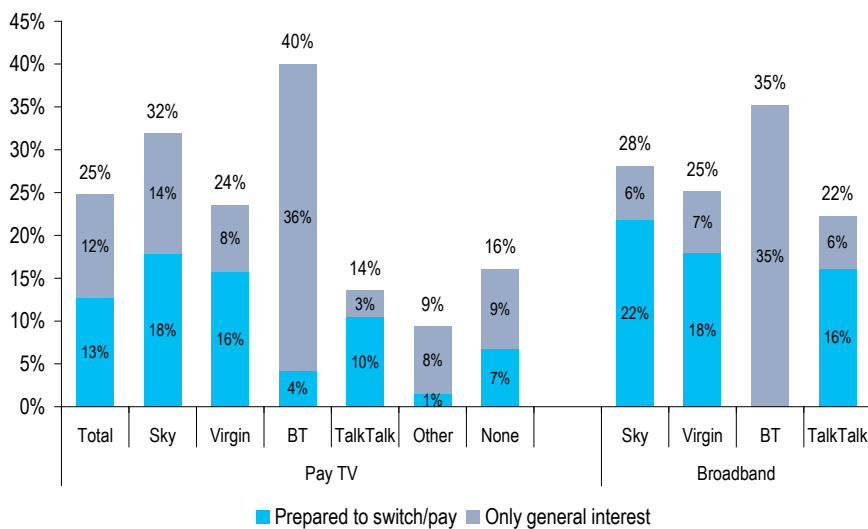
- **Although sport is a niche offer it is a large one** that engenders strong emotional support from committed consumers. The positive for BT is that general interest levels are high. Although that does reduce once the requirement to pay is included (by about half), it may well be that the company's marketing efforts can improve that balance.

Figure 1. TV provider split within broadband customer base of each operator
% of broadband customers



Source: GfK survey for Citi Research

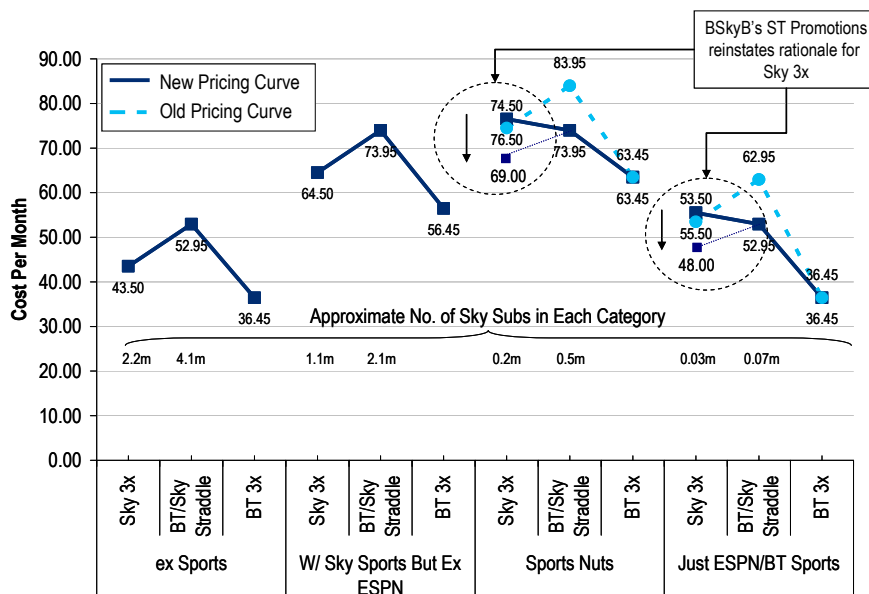
Figure 2. Proportion of pay TV and broadband customers bases interested in BT Sport, %



Source: GfK survey for Citi Research

- **Sky may see some cramping of its growth but could also benefit as** customers of Virgin and TalkTalk review their pay TV options given they cannot offer BT Sport (currently). There are a number of elements here:
 - As we show in Figure 3, Sky has reacted to the announced terms for BT Sport by making broadband free for 12 months for Sky Sports customers who take at least one additional product. As a tactical competitive response it looks sound: by toggling pricing for triple play, BSkyB has ensured that its price advantage for triple-play customers remains vs those choosing a straddle with another operator for voice and broadband.
 - The 43% of BT's base that, according to our survey, currently take Sky for TV are at risk of churning to Sky for broadband too. In our view the primary purpose of BT's move on BT Sport is to retain this group of customers. This is likely to slow Sky's broadband customer growth to a degree.

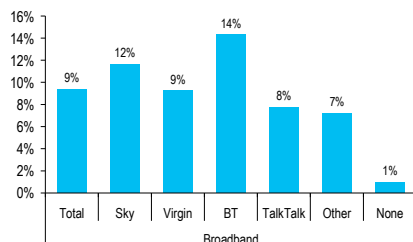
Figure 3. Total Pricing Curves for Different Categories – BSkyB Triple Play vs. BT Triple Play vs. BT/BSkyB Straddle (Price per Month in £)



Source: Company Reports and Citi Research Estimates

- **Virgin Media (part of Liberty Global) is most exposed of the competitors.** It has a reasonably sizeable base of Sky Sports customers (around a quarter of its TV customers), high take-up of its own TV service (82% of its broadband customers currently take Virgin's TV) and currently no contract to provide the BT Sport channels. The survey indicates about 1m Virgin customers are interested in BT Sport of which around two thirds would be prepared to either switch broadband supplier or, if it were an option, pay £12/month for the channels. Virgin may yet sign up, but if it does not we see the risk of elevated churn for a period. Likely destinations for customers could be one or the other of:
 - Sky triple play plus BT Sport via a satellite subscription;
 - Sky for TV with Virgin for broadband and voice;
 - Sky for TV with BT for broadband and voice.

Figure 4. Households with no Pay TV who would adopt it to receive BT Sport
% of total households, by broadband supplier



Source: GfK survey for Citi Research

Based on our survey around 28% of TalkTalk's broadband customers have Sky TV and so can access BT's channels indirectly - they make up more than half of those "at risk" for TalkTalk.

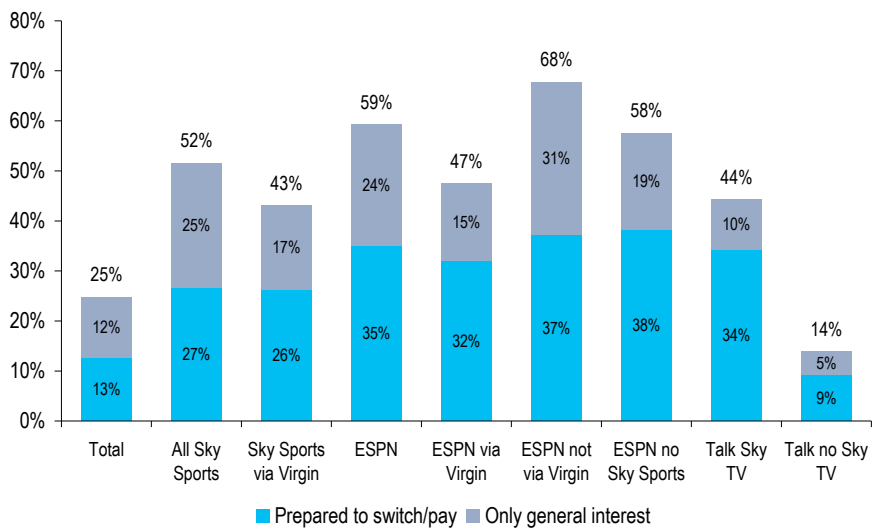
The survey suggests around 1m non Pay-TV customers are interested in adopting to get BT Sport.

- BT is offering BT Sport over Sky's satellite platform and is promoting it to Sky's TV customers on the basis that they can receive this and keep Sky Sports ("You don't have to pick sides"), ie without switching supplier. In this situation Sky acts as wholesale distributor, a regulatory obligation, with BT retailing direct to the customer. However, it gives Sky an opportunity to target TV customers of other players that don't offer BT Sport. Virgin Media looks likely to be the main target, as 82% of its broadband customers take its own TV service (unlike TalkTalk which still has a substantial base of Sky TV customers among its broadband base). According to our survey, roughly a quarter of Virgin Media's TV customers subscribe to Sky Sports, likely making them a key target.
- The last time we analyzed the impact of BT Sport on Liberty Global was on May 14, 2013. At the time, we suggested a few things. First, that about 20% of Virgin's video subs subscribed to Sky Sports. That put about 800K video subs at risk. Second, we suggested Virgin could offer a discount of \$25 per month to keep these subs. That would reduce Liberty's equity value by \$4 per share. Third, we suggested that if 25% of these at risk subs actually left Virgin for BT, it would reduce Liberty's equity value \$3 per share. So, the total risk to Liberty was \$3-4 per share.
- With this new survey data, we learned a few things. First, the survey suggests there are about 1M subs that could be at risk. In other words, the risks are about 20% higher than we suggested previously. **That increases our downside from \$3-4 per share to \$4-5 per Liberty share depending on the tactics Liberty uses to mitigate the losses.**
- **TalkTalk's base is interested enough to slow its progress.** Although the survey shows that as many as 22% of TalkTalk's broadband customers are interested in BT Sport, and 16% are prepared to either switch broadband supplier or pay £12/month for the channels, this somewhat overstates the challenge. The survey suggests 28% of TalkTalk's broadband customers have Sky TV (Figure 1) anyway and they make up more than half of the enthusiasts (prepared to switch/pay) for BT Sport. These customers probably nonetheless represent a higher churn risk for TalkTalk and could slow any conversions to TalkTalk TV. The non-Sky Sport customers amount to 10% of TalkTalk's broadband customers who are interested in BT Sport, and 7% who are prepared to either switch/pay.
- **13% of non Pay-TV customers say they are interested** in BT Sport. This becomes only 9% who are prepared to adopt pay TV (at £5 per month or more) to get it (Figure 4), however this is quite a large category and equates to around 1m prospects. BT Sport may not be enough on its own to persuade non-Pay customers to adopt, but it could contribute to quite a powerful proposition alongside YouView with catch-up functionality and lower priced basic channels.

Alternative cuts of the customer bases

- **ESPN customers** are the most enthusiastic about BT Sport with ~60% interested and 35% prepared to switch or pay (Figure 5) which becomes 70% and nearly 40% once the Virgin customers are excluded, a number of which have the service by default via their XL TV pack.
- **Sky Sport subscribers** (whether via Sky or not) are also more than averagely keen, not surprisingly, with ~50% interested and 27% prepared to switch or pay.
- **TalkTalk's broadband customers** who subscribe to Sky TV see around 44% interested and 35% prepared to switch or pay, which they could do by subscribing to BT Sport via Sky satellite. The remainder of the base is much less interested but still at 14% and 9% prepared to switch or pay could present TalkTalk with a churn issue.

Figure 5. Proportion of other customer groups interested in BT Sport, %



Source: GfK survey for Citi Research

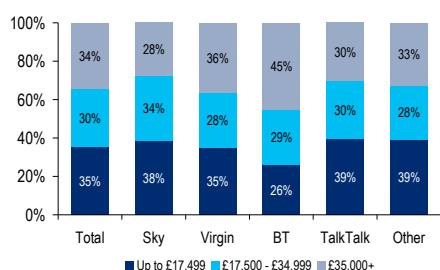
What is behind BT's thinking?

BT's commitment suggests more than a three year play with premiership football.

The BT Sport offer, although expensive, makes sense for BT in a number of ways. It targets a large, committed niche audience and undoes some of the exclusivity over key content previously enjoyed by Sky. BT's commitment, including its heavy investment in studios in the Olympic Park, suggests more than a three year play, indeed possibly ambition to capture more of the English Premier League rights from Sky next time around.

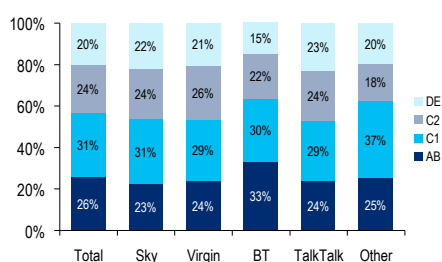
Additionally, BT Sport could sharpen and modernise the brand with its younger celebrity endorsement and heavy marketing. Early in the new football season we expect BT to aggressively promote its high profile premier league matches to drive take-up. In the process the company is adopting greater interactivity and multi-channel distribution in the era of mobile broadband, Facebook and Twitter. Our survey shows BT over indexes among older customers (Figure 8) and the AB social demographic (Figure 7), currently ceding the younger market to Sky in particular and to some extent TalkTalk. Adding BT Sport addresses the younger market more convincingly without cannibalising the core base.

Figure 6. Broadband base income distribution
% broadband customers



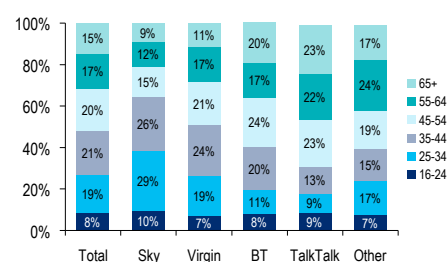
Source: GfK survey for Citi Research

Figure 7. Broadband base social distribution
% broadband customers



Source: GfK survey for Citi Research

Figure 8. Broadband base age distribution
% broadband customers



Source: GfK survey for Citi Research

Most importantly, on its own BT Sport would probably not be enough but combined with YouView, which has already had a very successful start, a somewhat beefed up basic channel line-up and fibre broadband, BT will have greatly improved its proposition over 18 months ago.

BT's basic channels

■ The multicast channels offered today via the Vision+ set top box with the Humax YouView box due to launch soon (currently in testing) are:

- Discovery
- Animal Planet
- Comedy Central
- Gold
- Watch
- Alibi
- National Geographic
- Nat Geo Wild
- British Eurosport
- British Eurosport 2
- Crime & Investigation
- Fox
- MTV
- Syfy
- TLC
- E!
- Universal
- History

■ It is also due to add Nickelodeon and Nick Jr and looking to offer more channels in the future.

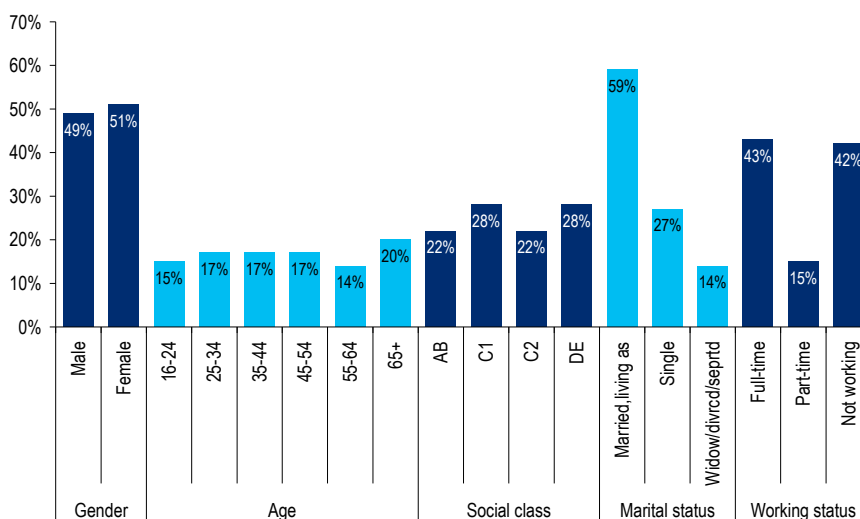
On The Survey

We go through the main results from the individual survey questions in the next section. Additionally, we make some observations about the nature of the survey.

Size, Scope & Timing

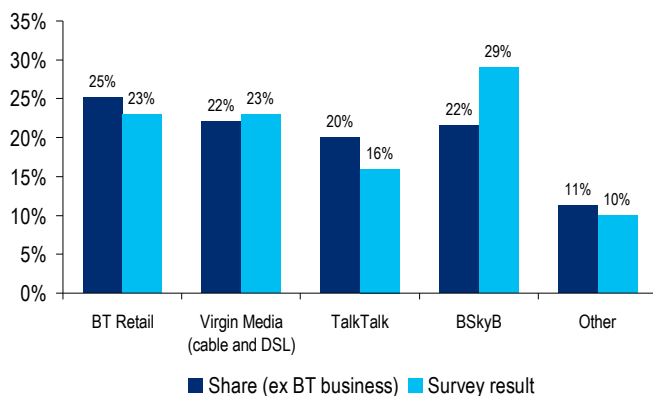
The survey fieldwork was carried out by GfK between 30 May and 4 June 2013. The BT Sport offering was announced and advertising campaign launched on 9 May. The sample group is based on adults older than 16 years old and includes responses from 1,963 participants. From the 1,963 the views of 1,365 household decision makers were included in the survey. With the potential exception of the working vs. non-working split (although this may be distorted by the 65+ and 16-24 demographics – adjusted for these it would 25% not working), the sample seems broadly representative of the UK population.

Figure 9. Composition of the Sample (1,963 respondents, Fieldwork done 30 May-4 June)



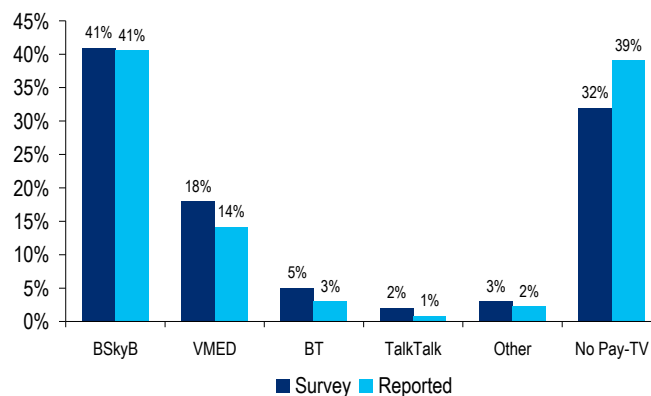
Source: GfK survey for Citi Research

Figure 10. Implied broadband market shares in survey versus reported



Source: GfK survey for Citi Research

Figure 11. Implied TV market shares in survey versus reported



Source: GfK survey for Citi Research

Cross Check of Results vs. Market Stats

We check the accuracy of the survey by cross referencing to reported market shares. For BT we strip out the number of business broadband customers reported within the customer base which we estimate at 1.6m out of 6.7m overall broadband customers. However there is still a bias to Sky broadband customers within the survey.

For TV there is a slight bias towards VMED and BT TV customers and away from non-pay TV customers. However, overall the survey appears to be quite accurate.

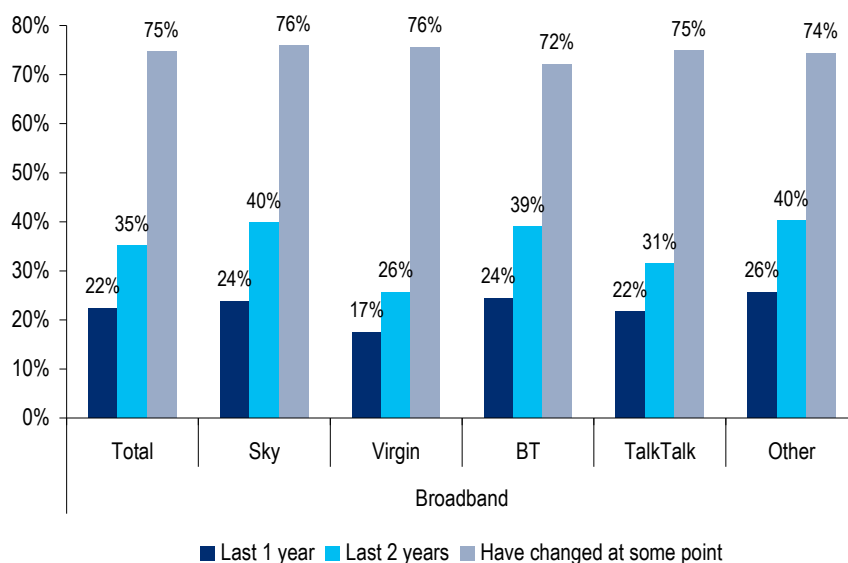
Dealing with Churn

The results we focus on are those which indicate that people may or may not be interested or willing to change broadband/payTV supplier in order to get BT Sport. As a control, we also asked about whether the respondents had changed broadband supplier recently (and therefore may be under contract) and those that have never changed broadband provider (and therefore, despite interest levels, where history may suggest users are less willing to move).

At a headline level, this showed that 22% of the sample had changed broadband provider in the last 12 months (and therefore may be under contract). 25%, meanwhile, indicated that they have never changed broadband provider.

By supplier, the survey showed little difference between broadband providers for implicit churn (for that is the reciprocal of this question). BT and Sky are very similar. Interestingly VMED and Talk Talk are lower than BT and Sky, potentially reflecting their more distinct customer propositions (VMED speed, Talk Talk value).

Figure 12. Proportion of broadband customer base having changed provider in last year, 2 years and having changed at some point.



Source: GfK survey for Citi Research

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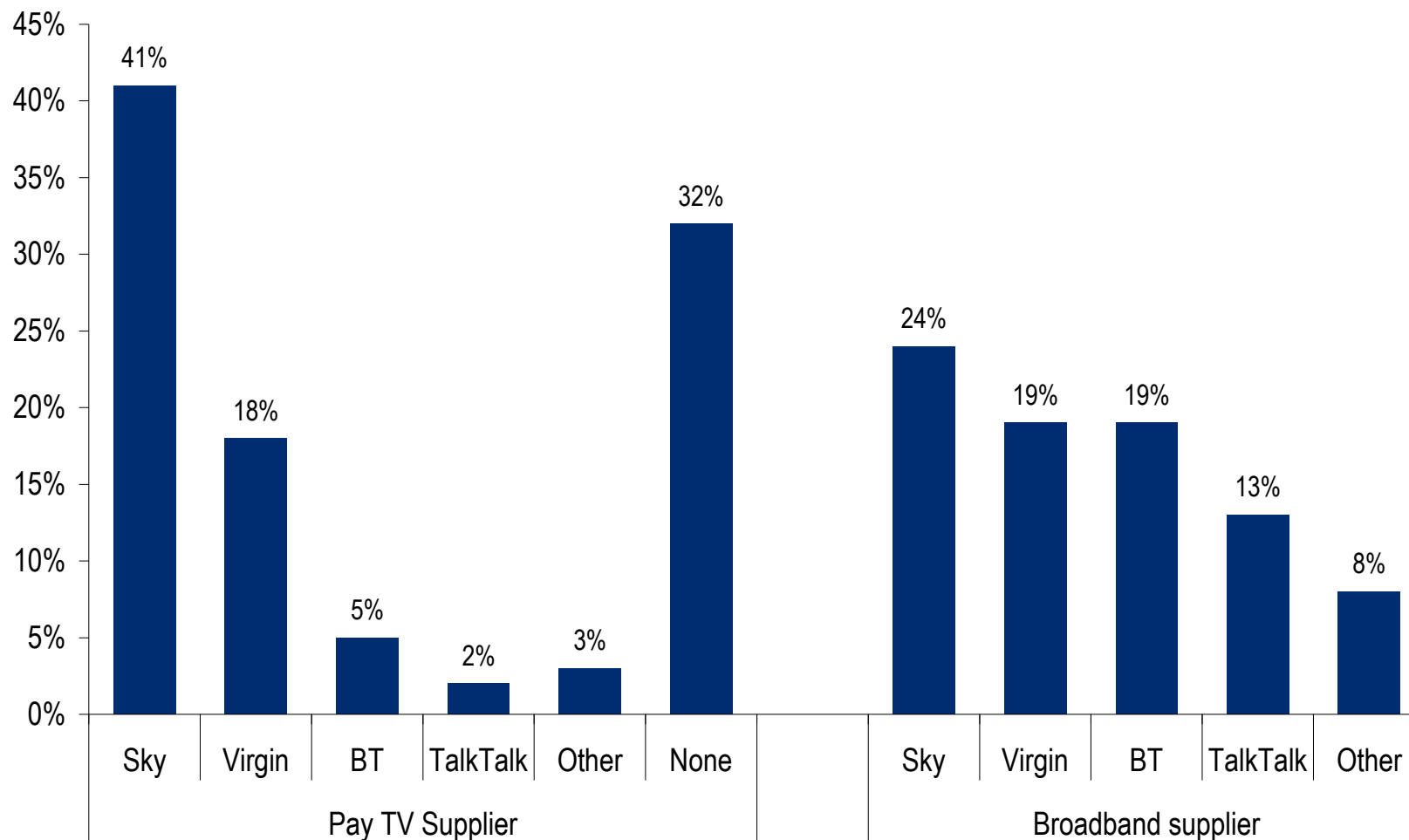
Survey Results

Citi BT Sport Consumer Survey Results

Question #1

Figure 13. "Who supplies the Pay TV service in your household? If you do not currently have a Pay TV service and only receive your channels through Freeview or Freesat please say so."

Base : all adults 16+ who choose/influence the choice of broadband or Pay TV supplier (1,365)

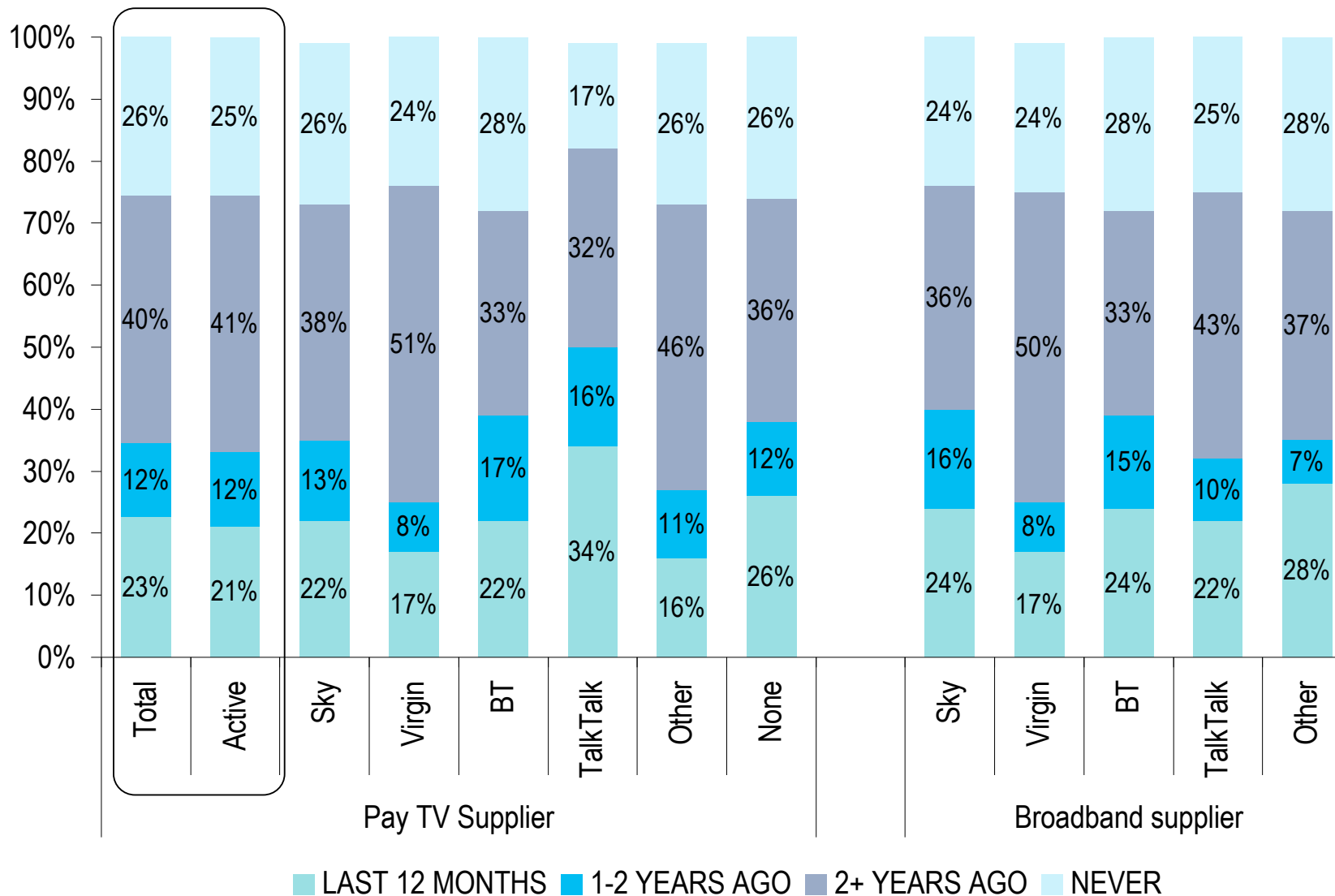


Source: GfK survey for Citi Research

Question #2:

Figure 14. "When did you last change your broadband supplier?"

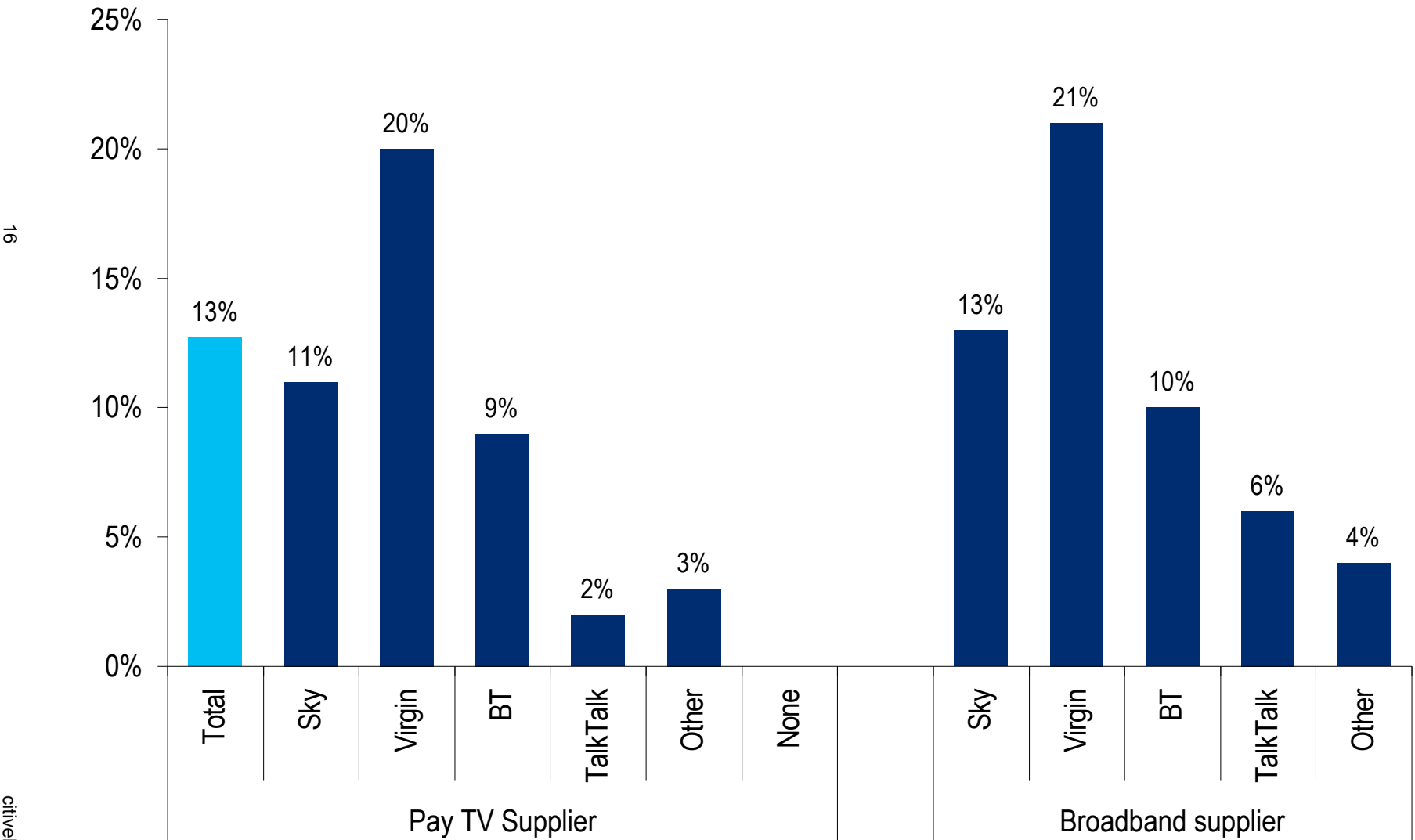
Base : all adults 16+ who have broadband in the home (1071)



Source: GfK survey for Citi Research

Question #3:

Figure 15. "Do you subscribe to the ESPN sports channels?"
Base : all adults 16+ with a Pay TV service in the household (881)

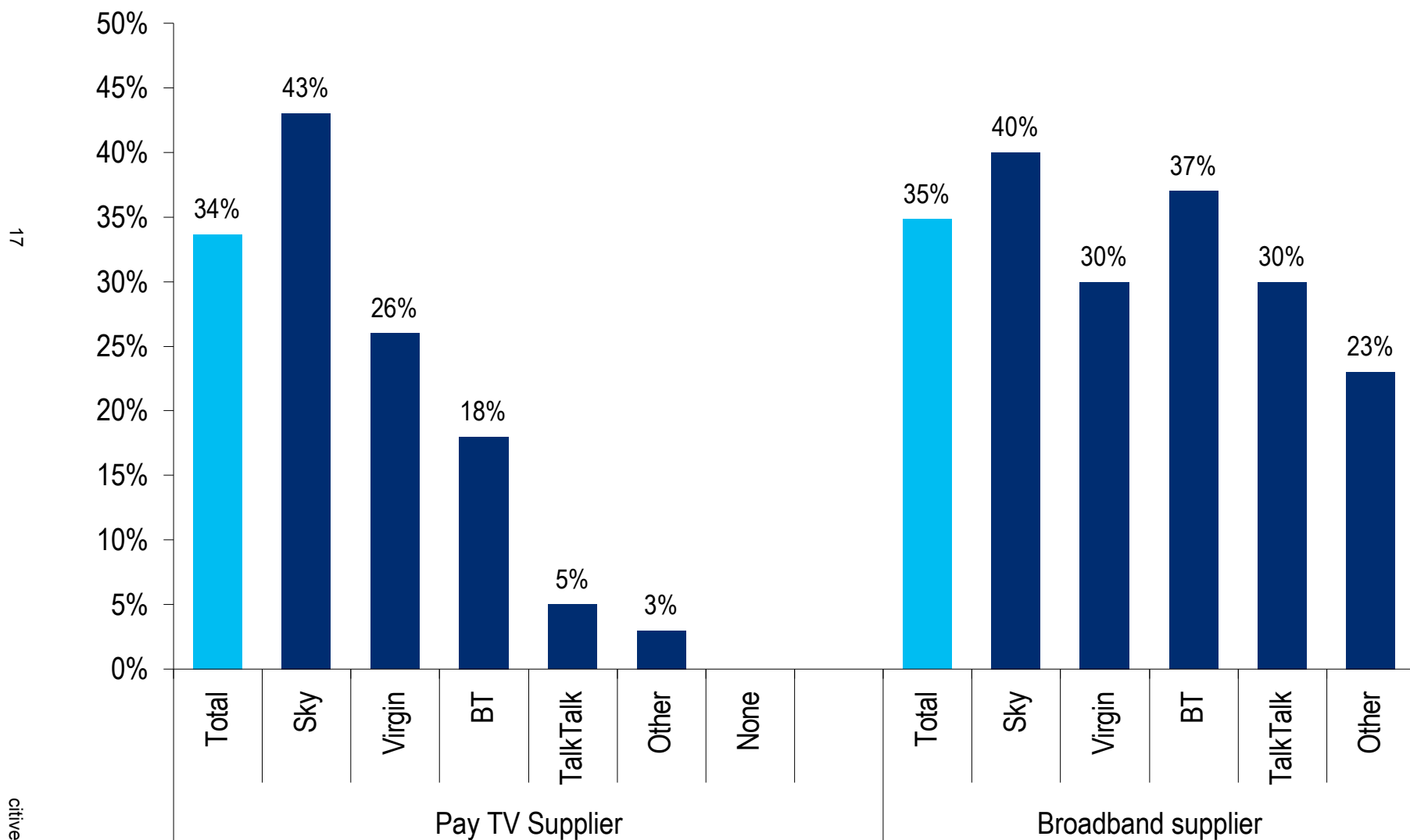


Source: GfK survey for Citi Research

Question #4:

Figure 16. "Do you subscribe to any Sky sports channels, whether from Sky or from one of Virgin, BT or TalkTalk?"

Base : all adults 16+ with a Pay TV service in the household (881)

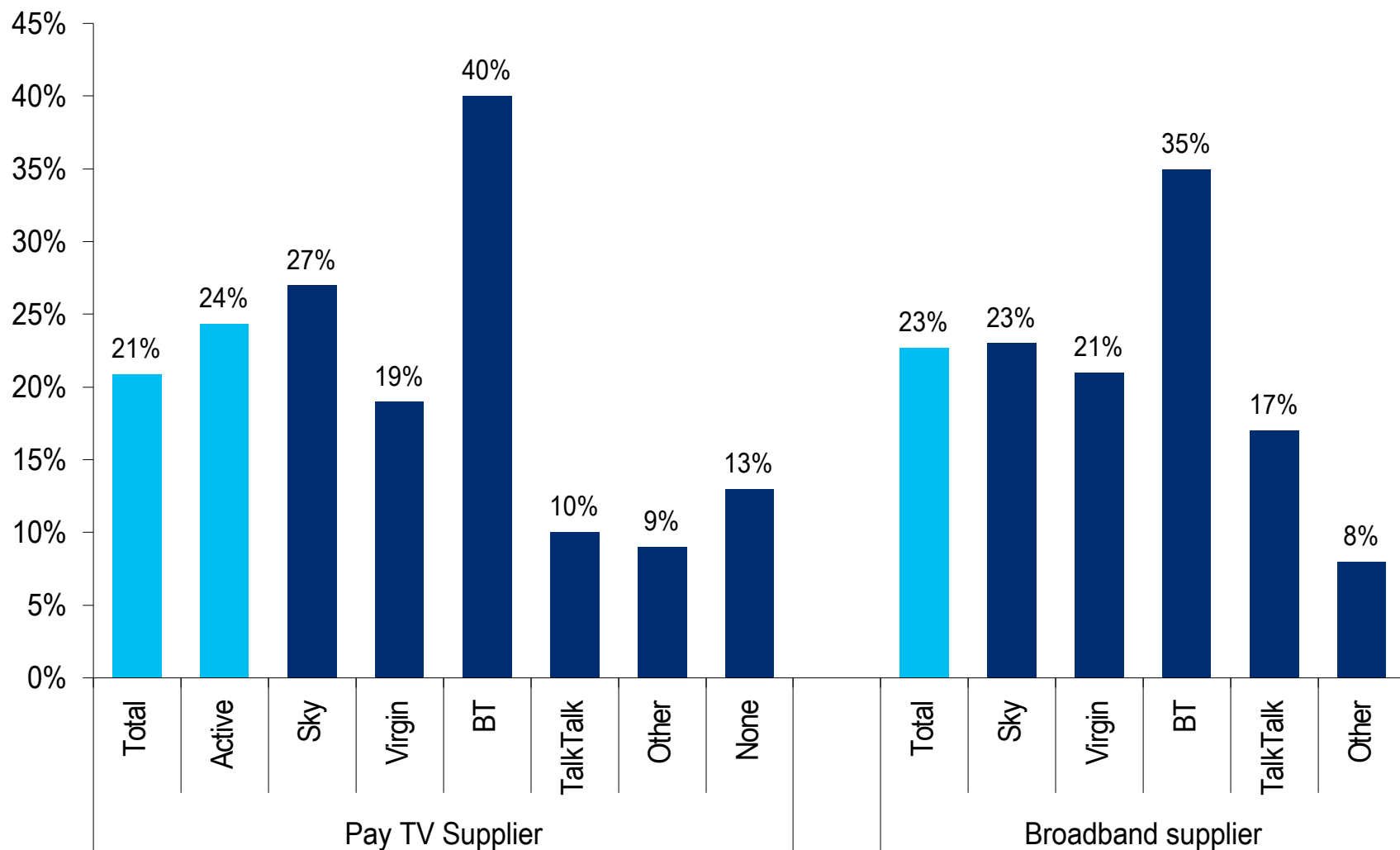


Source: GfK survey for Citi Research

Question #5:

Figure 17. "From this summer some top pick English premier league football, and all premiership rugby will only be available on BT Sport which will come with ESPN. Is BT Sport likely to be of interest to you?"

Base : all adults 16+ who choose/influence choice of Broadband or Pay TV supplier (1365)

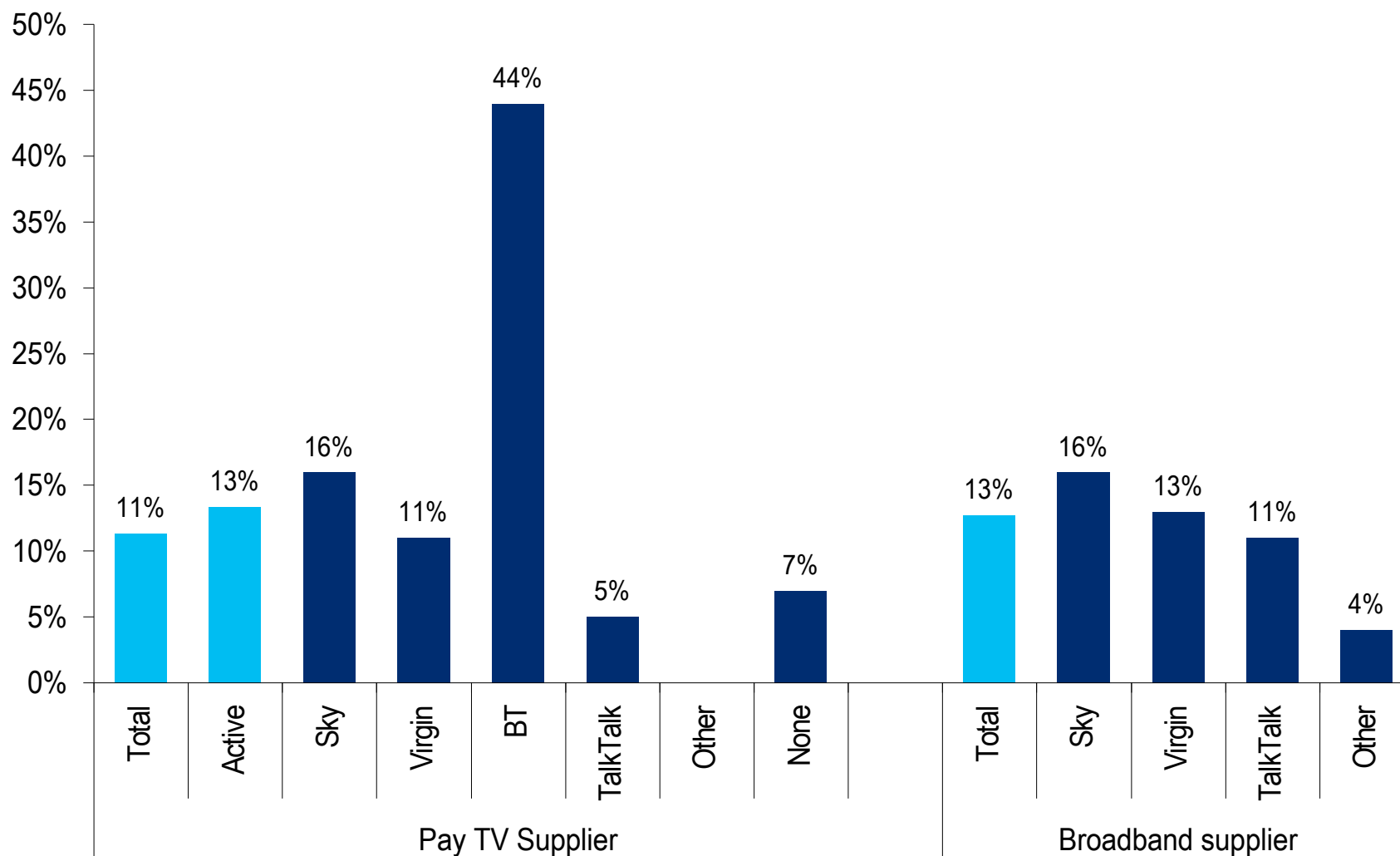


Source: GfK survey for Citi Research

Question #6:

Figure 18. "From this summer BT is offering BT Sport/ESPN free to its broadband customers. If necessary, would you be prepared to switch broadband providers (or install broadband) to qualify, even if you have to pay a bit more for the Broadband?"

Base : all adults 16+ who don't currently receive broadband from BT or decision makers who don't have broadband at home (1116)

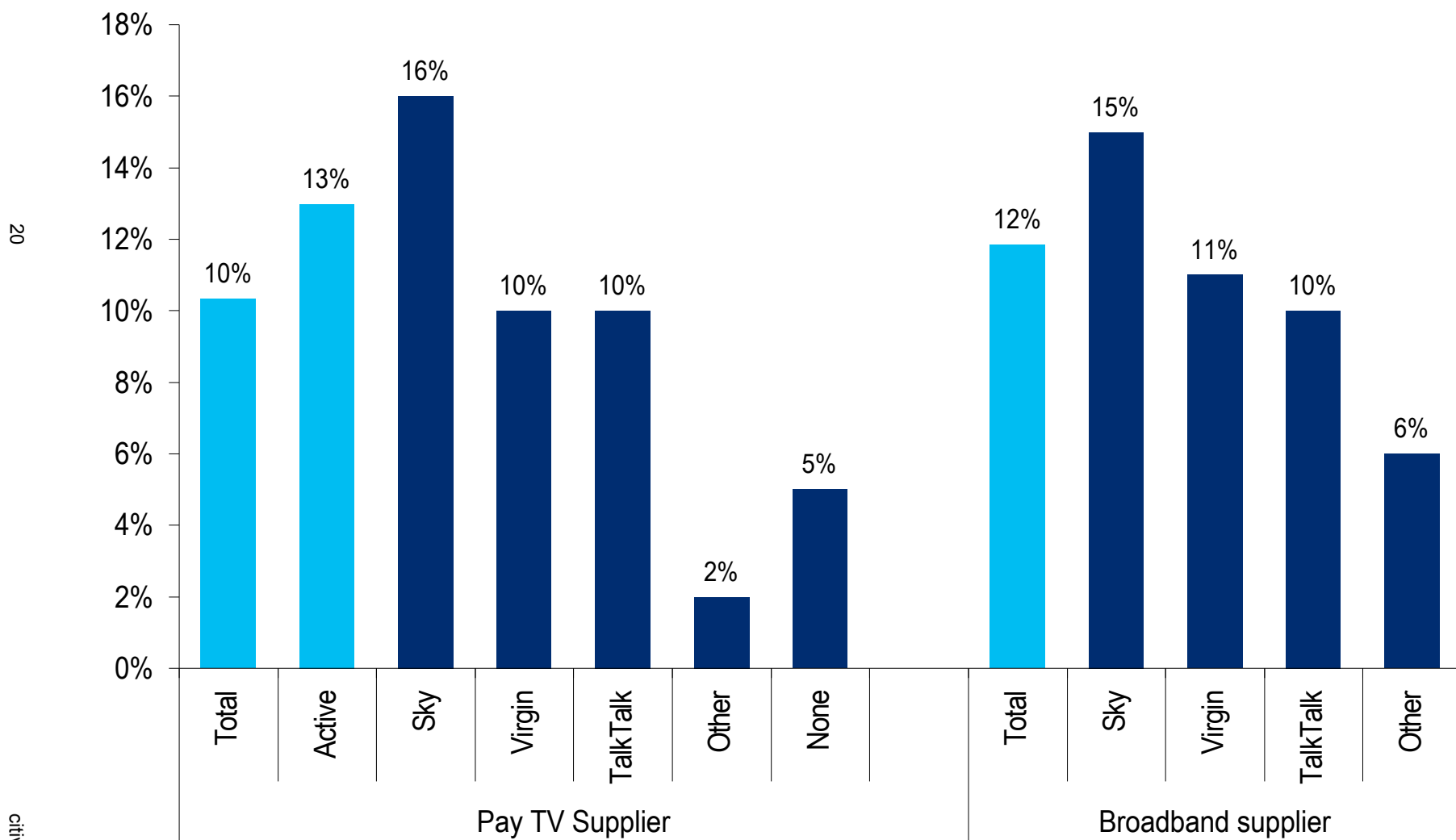


Source: GfK survey for Citi Research

Question #7:

Figure 19. "Non-BT customers will be able to watch BT Sport and ESPN via a Sky set-top box and satellite dish for £12/month. Might you be prepared to pay £12/month?"

Base : all adults 16+ who don't currently receive Pay TV or broadband from BT (1110)



Source: GfK survey for Citi Research

Company Sections

Company Focus

BT Group PLC (BT.L) A Sporting Chance; upgrade to Buy

- Estimate Change
- Target Price Change
- Rating Change

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Buy	1
from Neutral	
Price (20 Jun 13)	£3.11
Target price	£3.65
from £3.00	
Expected share price return	17.5%
Expected dividend yield	3.2%
Expected total return	20.7%
Market Cap	£24,477M
	US\$37,905M

Price Performance (RIC: BT.L, BB: BT/A LN)



- **Upgrade to Buy, 365p target price** — Our survey suggests that the impact of BT Sport will be greater than we or, in our view, the market are currently expecting and has the potential to contribute to the next stage to BT's recovery. Our DCF-based target price rises on slightly higher estimates and increased long-term growth expectations due to the strengthening of BT's consumer triple-play offer. Our new estimates put BT on 12.2x cal 2013e earnings and 10.4x 2015e with the benefit of stronger EBITDA, lower interest costs and a lower tax rate.
- **The sense in BT Sport** — As our survey exposes, the primary aim of BT's push into sports rights and TV is probably to defend the around 43% of its broadband base that also takes Sky TV. In addition it may be a reflection of a maturing overall UK broadband market and allow BT to target the broadband customers of competitors while also sharpening its brand for a younger audience.
- **New CEO as business attempts to transition to growth** — We expect BT to grow revenue at +1% CAGR from FY13-17 ex transit, a notable improvement from the -2.5% it managed from FY09-13. Soon-to-be CEO Gavin Patterson provides continuity of an insider, but his predecessor is closely associated with BT's turnaround for most investors. Nonetheless, Mr Livingston leaves for positive reasons, importantly the CFO remains in post, and we expect the strengthening of BT's business to continue under the new boss.
- **Regulatory matters** — BT already faces regulatory drag from access and leased-line charge controls worth around £200m to revenue in FY14, but we see it consolidating an improved environment with the pending EC's fibre regulation announcement. We expect Ofcom's first consultation on the new ULL rates to be published within the next month and given its latest revision is fairly recent we do not anticipate big surprises. Beyond that Ofcom is investigating a margin squeeze complaint from TalkTalk's re wholesale fibre broadband, something we regard as an inevitable trial balloon on the alternate operator's part at this stage. Given the EU's support for the UK's fibre regulation, that UK full ULL rental (£8.3) is towards the lower end of the EC's proposed €8-10 target, and the strong political momentum behind fast broadband, this seems unlikely to upset BT's local economics.
- **Forecast revisions** — We upgrade broadband and TV customer estimates and factor in BT's latest divisional reporting and IAS19 restatement. The restatements have a small negative impact on EBITDA but the forecast revisions are larger, leading to FY14 revenue and EBITDA rising slightly and FY15 revenue and EBITDA rising by 1%.

BT Group PLC (GBP)

Year to 31 Mar	2012A	2013A	2014E	2015E	2016E
Sales (£M)	19,397.0	18,339.0	17,950.3	18,134.6	18,261.5
Profit Before Tax (£M)	2,391.0	2,656.0	2,726.7	3,150.7	3,516.1
Diluted EPS (p)	22.1	25.1	25.9	30.8	34.6
Diluted EPS (Old) (p)	22.4	25.5	25.7	30.3	33.9
PE (x)	14.1	12.4	12.0	10.1	9.0
EV/EBITDA (x)	5.6	5.4	5.2	4.7	4.3
DPS (p)	8.3	9.5	10.9	12.5	19.1
Net Div Yield (%)	2.7	3.1	3.5	4.0	6.1

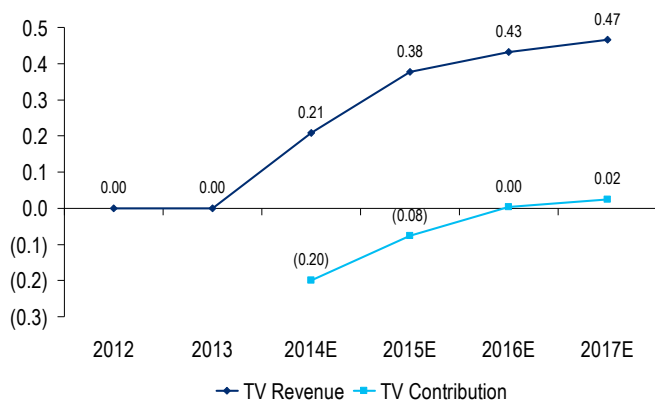
Forecast revisions

As Figure 26 shows this set of forecast revisions are relatively minor in aggregate.

We raise our expectations for TV and broadband net additions in FY14 to reflect the better momentum that we think will be encouraged by the BT Sport launch. Retail broadband net additions rise to 690k from 520k, BT Sport indirect customers (via satellite) rise to 900k vs 600k at March 2014 and BT Sport direct customers rise proportionately much less to of 830k vs 780k. We raise fibre connection forecasts slightly, and continue to expect the number of fibre wholesale customers to accelerate (Figure 21).

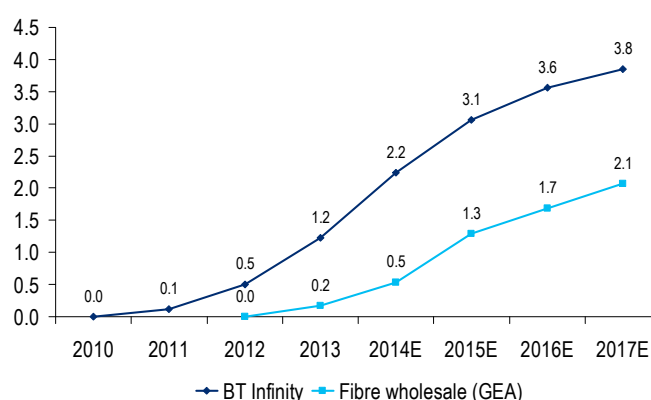
We have also factored in BT's latest restatement with divisional revenue treatment slightly changed, notably for Wholesale which is now to report only its external revenue with an offsetting decrease in group eliminations.

Figure 20. TV attributable revenue and contribution
£bn, Year to March



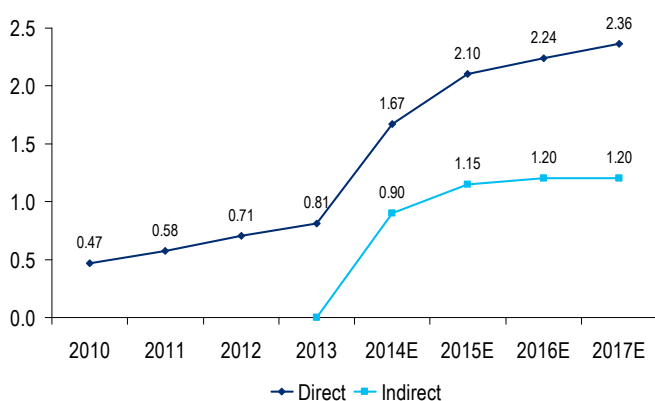
Source: Company reports, Citi Research Estimates

Figure 21. We expect fibre connections to accelerate
Million, end-March



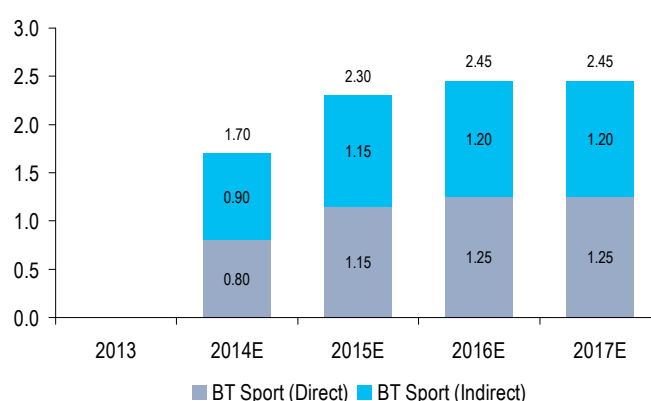
Source: Company Reports and Citi Research Estimates

Figure 22. TV customers including Vision, direct and indirect
Million, end-March



Source: Company Reports and Citi Research Estimates

Figure 23. BT Sport customers
Million, end-March



Source: Citi Research Estimates

Figure 24. TV revenue and principal costs

£m, year to March

	2013	2014E	2015E	2016E	2017E	2018E	2019E
BT TV (Direct) customers, y/e	810	1,671	2,104	2,240	2,364	2,430	2,495
of which:							
BT Sport (Direct)	0	800	1,150	1,250	1,250	1,250	1,250
Non Sport subs	810	871	954	990	1,114	1,180	1,245
BT Sport (Indirect)	0	900	1,150	1,200	1,200	1,200	1,200
Total TV customers	810	2,571	3,254	3,440	3,564	3,630	3,695
Total BT Sport customers	0	1,700	2,300	2,450	2,450	2,450	2,450
Revenue							
TV ex Sport	74	132	206	243	264	281	296
Sport (Retail)	0	0	0	0	0	0	0
Sport (Wholesale)	0	56	131	150	161	161	161
Pubs & Clubs	0	20	40	40	42	42	42
Total	74	208	377	433	466	484	499
Attributable operating costs							
Sport rights	0	(234)	(320)	(320)	(336)	(336)	(336)
Set top box subsidy	(22)	(123)	(82)	(58)	(52)	(47)	(48)
Other opex	0	(50)	(51)	(53)	(54)	(55)	(57)
Contribution	53	(199)	(77)	2	25	46	59

Source: Company data and Citi Research Estimates

Figure 25. Citi estimates for BT compared to consensus

£m

Year to Mar	2012	2013	2014E	2015E	2016E	2017E	2018E
Revenue	19,397	18,339	17,950	18,135	18,261	18,484	18,714
growth, yoy	(3.4%)	(5.5%)	(2.1%)	1.0%	0.7%	1.2%	1.2%
Operating costs	(13,363)	(12,196)	(11,874)	(11,706)	(11,550)	(11,633)	(11,725)
growth, yoy	(5.8%)	(8.7%)	(2.6%)	(1.4%)	(1.3%)	0.7%	0.8%
EBITDA	6,034	6,143	6,077	6,428	6,711	6,851	6,989
growth, yoy	2.5%	1.8%	(1.1%)	5.8%	4.4%	2.1%	2.0%
margin	31.1%	33.5%	33.9%	35.4%	36.7%	37.1%	37.3%
Consensus EBITDA	6,064	6,181	6,047	6,170	6,270	6,262	6,490
EBIT	3,062	3,300	3,331	3,695	3,992	4,140	4,283
Net income	1,814	2,059	2,100	2,489	2,813	2,977	3,112
Basic EPS	23.4	26.3	26.7	31.2	34.7	36.6	38.2
Consensus EPS	23.7	25.4	25.9	28.1	30.5	31.8	37.1
DPS	8.3	9.5	10.9	12.5	19.1	21.1	22.9
Consensus DPS	8.3	9.5	10.8	12.3	14.2	15.3	18.5
Capex	(2,560)	(2,640)	(2,429)	(2,427)	(2,432)	(2,446)	(2,431)
of which: spectrum	0	(202)	0	0	0	0	0
FCF (co definition*)	2,306	2,299	2,391	2,786	3,075	3,383	3,428
FCF	317	1,966	1,793	2,510	2,841	3,147	3,192
Net debt & pensions	10,904	12,215	11,626	10,430	8,824	7,283	5,856
Net debt/EBITDA	1.8x	2.0x	1.9x	1.6x	1.3x	1.1x	0.8x

Source: Company reports, dataCentral

Figure 26. Forecast revisions including restatement of FY13 figures for new divisional treatments and IAS19, £m, year to March

Year to March:	New			Prior			Δ			Δ%		
	2013	2014E	2015E	2013	2014E	2015E	2013	2014E	2015E	2013	2014E	2015E
	Restated											
Retail voice lines	14,372	13,522	12,922	14,372	13,422	12,822	0	100	100	0.0%	0.7%	0.8%
Retail broadband	6,704	7,394	7,664	6,704	7,224	7,494	0	170	170	0.0%	2.4%	2.3%
o/w fibre (Infinity)	1,229	2,243	3,061	1,229	2,192	2,993	0	52	68	0.0%	2.4%	2.3%
BT TV (Direct)	810	1,671	2,104	810	1,594	1,994	0	77	111	0.0%	4.9%	5.6%
BT Sport (Indirect)	0	900	1,150	0	600	650	0	300	500	NM	50.0%	76.9%
Unbundled local loop	8,860	9,310	9,660	8,860	9,310	9,660	0	0	0	0.0%	0.0%	0.0%
Wholesale broadband	2,066	1,866	1,716	2,066	1,866	1,716	0	0	0	0.0%	0.0%	0.0%
o/w fibre (GEA)	169	531	1,291	169	531	1,291	0	0	0	0.0%	0.0%	0.0%
BT Global Services	7,170	6,894	6,863	7,166	6,894	6,863	4	0	0	0.1%	(0.0%)	0.0%
BT Retail	7,299	7,286	7,386	7,228	7,214	7,247	71	72	139	1.0%	1.0%	1.9%
BT Wholesale	2,608	2,425	2,390	3,588	3,428	3,413	(980)	(1,003)	(1,023)	(27.3%)	(29.3%)	(30.0%)
Openreach	5,115	5,046	5,149	5,067	5,015	5,114	48	31	34	0.9%	0.6%	0.7%
Other	97	97	97	61	61	61	36	36	36	59.0%	59.0%	59.0%
Eliminations and other	(3,950)	(3,798)	(3,750)	(4,857)	(4,696)	(4,666)	907	897	917	(18.7%)	(19.1%)	(19.6%)
Revenue	18,339	17,950	18,135	18,253	17,917	18,031	86	34	103	0.5%	0.2%	0.6%
											0.4%	0.8%
BT Global Services	832	893	962	626	741	815	206	152	146	32.9%	20.5%	18.0%
BT Retail	2,025	1,935	2,101	1,935	1,742	1,842	90	193	259	4.7%	11.1%	14.1%
BT Wholesale	620	602	578	1,168	1,140	1,141	(548)	(537)	(563)	(46.9%)	(47.1%)	(49.4%)
Openreach	2,642	2,622	2,763	2,314	2,353	2,496	328	269	267	14.2%	11.4%	10.7%
Other	24	25	25	138	100	100	(114)	(75)	(75)	(82.6%)	(75.0%)	(75.0%)
EBITDA pre exceptionals	6,143	6,077	6,428	6,181	6,075	6,394	(38)	2	35	(0.6%)	0.0%	0.5%
% margin	33.5%	33.9%	35.4%	33.9%	33.9%	35.5%					0.8%	1.6%
Depreciation & amortisation	(2,843)	(2,746)	(2,734)	(2,843)	(2,773)	(2,759)	0	28	25	0.0%	(1.0%)	(0.9%)
EBIT pre exceptionals	3,300	3,331	3,695	3,338	3,302	3,635	(38)	29	60	(1.1%)	0.9%	1.6%
Share assoc net income	9	0	0	9	0	0	0	0	0	0.0%	nm	nm
Net finance costs	(653)	(604)	(544)	(653)	(628)	(567)	0	24	24	0.0%	(3.7%)	(4.1%)
Pension interest credit/(debit)	(117)	(240)	(240)	31	(195)	(195)	(148)	(45)	(45)	nm	23.4%	23.4%
Exceptionals	(224)	(350)	(50)	(224)	(300)	(100)	0	(50)	50	0.0%	16.7%	(50.0%)
PBT	2,315	2,137	2,861	2,501	2,180	2,773	(186)	(43)	88	(7.4%)	(2.0%)	3.2%
Clean PBT	2,656	2,727	3,151	2,694	2,674	3,067	(38)	53	83	(1.4%)	2.0%	2.7%
Tax (ordinary)	(597)	(627)	(662)	(606)	(615)	(644)	9	(12)	(17)	(1.5%)	2.0%	2.7%
Tax (exceptional)	230	98	14	196	84	28	34	14	(14)	17.3%	16.7%	(50.0%)
Minorities	0	0	0	0	(1)	(1)						
Net Income	1,948	1,608	2,213	2,091	1,648	2,156	(143)	(40)	57	(6.8%)	(2.4%)	2.7%
Clean Net Income	2,059	2,100	2,489	2,088	2,058	2,422	(29)	42	67	(1.4%)	2.0%	2.8%
Clean EPS: Basic	26.3	26.7	31.2	26.7	26.5	30.7	(0.4)	0.2	0.5	(1.4%)	0.8%	1.5%
Clean EPS: Diluted	25.1	25.9	30.8	25.5	25.7	30.3	(0.4)	0.2	0.5	(1.4%)	0.8%	1.5%
Dividend per share	9.5	10.9	12.5	9.5	10.9	12.5	0.0	0.0	0.0	0.0%	0.0%	0.0%
Payout ratio	36.1%	40.8%	40.0%	35.6%	41.2%	40.7%						
Stock repurchase	(302)	(300)	(300)	(302)	(300)	(300)	0	0	0	0.0%	0.0%	0.0%
Net (debt)/cash	(7,797)	(7,126)	(5,799)	(8,558)	(7,795)	(6,563)	761	669	764	(8.9%)	(8.6%)	(11.6%)
Change WC & Other	(93)	(182)	(72)	(131)	(97)	(81)	38	(85)	8	(29.0%)	88.4%	(10.1%)
Net pension top-up	235	(249)	(227)	235	(249)	(227)	0	0	0	0.0%	0.0%	0.0%
Interest paid	(692)	(585)	(525)	(692)	(609)	(548)	0	24	24	0.0%	(3.9%)	(4.3%)
Tax paid ex pension	(624)	(489)	(618)	(624)	(501)	(595)	0	12	(23)	0.0%	(2.4%)	3.9%
Net capex	(2,640)	(2,429)	(2,427)	(2,640)	(2,439)	(2,439)	0	10	12	0.0%	(0.4%)	(0.5%)
FCF post pension top up	1,966	1,793	2,510	1,966	1,881	2,404	0	(88)	105	0.0%	(4.7%)	4.4%
FCF adj for net pension/excepts	2,299	2,391	2,786	2,299	2,430	2,731	0	(38)	55	0.0%	(1.6%)	2.0%

Source: Company Reports and Citi Research Estimates

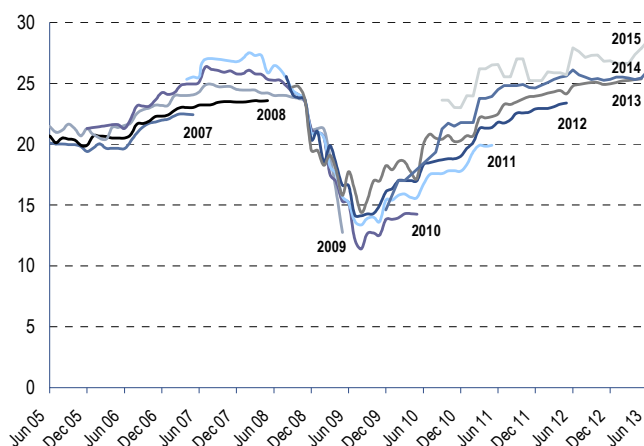
Valuation

Figure 27. Discounted cash flow valuation comes to 365p, £m, year to March

Free cash flow	2010	2011	2012E	2013E	2014E	2015E	2016E
EBITDA	5,639	5,886	6,034	6,143	6,077	6,428	6,711
Movements in working cap	(170)	13	(3)	(2)	(137)	(112)	(96)
Restructuring/other	(920)	(94)	(73)	(456)	(395)	(12)	33
Capex inc spectrum	(2,480)	(2,630)	(2,560)	(2,640)	(2,429)	(2,427)	(2,432)
Tax paid	276	(356)	(615)	(624)	(489)	(618)	(689)
Interest paid	(940)	(944)	(685)	(692)	(585)	(525)	(457)
Divs received	3	7	4	3	0	0	0
Divs paid to minorities	0	0	0	0	0	0	0
FCF pre net pension top ups	1,408	1,882	2,102	1,732	2,041	2,735	3,071
Interest/divs added back	937	937	681	689	585	525	457
Tax shield on interest	0	(189)	(137)	(138)	(117)	(105)	(91)
Unlevered FCF	2,345	2,630	2,646	2,283	2,509	3,155	3,436
Value of yrs 1-7 cash flows	18,706						
Fade period value	15,416						
Terminal value	3,483						
Other	0						
Enterprise value	37,606						
Post BS events	(47)						
Minority equity value	0						
Associate equity value	303						
Net debt @ end 2014E	(7,126)						
Net pension deficit	(1,963)						
Equity value	28,773						
Market gearing (D/E)							33.0%
Tax rate							20.0%
Risk free rate							2.1%
Bond spread							3.5%
Equity market premium							6.0%
Asset beta							1.10
WACC							9.0%
Capex growth during fade period							3.0%
TY ROCE spread over WACC							3.0%
Number of shares (mn)	7,854						
Implied share price (£)	3.66						
Perpetuity growth (post yr 25)							1.5%
Implied perp growth post year 4							(1.2%)

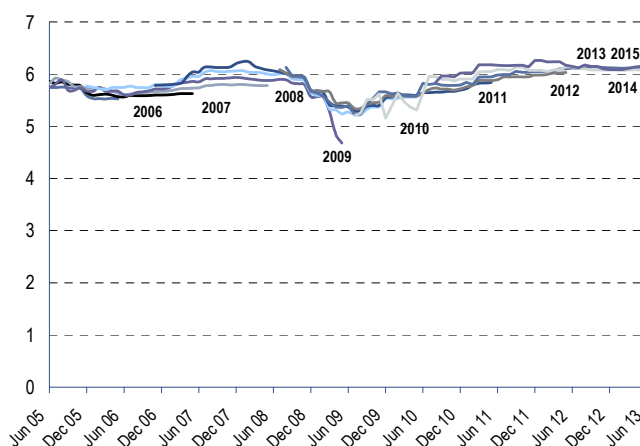
Source: Citi Research estimates

Figure 28. BT EPS consensus continuing its upswing
p/share, financial year to Mar



Source: Company Reports and Citi Research Estimates

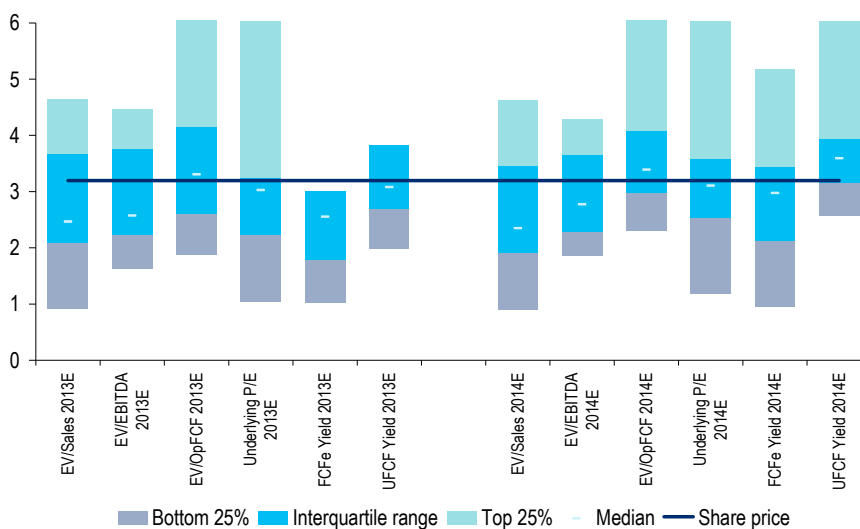
Figure 29. BT EBITDA consensus - relatively steady since mid-11
£bn, financial year to Mar



Source: Company Reports and Citi Research Estimates

Figure 30. BT is trading at or slightly above the median of the European incumbent and wireless names for calendar 2013E and 2014E

£/share, implied share price from peer multiples



Source: dataCentral

Company Focus

■ Estimate Change

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Buy	1
Price (20 Jun 13)	£7.76
Target price	£9.50
Expected share price return	22.4%
Expected dividend yield	3.8%
Expected total return	26.2%
Market Cap	£12,367M
	US\$19,152M

Price Performance (RIC: BSY.L, BB: BSY LN)



British Sky Broadcasting Group PLC (BSY.L)

In The Corridor of Uncertainty But Stay Buyers for Now

- **Injury time** — BT Sport looks like it will have traction in the UK triple play (3x) market and BSkyB appears vulnerable as our survey suggests a higher than average proportion of its customer base – both in pay TV and broadband – is interested and, critically, potentially willing to pay (18% of former; 22% of latter).
- **Direct risk from BT Sport in line with our original thinking; indirect risk lower than originally thought** — In early May we estimated the direct risk for Sky (those likely to give up 3x) at 300-400k (see [4 Charts That May Make You Think Differently About BT Sport](#), 13 May) and indirect risk (i.e. foregone 3x converters) at 2.5m-3.0m. The survey indicates that direct risk could be as high as 1m, although this includes customers who might consider paying for BT Sport rather than switching broadband – taking into account recent promotional activity, 300k-400k still feels about right. On the indirect side, the survey actually suggests the indirect risk is nearer 1m subs. This would still leave upwards of 4m future potential 3x converters for Sky for whom BT Sport would not alter the upgrade rationale. In our model, we assume only 1m eventually convert.
- **There is even scope for a positive sub surprise near term** — The survey also bears out our tentative thesis that BT Sport, at least initially, might attract customers to the platform, in the form of VMED-subscribing sports nuts for whom the BT/BSkyB straddle is now more attractive than VMED 3x. This is not wholly additive because Sky would lose wholesale revenues, but it could throw out the total sub numbers. If we are right, we should know in short order.
- **A game of two halves** — So far, so good. The problem comes when we look medium-term. While we think the near-term risk for BSkyB is not significant – continued EPS growth at Sky and a successful BT Sport strategy are not mutually exclusive – we recognise that a successful BT Sport rollout may well embolden BT to push harder into content. The risk here, in our judgment, is not so much that BT pushes deeper into sport, rather that BT broadens into other premium content verticals (movies, drama, original programming).
- **We stay Buyers of Sky but take it off the Focus List** — BSkyB now trades at a market multiple, suggesting that the market thinks it has gone ex growth. We think is premature. We see the company delivering c.10% compound EPS growth and returning c.8% of market cap pa (50:50 dividend vs. buyback). That said, our conviction on a sharp rerating near-term is low, even if we think this will come in due course. As such we stay Buyers, but remove BSkyB from the Focus List.

British Sky Broadcasting Group PLC (GBP)

Year to 30 Jun	2011A	2012A	2013E	2014E	2015E
Sales (£M)	6,597.0	6,791.0	7,253.6	7,711.7	8,128.8
Profit Before Tax (£M)	987.3	1,148.7	1,240.6	1,232.7	1,404.6
Diluted EPS (p)	41.6	50.9	58.1	59.8	69.9
Diluted EPS (Old) (p)	41.6	50.9	57.8	62.2	69.6
PE (x)	18.6	15.3	13.3	13.0	11.1
EV/EBITDA (x)	9.0	7.9	7.4	7.4	6.5
DPS (p)	23.3	25.4	29.1	29.9	34.9
Net Div Yield (%)	3.0	3.3	3.7	3.9	4.5

Why are We Still Buyers?

How does the Survey Change our Thinking?

- **Revisiting estimates of direct risk from BT Sport: in line with our original thinking** — In early May we estimated the direct risk for Sky (those likely to give up 3x) at 300-400k (see [4 Charts That May Make You Think Differently About BT Sport](#), 13 May). The survey indicates that this figure could be as high as 1m, although this includes customers who might consider paying for BT Sport rather than switching broadband. With BSkyB's pricing promotions (12 months free broadband for Sky Sports as long as customers take an additional product) partially covering the cost of BT Sport (and covering the saving on offer from moving back to the straddle), we think our first estimate of direct risk is about right, if not too high.
- **Revisiting estimates of indirect risk: lower than first thought** — In the May report we argued that BSkyB could have lost up to 2.5m-3m triple play converters. The implication of the survey is that the number is not that high. Adding up the Sky pay-TV subs who take another broadband provider and then looking at those who indicate they would be interested in BT Sport would suggest the indirect risk is nearer 1m subs. This would still leave upwards of 5m future potential 3x converters for Sky for whom BT Sport would not alter the upgrade rationale. In our model, we assume only 1m eventually convert.
- **There is Even Scope for a Positive Sub Surprise Near-Term** — The survey also bears out our tentative thesis that BT Sport, at least initially, might attract customers to the platform, in the form of VMED-subscribing sports fans for whom the BT/BSkyB straddle is now more attractive than VMED 3x. This is not wholly additive because Sky would lose wholesale revenues, but it could throw out the total sub numbers. If we are right, we should know in short order.

Looking at BSkyB's Response: Tactics vs. Strategy

In the last week BSkyB has given some insight into both its tactics and its strategy around the launch of BT Sport. We think the former can be seen in the new (temporary) promotional offers that the company publicised on Friday, while the latter can be deduced from its standard disclosure on future price rises. Going into both in turn:

Tactics

BSkyB announced its new pricing promotions at the tail end of last week. The framework of the offer is as follows:

- Broadband is half price for 12 months; this offer is for new customers. Fibre is half price for six months; this offer is for new customers and those upgrading from standard broadband.
- Sky Sports customers – whether existing or new – get double these discounts – i.e. 12 months free - when they switch their broadband to Sky or upgrade to Sky Fibre.

Strategy

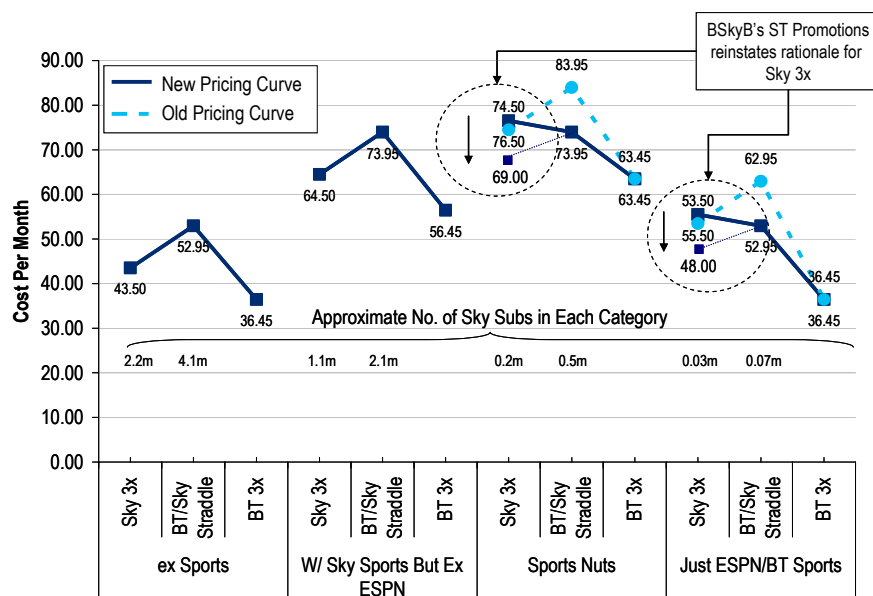
The standard pre-warning on price increases (we expect customers to start receiving letters informing them of price increases in late June/early July) suggests Sky TV pricing could go up by up to 10% from 1 September. Any commentary on broadband/communications is notable by its absence. We think this means BSkyB will continue with its asymmetric pricing model: pricing may well rise for TV – we

would expect increases focused on Sports and Basic (not HD, not multiroom, not movies, maybe not Ireland again) – but stay the same for broadband and telephony (price increases in line rental are more likely). Accompanying this, we expect Sky to continue with its 'switch and save' marketing messaging.

What does this mean?

Firstly, on the tactics, we should underline that the impact on financials may be less dramatic than we first thought. In our first glance we argued that a worst case adoption of the free broadband offer could take as much as 2% off consensus operating profit. In reality this is unlikely because to qualify, customers have to take at least one more product. More broadly, as a tactical competitive response it looks sound: by toggling pricing for 3x, BSKyB has once again ensured that the pricing 'curve' that became a 'slope' in the aftermath of the BT Sports announcement (the right-most two columns in the chart below) has become a slope again.

Figure 31. Total Pricing Curves for Different Categories – BSKyB Triple Play vs. BT Triple Play vs. BT/BSkyB Straddle (Price per Month in £)



Source: Company Reports and Citi Research Estimates

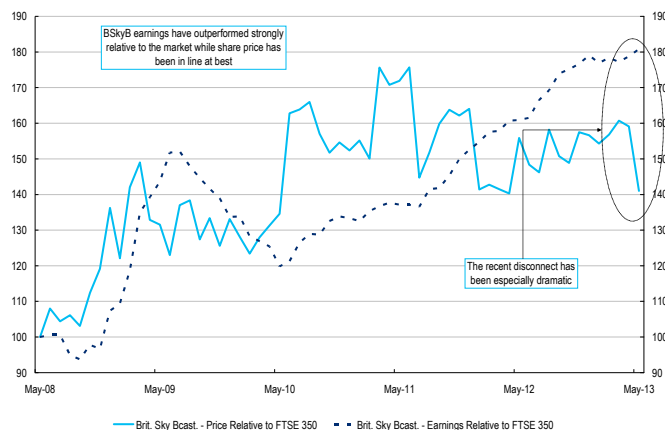
This is where the second point on strategy comes in. The details announced on Friday are short-term in nature. The indication on future pricing is that BSKyB will allow inflation to provide the 'real' price cut over time. In other words, we believe BSKyB's thinking is likely to be that the short-term offer reinstates the price curve in the short-term while holding broadband pricing flat for another year (at least), will reinstate it in the medium-term – based on commentary at its investor day, we note that BT still seems clearly committed to price increases.

This seems like a sensible way of minimising both the direct and indirect risk associated with BT Sport. For Sports Nuts who will subscriber to BT Sport come what may, BSKyB is effectively covering the cost of this (plus giving them a bit of an incremental discount); for potential 3x converters who take Sport and for whom the upgrade path had become muddled, the promotion reinstates a rationale for upgrade.

Why Are We Still Buyers?

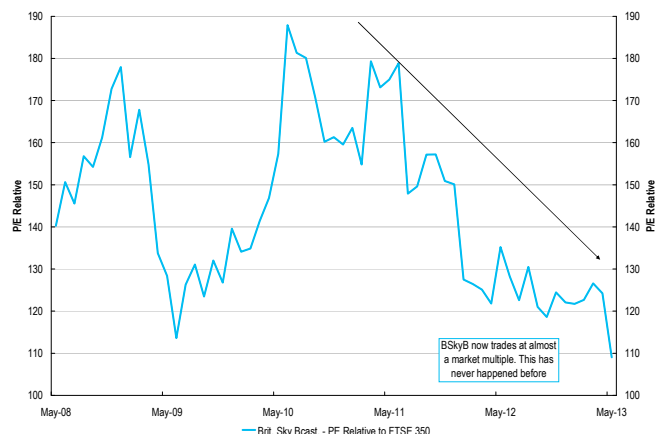
In the charts below we show BSKyB's earnings/price relative to the market on both a disaggregated and aggregated basis.

Figure 32. BSKyB – Market Relative P/E Deconstructed



Source: DataStream

Figure 33. BSKyB – Market Relative P/E



Source: DataStream

This shows two things: first that BSKyB has consistently delivered above market-average earnings growth and second that this, by and large, hasn't been reflected in market relative share price performance. In other words, as the chart on the right shows, BSKyB has been consistently and ruthlessly derated such that, for the first time as far as we can tell, the group is almost trading on a market multiple.

Turning to the investment thesis, although we acknowledge the existential risk medium-term with respect to whether the BT Sport experiment emboldens BT to push into other premium content verticals, we think near-term the investment case will be judged on two things: first, on whether BT Sport impacts earnings and second, on whether it could/should justify a further derating.

Our view on both is sanguine. As above, we are not convinced that the launch of BT Sport will significantly disrupt the earnings profile in the short- to medium-term; indeed we argue it could even be a catalyst for upgrades in the short-term.

With regard to the multiple, we see limited room for a further derating but also make the point that a (sustainable) rerating is unlikely. Even so, with 10%+ compound EPS growth and a cumulative 8% cash return (c. 50:50 dividend vs. buyback) we still think this is consistent with a double-digit ETR.

Putting this together, we stay Buyers of BSKyB.

Examining Sensitivities on BT Sport

We don't see any meaningful EPS risk from BT Sport...

....but what if we are wrong?

In our base case we do not see BT Sport significantly disrupting the EPS/cash returns profile of BSkyB as those customers who are interested in BT Sport, we think will be incentivised to stay via tactical promotions. We note again that the effective saving of offer for Sports Nuts, even before the recent pricing promotion announcement by BSkyB, is as little as £2.55 per month.

But what if we are wrong?

In this section, we briefly outline the risk profile associated with the more extreme scenarios. These nearly all apply to the direct risk associated with BT Sport rather than the indirect risk as the former applies to customers Sky already has and therefore can lose, while the latter applies to potentially foregone future triple play converters.

Building Up a Scenario Analysis

We examine best- and worst-case scenarios

Before we dig into the scenarios themselves, it is worth dwelling briefly on the assumptions that drive our analysis. Key to this is the chart below where we outline what we estimate the marginal revenue/gross profit contribution to be from various product categories.

Figure 34. BSkyB – Incremental Revenue/Gross Margin by Product (£)

	<i>Incremental Revenue (£)</i>	<i>Incremental Profit (£)</i>	<i>Comment</i>
HD	103	87	HD: £10.25 less VAT; pretty high margin; some channel cost (per channel HD costs); conditional access cost
Multiroom	103	97	Multiroom: again £10.25 less VAT; almost 100% margin save VAT; some conditional access cost
Broadband	75	24	Off-net is £17 flat; on-net is £7.50 or free; off-net is zero margin; PULL = £1.30 per month bband SMPF; other costs relate to subscriber management etc.
Telephony	108	43	Revenue tends to be between £8 and £9 regardless of basic package (£5 or £0); gross margin level is 40%-50%
Line rental	143	43	Cost is £8.40 for PULL; FULL = total cost £7.20

Source: Citi Research

In the context of the scenarios we look at we are more narrowly focused on the latter three categories as our core assumption is that even if BT Sport is successful in prising away BSkyB 3x customers, it is unlikely to migrate them to BT 3x given the lack of HD content and the weaker basic channel offering.

Worst Case – Sky loses 1m broadband/line rental/telephony customers

In a worst case scenario, Sky loses 1m broadband customers

Our survey suggests this is possible, although tactical promotions/inertia means some of these subs will choose to subscribe direct to BT Sport rather than switch broadband provider

This could take upwards of 8% off earnings in our analysis

As per the survey, the worse case scenario for Sky is that all the broadband customers who indicate they are interested and willing to pay for BT Sport do so by moving their broadband/telephony back to BT, rather than opting to pay the £12-15 per month for the channel direct.

We can critique whether this is realistic given BSkyB's promotional response as well as the fact that some of these customers will still be in contract, but it reflects a realistic worst case.

Based on the revenue/gross profit calculations above, we estimate the worst case impact of losing 1m broadband/telephony subs would be equivalent to c.£325m of revenue (c. 4.2% of our 2014E forecast) and c.£110m of EBITA (about 8.2% of our 2014E forecast).

Figure 35. BSkyB – Worst Case Scenario – BSkyB loses 1m Broadband/Telephony/Line Rental Customers (Year-end June, £m)

	Incremental Adds	Incremental Revenue (£m)	As % of group 2014E Revenue	Incremental Profit (£m)	As % of group 2014E EBIT
HD	0.0	0.0	0.0%	0.0	0.0%
Multiroom	0.0	0.0	0.0%	0.0	0.0%
Broadband	-1,000.0	-75.0	-1.0%	-23.8	-1.8%
Telephony	-1,000.0	-108.0	-1.4%	-43.2	-3.2%
Line rental	-1,000.0	-142.8	-1.9%	-42.7	-3.2%
Total	-3,000.0	-325.8	-4.2%	-109.6	-8.2%

Source: Company Reports and Citi Research Estimates

This is equivalent to a meaningful downgrade. It is, however, also consistent with the c. 8% drop in the shares since the announcement of the 'free' BT Sport positioning in early May.

Best Case – BSkyB Gains 600k Virgin Media TV Subs

In a best case scenario, Sky actually gains an additional 600k direct customers

The survey indicates around 1m Virgin customers are interested in BT Sport of which around two thirds are prepared to either switch broadband supplier or, if it were an option, pay £12/month for the channels.

At this stage, Virgin and BT have not reached an agreement on wholesale, so the latter would not be an option. Even if this situation changes, we see a risk that Virgin may yet see a period of elevated churn. Likely destinations for customers could be one or the other of:

- Sky triple play plus BT Sport via a satellite subscription;
- Sky for TV with Virgin for broadband and voice;
- Sky for TV with BT for broadband and voice.

Again, this is consistent with our survey. The issue is that not all of this would be 100% additive – BSkyB would lose some wholesale revenues through this transition

This could add upwards of 7% to earnings in our analysis

In Figure 36 below, we look at the return profile based on these 600k subscribers taking Sky TV only. The key point here is to balance the additive effect of the direct subscription, with the dilutive impact of lower wholesale revenue. As we show below it is almost the mirror image of the bear case scenario: on a best case, this could drive upwards of £120m additional revenue (1.6% of our 2014E forecast) and c. £100m additional EBITA (around 7.2% of our 2014E forecast).

Figure 36. BSkyB – Best Case Scenario – BSkyB Gains 600k Direct TV Customers (Year-end June, £m)

	Incremental revenue (£)	Incremental Profit (£)	Comment
Basic TV	215	187	Basic TV offering at £21.50 less VAT; Gross margin calculation is tricky; we estimate the gross margin is around 85% based on our estimate of per sub third-party channel costs
Sky Sports	210	210	Sky Sports at £21 per month less VAT; should be 100% gross margin
HD	103	87	HD: £10.25 less VAT; pretty high margin; some channel cost (per channel HD costs); conditional access cost
Total Per Direct Customer (£)	528	484	
Wholesale Sports Subscriptions	228	228	There is no visibility on this figure; we assume £18 per sub per month; implicit within this is the charge for the HD versions of the content
Wholesale Other Channel Subscriptions	95	95	We estimate that BSkyB gets paid around £7.50 per month for access to its non-Sports channels; again this should be 100% gross margin
Total Per Indirect Customer (£)	323	323	
Incremental Impact of 600k Direct Customers (£m)	123	97	
as % of 2014E Base Case	1.6%	7.2%	

Source: Citi Research

Putting this Together: We Should Have a Sense of Trends by 1Q results in October

It seems to us that the market is expecting some form of negative impact on BSkyB, albeit not as significant as our worst case

In the event BSkyB loses 1m customers – our worst case outcome – we could reasonably expect around a 10% hit to EPS and presumably some form of derating on top of that. In addition, we should probably take into account the risk to the rating: if we assume that investors would want a 10% discount to the market multiple to reflect the threats to growth, this would suggest a cumulative share price impact of around 20%.

At the same time, we should consider the best case outcome we discuss above. In this context, we estimate there is upwards of 5%-10% EPS upside potential and, should Sky see an acceleration in sub growth even at the expense of wholesale revenue, this should give comfort in the existing multiple (approaching a market multiple), if not justify a slight rerating.

We see scope for positive surprise on a pick-up in direct sub numbers...

Looking at actual performance, it is fair to say the market is closer to the former than the latter. BSkyB has come off by around 10% since the announcement of the BT Sport offer, which suggests to us that the market is anticipating a direct risk to Sky, albeit potentially not one as bad as our worst case scenario.

...and we may start to see this as soon as the 1Q results in October

What is interesting about this situation is that we should start to see the effects in relatively short-order: given the customer base that will be primarily affected by BT Sport are Sports Nuts, the beginning of the football new season (17 August) provides something of a hard deadline for some of these changes to occur. In this context, we would anticipate some relatively clear directional indicators potentially as soon as BSkyB's 1Q results in October.

Changes to Forecasts

We make some changes to our forecasts. The main changes are:

- **We update our sub assumptions for 2013E** on the back of 3Q trading. We mildly move up our forecast of total TV subs (inflated by NowTV); we also lift our forecast of multiroom and broadband/telephony. Finally we include some revenue for Sky Go Extra, although the impact of this is very small.
- **For 2014E**, the main change we make is to include the Telefonica/O2 broadband base. The group announced the acquisition of TEF/O2's UK broadband business in early March and although this will bring with it around 500k broadband subs, of whom we estimate around two-thirds are stand-alone communications customers (i.e. don't overlap with the Sky TV customer base), we expect the impact near-term to be dilutive as the customer base is integrated. The direct costs of this, combined with the uplift in programming expenses – driven by the FAPL costs and already anticipated – mean EBITA is essentially flat YoY on our estimates.
- **From 2015E**, the integration costs of the broadband deal integration fall away. We also assume much less aggressive programme cost inflation – the result of the straight-line amortisation of the Premier League programme rights. This means we anticipate a relatively sharp acceleration in profit growth and a resumption – even without a buyback – of mid-teens EPS growth.

We summarise the changes to forecasts in the table below. In summary, though, we mildly increase our forecasts for 2013E, although we note we are above consensus. We reduce our forecasts for 2014E, and end up in line with consensus. We increase our forecasts for 2015E and end up at the upper end of quite a wide consensus range.

Figure 37. BSKyB – Changes to Forecasts (Year-End June, £m except where stated)

	Old				New				% change			
	2012	2013E	2014E	2015E	2012	2013E	2014E	2015E	2012E	2013E	2014E	2015E
Revenues	6,791	7,189	7,563	7,917	6,791	7,254	7,712	8,129	0.0%	0.9%	2.0%	2.7%
Total Costs	5,567	5,874	6,196	6,472	5,567	5,911	6,371	6,648	0.0%	0.6%	2.8%	2.7%
EBIT	1,224	1,314	1,367	1,445	1,224	1,342	1,340	1,480	0.0%	2.1%	-1.9%	2.4%
EBIT Margin	18.0%	18.3%	18.1%	18.3%	18.0%	18.5%	17.4%	18.2%	0bps	22bps	-69bps	-5bps
Profit Before Tax	1,149	1,233	1,283	1,399	1,149	1,241	1,233	1,405	0.0%	0.6%	-4.0%	0.4%
EPS (p)	50.9	57.8	62.2	69.6	50.9	58.1	59.8	69.9	0.0%	0.6%	-4.0%	0.4%

Source: Company Reports and Citi Research Estimates

Figure 38. BSkyB – Adjusted Profit and Loss Summary (Year-end June, £m except where stated)

	2007	2008	2009	2010	2011	2012	2013E	2014E	2015E
DTH satellite subscribers	8,582	8,993	9,466	9,896	10,187	10,288	10,424	10,536	10,630
UK Cable subscribers	3,294	3,194	3,094	3,294	3,294	3,294	3,494	3,694	3,894
Eire Cable subscribers	604	604	604	604	604	604	604	604	604
DTT homes	9,200	10,200	10,250	10,300	10,350	10,400	10,450	10,400	10,350
Total UK/Eire multichannel subscribers	21,680	22,991	23,414	24,094	24,435	24,586	24,972	25,234	25,478
Total subscribers	8,582	8,980	9,442	9,860	10,187	10,288	10,424	10,536	10,630
of which:									
<i>Sky+ subscribers</i>	1,962	3,033	4,591	6,473	8,139	9,177	9,783	10,146	10,309
<i>Sky+ HD subscribers</i>	292	498	1,313	2,939	3,822	4,343	4,735	5,112	5,460
<i>Multiroom subscribers</i>	1,343	1,604	1,834	2,118	2,250	2,402	2,476	2,472	2,439
<i>Broadband subscribers</i>	716	1,628	2,203	2,624	3,335	4,001	4,521	5,504	5,919
<i>Telephony subscribers</i>	526	1,241	1,850	2,367	3,101	3,768	4,340	5,323	5,738
<i>NowTV subscribers</i>							68	134	198
UK/Cable subscribers	3,898	3,798	3,698	3,898	3,898	3,898	4,098	4,298	4,498
Total Sky subscribers	12,480	12,778	13,140	13,758	14,085	14,186	14,522	14,834	15,128
DTH satellite subscription	3,336.7	3,567.6	3,788.2	4,222.0	4,657.1	4,638.2	4,930.6	5,085.2	5,239.3
Broadband/Fixed line subscription	73.6	248.6	396.4	571.5	794.5	954.3	1,163.6	1,378.2	1,562.1
Wholesale revenues	207.7	180.9	206.0	231.7	323.0	350.8	377.8	436.4	480.0
Advertising	352.2	327.9	308.0	319.0	458.0	440.0	448.8	471.2	494.8
Other	580.3	626.6	624.9	567.8	364.4	407.7	332.8	340.8	352.5
Total revenues	4,550.5	4,951.6	5,323.5	5,912.0	6,597.0	6,791.0	7,253.6	7,711.7	8,128.8
Movie costs	285.0	281.1	278.0	294.7	278.1	295.0	327.0	360.7	393.6
Sports costs	841.9	929.4	943.6	1,031.0	1,206.2	1,207.8	1,315.8	1,481.2	1,550.8
Third party channels	293.1	298.0	323.0	320.4	309.4	293.3	290.8	288.4	285.4
Entertainment (Sky One)	130.0	138.0	149.0	196.9	334.2	440.5	502.2	537.3	574.9
News (Sky News)	54.0	56.7	57.8	59.0	60.2	61.4	62.6	63.9	65.1
Programming costs	1,603.9	1,703.1	1,751.4	1,902.0	2,188.0	2,298.0	2,498.4	2,731.4	2,869.8
Transmission etc	297.0	309.9	354.1	373.7	395.0	395.0	402.9	411.0	417.7
Marketing	685.3	708.8	857.1	1,118.0	1,041.7	882.2	849.1	835.3	842.0
Subscriber management	558.5	601.0	593.3	638.0	596.0	621.3	633.5	646.4	659.8
Administration	396.9	466.0	461.9	507.0	517.6	514.0	542.7	531.6	559.1
Broadband/Fixed line	242.8	411.7	524.9	518.0	785.4	856.8	984.8	1,215.7	1,299.9
Total costs	3,784.3	4,200.6	4,542.7	5,056.7	5,523.7	5,567.3	5,911.4	6,371.4	6,648.3
EBITA	766.2	751.1	780.9	855.3	1,073.3	1,223.7	1,342.2	1,340.4	1,480.4
Margin	16.8%	15.2%	14.7%	14.5%	16.3%	18.0%	18.5%	17.4%	18.2%
Associates	12.0	15.0	19.0	29.0	34.0	32.0	33.6	35.3	37.0
Net interest	-136.0	-152.0	-161.0	-132.0	-120.0	-125.0	-148.7	-159.8	-134.5
Profit before tax (adjusted)	675.2	635.6	638.9	752.3	987.3	1,148.7	1,240.6	1,232.7	1,404.6
Tax	-213.0	-195.1	-191.0	-295.0	-262.0	-283.0	-297.7	-283.5	-295.0
Profit after tax (adjusted)	462.2	440.5	451.0	542.3	725.3	875.7	942.9	949.2	1,109.6
Extraordinary items (pre-tax)	49.0	-28.0	-185.0	421.0	33.0	41.0	32.0	0.0	0.0
Goodwill amortisation (pre-tax)	0.0	-549.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Exceptional tax	0.0	0.0	0.0	-85.0	0.0	-10.0	0.0	0.0	0.0
Reported net income	511.2	-136.5	266.0	878.3	758.3	906.7	974.9	949.2	1,109.6
Reported basic EPS (p)	28.9	-7.8	15.2	50.1	43.5	52.7	60.1	59.8	69.9
Adjusted basic EPS (p)	26.2	25.1	25.5	30.9	41.6	50.9	58.1	59.8	69.9
DPS (p)	15.5	16.8	17.6	19.4	23.3	25.4	29.1	29.9	34.9

Source: Company Reports and Citi Research Estimates

Figure 39. BSKyB – Cash Flow Statement (Year-end June, £m except where stated)

	2007	2008	2009	2010	2011	2012	2013E	2014E	2015E
Operating profit	766.2	751.1	780.9	855.3	1,073.3	1,223.7	1,342.2	1,340.4	1,480.4
Depreciation	192.0	246.0	311.9	337.0	332.0	344.0	367.4	390.6	411.8
Amortisation of govt grants etc.	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net working capital	42.0	0.0	53.0	139.0	95.0	84.0	48.2	49.7	51.3
Use of provisions (migration)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Exceptionals	0.0	0.0	0.0	35.0	69.0	86.0	0.0	0.0	0.0
Operating cashflow	1,000.2	997.1	1,145.7	1,366.3	1,569.3	1,737.7	1,757.8	1,780.8	1,943.4
Dividends from JVs	9.0	11.0	17.0	30.0	29.0	39.0	40.6	42.2	43.9
Net interest	-108.0	-122.0	-170.0	-152.0	-117.0	-108.0	-148.7	-159.8	-134.5
Taxation	-128.0	-163.0	-178.0	-231.0	-219.0	-254.0	-273.0	-297.7	-283.5
Dividends	-233.0	-280.0	-301.1	-314.0	-353.0	-410.0	-468.7	-478.1	-514.7
Cashflow post servicing of financing/tax	540.2	443.1	513.7	699.3	909.3	1,004.7	908.0	887.3	1,054.6
Capex (net)	-356.0	-339.0	-400.0	-387.0	-423.0	-457.0	-507.8	-539.8	-569.0
JV funding	-3.0	-6.0	-6.3	-1.0	-4.0	-6.0	-6.3	-6.6	-6.9
Open	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Acquisitions/disposals	-1,051.0	-75.0	6.0	197.0	-190.0	-20.0	-180.0	-20.0	0.0
ESOP share purchases	-253.0	-23.0	0.0	0.0	-58.0	-151.0	0.0	0.0	0.0
Man United	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Cashflow before financing	-1,122.8	0.1	113.4	508.3	234.3	370.7	213.9	320.9	478.7
Net shares issued	0.0	0.0	0.0	152.0	91.3	-495.7	-704.0	0.0	0.0
Net cash flow	-1,083.8	-4.4	113.4	660.3	325.6	-125.0	-490.1	320.9	478.7
Opening net debt/(cash)	761.0	1,844.8	1,849.2	1,735.9	1,075.6	750.0	875.0	1,365.1	1,044.2
Net cash flow	-1,083.8	-4.4	113.4	660.3	325.6	-125.0	-490.1	320.9	478.7
Closing net debt/(cash)	1,844.8	1,849.2	1,735.9	1,075.6	750.0	875.0	1,365.1	1,044.2	565.6

Source: Company Reports and Citi Research Estimates

Figure 40. BSkyB – Balance Sheet Forecasts (Year-end June, £m except where stated)

	2007	2008	2009	2010	2011	2012	2013E	2014E	2015E
Fixed assets									
Intangibles	1,051	517	1,197	1,188	1,406	1,479	1,515	1,519	1,519
Tangibles	1,524	1,677	799	899	896	948	1,232	1,398	1,555
Investments in JVs	336	341	135	149	151	156	187	187	187
Other investments	2	2	501	582	572	651	651	651	651
Total fixed assets	2,913	2,537	2,632	2,818	3,025	3,234	3,586	3,755	3,912
Current assets									
Stocks	324	324	386	343	375	456	456	456	456
Debtors	0	0	0	0	0	0	0	0	0
Trade debtors	468	468	613	538	592	621	621	621	621
Deferred tax < 1 year	0	0	0	0	0	0	0	0	0
Creditors - within 1 year	-15	-15	-46	-10	-21	-3	-3	-3	-3
Trade creditors	-1,268	-1,268	-1,492	-1,526	-1,675	-1,855	-1,903	-1,953	-2,004
Trade working capital	-491	-491	-539	-655	-729	-781	-829	-879	-930
Other debtors	133	155	37	56	11	24	38	54	76
Deferred tax > 1 year	0	0	0	0	0	-1	-1	-1	-1
Other creditors - more than 1 year	-247	-309	-173	-170	-492	-602	-627	-613	-624
Working capital	-605	-646	-675	-769	-1,210	-1,360	-1,419	-1,438	-1,479
Cash	401	397	901	1,049	1,351	1,174	684	1,005	1,483
Short term borrowings	-421	-421	-465	0	-8	-8	-8	-8	-8
Long term borrowings	-1,825	-1,825	-2,172	-2,125	-2,093	-2,041	-2,041	-2,041	-2,041
Net debt	-1,845	-1,849	-1,736	-1,076	-750	-875	-1,365	-1,044	-566
Provisions	-25	-25	-30	-38	-30	-55	-55	-55	-55
Ordinary net assets	438	17	191	935	1,035	944	746	1,217	1,812
Called-up share capital	896	896	1,105	1,113	876	837	767	767	767
Share premium	1,437	1,437	1,437	1,574	1,437	1,437	803	803	803
Shares to be issued	0	0	0	0	0	0	0	0	0
ESOP reserve	-25	-25	-25	-25	-25	-25	-25	-25	-25
Special reserve	37	37	37	37	37	37	37	37	37
Merger reserve	222	222	222	222	222	222	222	222	222
P&L account	-2,129	-2,550	-2,585	-1,986	-1,512	-1,564	-1,058	-587	8
Shareholders equity	438	17	191	935	1,035	944	746	1,217	1,812

Source: Company Reports and Citi Research Estimates

Company Focus

- Estimate Change
- Target Price Change
- Rating Change

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Sell	3
from Neutral	
Price (20 Jun 13)	£2.34
Target price	£2.00
from -	
Expected share price return	-14.5%
Expected dividend yield	5.1%
Expected total return	-9.4%
Market Cap	£2,178M
	US\$3,372M

Price Performance (RIC: TALK.L, BB: TALK LN)



TalkTalk Telecom Group PLC (TALK.L)

BT Sport enough to disrupt growth, downgrade to Sell

■ **Downgrade to Sell, target price 200p** — TalkTalk has outperformed the sector by 78% since the start of 2012 as better churn, customer mix and opex were lately joined by a first quarter of revenue growth for some time. However, we see drivers of margin expansion including customer mix and cost savings as having largely run their course for now, while fast growing fibre customers and B2B will likely to slow gross margin improvement. Although M&A is elevated in the sector we do not regard the company as an acquisition target at this stage, indeed in the UK mobile operators have been exiting the fixed broadband market. We downgrade the stock to Sell and introduce a DCF based target price of 200p ex div with WACC 9.8% and long-term growth of 0%.

■ **Relatively lower risk from BT Sport is not the same as none** — Our survey largely supports TalkTalk management's line that its customer base is relatively unexposed to BT Sport due to demographics, however, that is not the same as saying it has no exposure. Based on the survey, around 28% of broadband customers take Sky TV and among the 72% that don't, 9% say that they would switch or pay to get BT Sport. Losing even half of those would equate to around 130k customers, aside from lost TV prospects who may choose to stay with Sky. Reacting to this and to Sky's "broadband free with an extra product" offer we expect to be enough to disrupt TalkTalk's growth in FY14.

■ **Forecast revisions** — We revise forecasts to reflect the FY13 results and the guidance on increased spending to accelerate TV rollout and slower cost reductions. FY14 EBITDA falls 14% to £286m and FY15 falls 11% to £336m. Pre TV SAC/marketing costs these come to £366m and £391m.

■ **Near-term valuation metrics demanding** — Given our estimates put TalkTalk on 18.2x cal 2013E earnings, we believe its ability to grow margin and/or revenue is key to justifying the current valuation. We expect its TV costs to fall over time boosting EBITDA and also see gross margin continuing to rise but at a slower rate. We currently forecast 13.2x earnings for cal 2015e but see downside risk to that figure from a more competitive broadband market.

■ **Positives remain with self install and low cost set-top box** — We expect self-install and the new, low cost set-top box to increase TalkTalk's TV connection capacity and note that it retains the advantage vs BT with its Sky basic channels. We also see a chance of a strong fiscal 1Q14 for some key metrics ahead of BT Sport's launch. Nonetheless, we also see the coming BT/Sky marketing battle over sport customers in the autumn as likely to create some collateral damage to TalkTalk's churn rate.

TalkTalk Telecom Group PLC (GBP)

Year to 31 Mar	2012A	2013A	2014E	2015E	2016E
Sales (£M)	1,687.0	1,670.0	1,689.0	1,716.3	1,767.6
Profit Before Tax (£M)	127.0	122.0	125.2	201.2	238.5
Diluted EPS (p)	16.5	14.0	12.7	16.6	19.9
Diluted EPS (Old) (p)	16.5	14.8	17.0	20.9	24.9
PE (x)	14.2	16.7	18.4	14.1	11.8
EV/EBITDA (x)	8.2	8.9	9.0	7.5	6.5
DPS (p)	9.0	10.4	12.0	13.2	14.5
Net Div Yield (%)	3.8	4.4	5.1	5.6	6.2

Forecast revisions

We expect the around 50% of broadband customers suggested by our survey with no pay TV to be a prime target for TalkTalk's new, low cost YouView set-top box and note that TalkTalk has so far out-executed BT with its YouView offer both in terms of its channel line-up and its customer add rate. The customer add rate could increase with the rollout of self-install and we see a chance of a strong fiscal 1Q14 from some key metrics ahead of BT Sport football rights launch in August. Nonetheless we also see the coming BT/Sky marketing battle over sport customers in the autumn as likely to create some collateral damage to TalkTalk's churn rate and given its naturally somewhat fixed cost structure, like any telco, see earnings risk being elevated as a result.

Our resulting forecast revisions capture lower broadband net additions, with the expectation that the company will focus more on TV upgrades, and higher TV costs (up by one third in FY14). Forecast EBITDA falls both pre and post TV SACs (Figure 41).

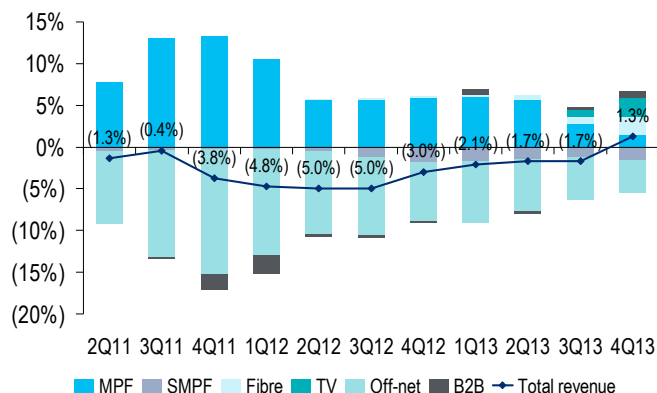
Figure 41. TalkTalk forecast revisions, £m

Year to March	New			Prior			Δ			Δ%		
	2013	2014E	2015E	2013E	2014E	2015E	2013E	2014E	2015E	2013E	2014E	2015E
Broadband base	4,063	4,050	4,097	4,067	4,141	4,265	(4)	(91)	(167)	(0.1%)	(2.2%)	(3.9%)
Full ULL	3,222	3,317	3,397	3,227	3,407	3,557	(5)	(90)	(160)	(0.2%)	(2.6%)	(4.5%)
Fibre	73	168	268	75	155	255	(2)	13	13	(2.7%)	8.4%	5.1%
YouView	230	594	899	210	585	899	20	10	(0)	9.5%	1.7%	(0.0%)
Broadband ARPU (£/month)	25.6	26.8	27.5	25.8	26.9	27.9	(0.2)	(0.1)	(0.5)	(0.7%)	(0.6%)	(1.6%)
Revenue												
Residential on net	1,170	1,257	1,321	1,175	1,276	1,384	(5)	(20)	(63)	(0.5%)	(1.6%)	(4.6%)
Residential off net	178	107	65	175	110	68	3	(3)	(2)	1.8%	(2.6%)	(3.5%)
Business	322	325	330	320	323	329	2	2	0	0.6%	0.6%	0.1%
Revenue	1,670	1,689	1,716	1,670	1,710	1,782	(0)	(21)	(65)	(0.0%)	(1.2%)	(3.7%)
Revenue growth	(1.0%)	1.1%	1.6%	(1.0%)	2.4%	4.2%	(0.0%)	(1.2%)	(2.6%)			
Cost of Sales	(751)	(750)	(758)	(741)	(742)	(773)	(10)	(7)	15	1.4%	1.0%	(1.9%)
Operating expenses	(567)	(573)	(567)	(579)	(574)	(576)	12	0	9	(2.1%)	(0.0%)	(1.5%)
TV SACs/marketing	(62)	(80)	(55)	(51)	(61)	(54)	(11)	(20)	(1)	21.2%	32.1%	2.0%
EBITDA, pre-excepts	290	286	336	299	333	378	(9)	(47)	(43)	(3.0%)	(14.2%)	(11.3%)
Gross margin	55.0%	55.6%	55.8%	55.7%	56.6%	56.6%	(0.6%)	(1.0%)	(0.8%)			
EBITDA margin	17.4%	16.9%	19.6%	17.9%	19.5%	21.2%	(0.5%)	(2.6%)	(1.7%)			
EBITDA, pre TV SACs	352	366	391	350	394	432	2	(28)	(42)	0.5%	(7.1%)	(9.7%)
Depreciation & Amortisation	(102)	(109)	(116)	(99)	(104)	(108)	(3)	(5)	(8)	3.0%	5.2%	7.3%
Amortisation of acq'd intangibles	(52)	(31)	0	(66)	(31)	0	14	0	0	(21.2%)	0.0%	n/a
EBIT, pre-exceptionals	188	176	220	200	229	270	(12)	(53)	(51)	(6.0%)	(23.1%)	(18.7%)
Share of associate profits	(4)	0	0	0	0	0	(4)	0	0	n/a	n/a	n/a
Net Interest	(19)	(20)	(19)	(19)	(20)	(17)	0	0	(1)	(2.3%)	(1.7%)	6.3%
PBT, pre-exceptionals	165	156	201	181	209	253	(16)	(52)	(52)	(8.7%)	(25.1%)	(20.5%)
Exceptionals	20	0	0	(9)	0	0	29	0	0	n/a	n/a	n/a
Tax, pre-exceptionals	(33)	(34)	(42)	(42)	(46)	(53)	9	12	11	(20.6%)	(25.1%)	(20.5%)
Net Income (pre-exceptionals)	132	122	159	139	163	200	(7)	(41)	(41)	(5.1%)	(25.1%)	(20.5%)
Net Income (post-exceptionals)	100	91	159	64	132	200	36	(41)	(41)	56.0%	(31.1%)	(20.5%)
Basic EPS (p) (pre-exceptionals)	14.9	13.1	17.1	15.8	17.5	21.5	(0.8)	(4.4)	(4.4)	(5.1%)	(25.1%)	(20.5%)
Basic EPS (p) (post-exceptionals)	14.0	12.7	16.6	14.8	17.0	20.9	(0.8)	(4.3)	(4.3)	(5.1%)	(25.1%)	(20.5%)
DPS (p)	10.4	12.0	13.2	10.4	12.0	12.9	0.0	0.0	0.3	0.0%	0.0%	2.3%
Capex	(104)	(106)	(105)	(105)	(108)	(109)	1	1	4	(1.2%)	(1.2%)	(3.7%)
Net debt	(393)	(387)	(331)	(408)	(355)	(256)	15	(33)	(74)	(3.8%)	9.3%	29.0%
Equity FCF	167	127	171	141	174	212	26	(48)	(41)	18.5%	(27.3%)	(19.2%)

Source: Company Reports and Citi Research Estimates

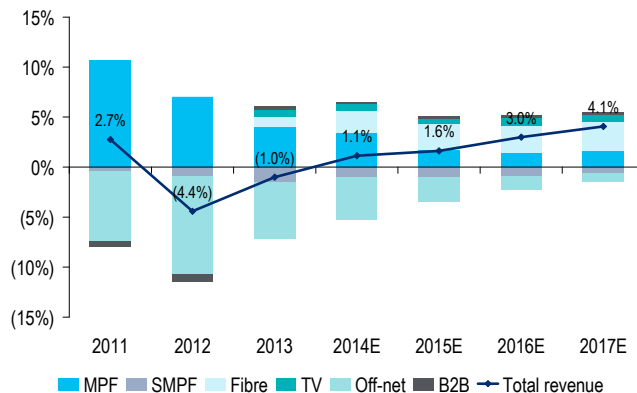
Operational progress

Figure 42. Components of revenue growth qtrly, % yoy, year to March



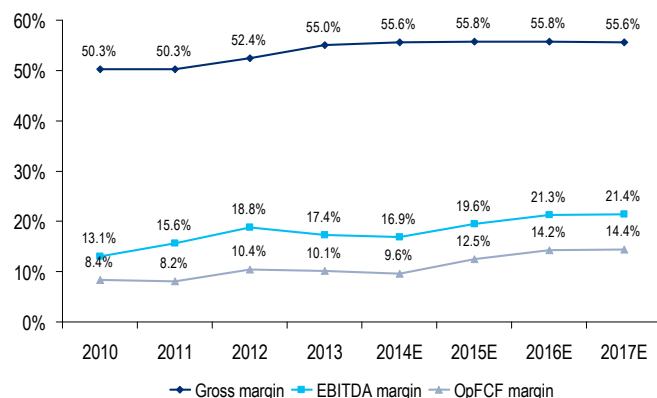
Source: Company Reports and Citi Research Estimates

Figure 43. Components of revenue growth pa, % yoy, year to March



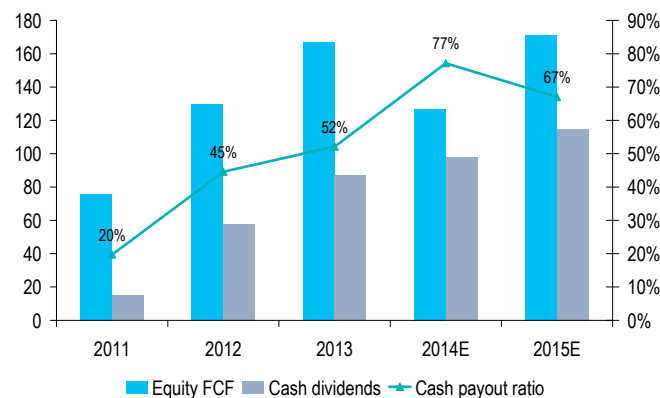
Source: Company Reports and Citi Research Estimates

Figure 44. Margin forecasts, % of sales, year to March



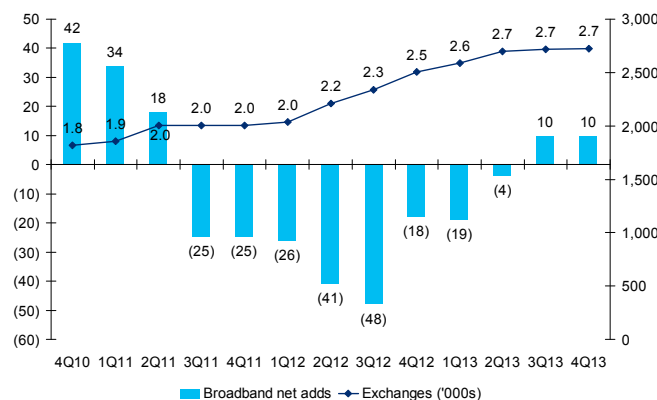
Source: Citi Research and Citi Research Estimates

Figure 45. Dividend outlook, £m/% FCF, year to March



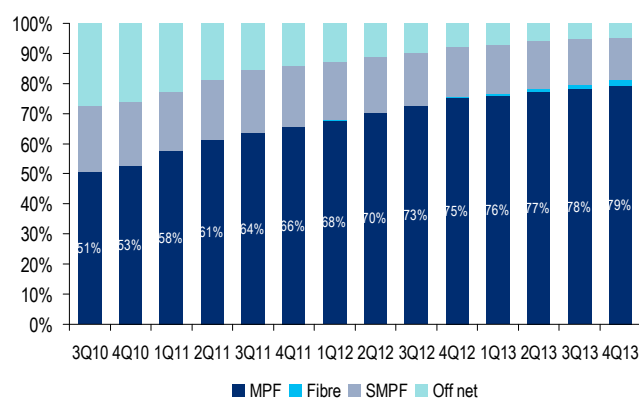
Source: Citi Research

Figure 46. Net additions and unbundled exchanges, '000s



Source: Company Reports

Figure 47. Customer mix of connections starting to top out



Source: Company Reports

TV offer summarised

Figure 48. Basic Pay content available with the TalkTalk Player

TV Starter Boost	Kids Boost	Music Boost	Entertainment Boost		Entertainment Extra Boost		
Sky 1	Nickelodeon	The Box	Sky 1	Sy-Fy	Sky 1	MTV Classic	Nickelodeon
Sky 2	Nick Jnr	Channels (x6)	Sky 2	Universal	Sky 2	MTV Music	Nick Jnr
Sky Living	Nick Toons	Music OD	Sky Living	FX	Sky Living	MTV Rocks	Nick Toons
Sky LivingIT	Cartoon Network	MTV Hits	Sky LivingIT	E!	Sky LivingIT	MTV Dance	Cartoon Network
Sky Arts 1	Disney Channel	MTV Base	Sky Arts 1	Comedy Central	Sky Arts 1		Disney Channel
Sky Arts 2	Disney Jnr	MTV Classic	Sky Arts 2	Comedy Central Extra	Sky Arts 2		Disney Jnr
Sky Sports	Disney XD	MTV Music	Sky Sports	MTV	Sky Sports News		Disney XD
News	Boomerang	MTV Rocks	G.O.L.D	Discovery Channel			Boomerang
	Scamp (OD)	MTV Dance	Watch	Nat Geo	G.O.L.D		Scamp (OD)
			Alibi	Discovery RT	Watch		
			Home	Discovery H & H	Alibi	Sy-Fy	
			Eden	Animal Planet	Home	Universal	
			Blighty	TCM	Eden	FX	
			Good Food		Blighty	E!	
					Good Food	Comedy Central	
						Comedy Central Extra	
						MTV	
					The Box x6	Discovery Channel	
					Music OD	Nat Geo	
					MTV Hits	Discovery RT	
					The Box Channels (x6)	Discovery H & H	
					Music OD	Animal Planet	
					MTV Hits	TCM	
					MTV Base		
£5	£5	£5					£15

Source: Company reports, Citi Research

Figure 49. TalkTalk pricing for Sky premium channel packages

Sky Movies	Sky Sports 1	Sky Sports 1	Sky Sports 1	Sky Sports 1
	Sky Sports 2	Sky Sports 2	Sky Sports 2	Sky Sports 2
	Sky Sports 3	Sky Sports 3	Sky Sports 3	Sky Sports 3
	Sky Sports 4	Sky Sports 4	Sky Sports 4	Sky Sports 4
	Sky Sports F1	Sky Sports F1	Sky Sports F1	Sky Sports F1
		Sky Movies	ESPN	Sky Movies
				ESPN
£15	£30	£40	£40	£45

Source: Company reports, Citi Research

£m, year to March

[illegible]

Source: dataCentral, Citi Research

Financial forecasts

Figure 51. TalkTalk income statement, £m

Year to March	2011	2012	2013	2014E	2015E	2016E	2017E
Residential (broadband & narrowband)	1,436	1,371	1,348	1,364	1,386	1,433	1,500
Business-to-business	329	316	322	325	330	335	340
Revenue	1,765	1,687	1,670	1,689	1,716	1,768	1,839
YoY growth	4.7%	(4.4%)	(1.0%)	1.1%	1.6%	3.0%	4.1%
Cost of Sales	(877)	(803)	(751)	(750)	(758)	(782)	(817)
- growth	4.7%	(8.4%)	(6.5%)	(0.2%)	1.2%	3.1%	4.5%
Gross Profit	888	884	919	939	958	986	1,023
Operating expenses	(612)	(567)	(629)	(654)	(622)	(610)	(628)
EBITDA, pre-excepts	276	317	290	286	336	376	394
- margin	15.6%	18.8%	17.4%	16.9%	19.6%	21.3%	21.4%
- growth	24.9%	14.9%	(8.5%)	(1.5%)	17.6%	12.0%	4.9%
Depreciation & Amortisation	(83)	(92)	(102)	(109)	(116)	(122)	(124)
Amortisation of acq'd intangibles	(69)	(61)	(52)	(31)	0	0	0
EBIT (pre-excepts, gw)	193	225	188	176	220	254	270
EBIT (post-excepts, gw)	76	137	145	145	220	254	270
Interest expense	(18)	(18)	(19)	(20)	(19)	(16)	(14)
Interest income	0	0	0	0	0	0	1
Share of associate profits	(1)	(1)	(4)	0	0	0	0
Exceptionals	(48)	(18)	9	0	0	0	0
Profit before tax (pre-excepts)	174	206	165	156	201	239	257
Profit before tax (post-excepts)	57	127	122	125	201	239	257
Tax	(52)	(54)	(33)	(34)	(42)	(48)	(51)
excepts	30	65	11	0	0	0	0
Net Income (pre-excepts)	122	152	132	122	159	191	206
Net Income (post-excepts)	35	138	100	91	159	191	206
Per share data							
Headline basic EPS (p) (pre-excepts)	13.5	17.2	14.9	13.1	17.1	20.5	21.9
Headline diluted EPS (p) (pre-excepts)	12.8	16.5	14.0	12.7	16.6	19.9	21.4
Statutory basic EPS (p) (post-excepts)	3.9	15.6	11.3	9.8	17.1	20.5	21.9
Statutory diluted EPS (p) (post-excepts)	3.7	14.9	10.6	9.5	16.6	19.9	21.4
Dividends awarded (p)	5.6	9.0	10.4	12.0	13.2	14.5	16.0
Payout ratio (of NI pre-excepts)	42%	52%	70%	91%	77%	71%	73%

Source: Company Reports and Citi Research Estimates

Figure 52. TalkTalk Balance Sheet, £m

Year to March	2011	2012	2013	2014E	2015E	2016E	2017E
Non-current assets							
Goodwill	471	480	479	479	479	479	479
Other intangible assets	255	202	154	123	123	123	123
Intangible Assets	726	682	633	602	602	602	602
Property, plant and equipment	290	292	295	292	281	267	255
Loans to related parties	4	7	9	9	9	9	9
Non-curr asset investments	1	1	0	0	0	0	0
Deferred tax assets	116	120	109	90	72	53	32
Total	1,137	1,102	1,046	993	964	931	899
Current assets							
Inventories	3	3	23	23	23	23	23
Trade and other receivables	155	184	226	243	260	277	294
Cash and cash equivalents	3	4	7	13	19	49	81
Total	161	191	256	279	302	349	398
Total Assets	1,298	1,293	1,302	1,272	1,266	1,281	1,297
Current Liabilities							
Trade and other payables	(376)	(379)	(431)	(431)	(431)	(431)	(431)
Corporation tax liabilities	(22)	(16)	(16)	(16)	(16)	(16)	(16)
Loans and other borrowings	(44)	(26)	(25)	(25)	(25)	(25)	(25)
Provisions	(32)	(8)	(5)	(5)	(5)	(5)	(5)
Total	(474)	(429)	(477)	(477)	(477)	(477)	(477)
Non-current liabilities							
Trade and other payables	(14)	(10)	(8)	(8)	(8)	(8)	(8)
Loans and other borrowings	(395)	(410)	(375)	(375)	(325)	(275)	(225)
Loans from related parties	0	0	0	0	0	0	0
Total	(409)	(420)	(383)	(383)	(333)	(283)	(233)
Total liabilities	(883)	(849)	(860)	(860)	(810)	(760)	(710)
Net assets	415	444	442	412	456	521	587
Invested Capital	415	444	442	412	456	521	587
Net debt (cash)	(436)	(432)	(393)	(387)	(331)	(251)	(169)
Net debt/EBITDA	1.6x	1.4x	1.4x	1.4x	1.0x	0.7x	0.4x

Source: Company Reports and Citi Research Estimates

Figure 53. TalkTalk cash flow statement, £m

Year to March	2011	2012	2013	2014E	2015E	2016E	2016E
EBITDA	276	317	290	286	336	376	394
Cash exceptionals/other	(49)	(26)	14	0	0	0	0
ΔWC/other	(22)	(36)	(17)	(17)	(17)	(17)	(17)
Cash generated by ops	205	255	287	269	319	359	377
Interest paid (net)	(17)	(17)	(16)	(20)	(19)	(16)	(13)
Tax paid	(2)	(2)	0	(16)	(24)	(29)	(31)
Net capex	(110)	(106)	(104)	(106)	(105)	(108)	(112)
Free cash flow	76	130	167	127	171	207	221
Free cash flow (fully taxed)	26	78	134	108	153	188	201
Dividends paid to s/hs	(15)	(58)	(87)	(98)	(115)	(126)	(140)
Acquisitions & disposals	9	(8)	(4)	0	0	0	0
Stock repurchases	0	(54)	(35)	(23)	0	0	0
Net repayments of borrowings	(72)	(2)	(35)	0	(50)	(50)	(50)
Other	2	1	0	0	0	0	0
Net cash from fin activities	(76)	(121)	(161)	(121)	(165)	(176)	(190)
Foreign exchange adjustment	0	0	0	0	0	0	0
Increase (decrease) in cash	0	9	6	6	7	30	31

Source: Company Reports and Citi Research Estimates

BT Group PLC

Company description

BT Group is the incumbent wireline operator in the UK. Its four principal divisions are: Retail, Global Services, Wholesale and its functionally separate local network business Openreach. The company is benefiting from its successful cost focus and strategic initiatives such as a push into entertainment, expansion of Global Services into key emerging markets and enhancement of its position in UK mobile with the recent purchase of 4G spectrum. BT operates the largest final salary pension fund (now closed to new members), with c£40bn of liabilities (Citi estimate).

Investment strategy

We rate BT Buy. Over the next 12 months, we see the investment case being dominated by the launch of its BT Sport TV channels and execution of cost savings. BT is targeting a BBB+ credit rating (BBB now) which is why its dividend payout ratio is comparatively low.

Valuation

Our valuation of BT and £3.65 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 9.0% and a 1.5% perpetuity growth rate from year 25. The perpetual growth in cash flow implied from year four from these assumptions is -1.2%. We assume a pension deficit of £2.0bn post tax in March 2014.

Risks

The principle risk factors are the presence of the sizeable pension fund, costs associated with building its TV business, historical stock volatility and exposure to one-country and regulatory risk. 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.

British Sky Broadcasting Group PLC

Company description

British Sky Broadcasting Group plc provides a pay television broadcasting service to customers in the UK and the Republic of Ireland on a subscription basis and serves just shy of 10m households. The group's channels broadcast news, movies, sports (it owns the most lucrative UK football rights) and other entertainment as well as pay-per-view events. BSkyB also offers a triple play package with broadband and fixed line telephony services. Over the past few years Sky has made significant investments in broadband and HD television, both of which have helped to drive customer volume growth.

Investment strategy

We rate BSkyB as a Buy.

While the newsflow cycle remains tough in the short-term - in particular we highlight the adverse outcome to the FAPL rights renewal process and a slower net addition growth profile - we don't think these factors will significantly derail strong earnings

growth for the group over the short- to medium-term. We see continued solid total product growth (in particular further penetration of triple play services), a resumption of price increases from next year and the potential for enhanced buybacks beyond the two programmes already announced, to drive EPS growth in the mid- to high-teens. We also note that after underperformance of the broader market YTD, the group is starting to screen well on dividend yield.

In this context, we think the near-term risk/reward tilts positively and rate the group Buy.

Valuation

Our primary valuation tool for BSkyB is discounted cash flow. We believe this best captures the group's growth and returns profile.

Based on our forecasts and assuming a LT growth rate of 3% and a WACC of 9%, our DCF valuation analysis implies a fair value of 950p.

Risks

We try to distinguish between risks to the core payTV business and broadband, but in reality there is a good degree of overlap. On the core payTV side, we argue that long-term concerns revolve around competition for subscribers and pressure on ARPU's, and also modeling risk. There is also some cyclical risk to sub additions. On the broadband side, there is some risk of the move to breakeven and also the possibility of fibre becoming more important than we expected.

If the impact on the company from any of these factors is more negative than we anticipate, the stock will likely have difficulty achieving our financial and price targets. Likewise, if any of these factors proves to have less of an effect than we anticipate, the stock could materially outperform our target.

TalkTalk Telecom Group PLC

Company description

TalkTalk Telecom Group is the UK's second-largest provider of residential broadband and fixed-line telephony having pioneered full local network unbundling in 2006. It also provides services to business customers, mobile through an MVNO and is a YouView partner. It became a standalone business on 26 March 2010.

Investment strategy

We rate TalkTalk Sell. We see downside risk due to increased competition with launch of BT sports. Also, the economics of local fibre broadband may present a challenge in time.

Valuation

Our target price of £2.00 is based on a DCF methodology. Our DCF uses a WACC of 9.8% and terminal growth rate of 0%.

Risks

Upside risks include 1) outperformance of the Business division relative to our expectations, 2) better growth in consumer broadband, and 3) TalkTalk potentially being an M&A target. Downside risks include 1) a slowing broadband market, 2) regulatory change, and 3) potential for loss of market share during the migration to fibre-based broadband services.

Liberty Global Inc.

(LBTYA.O; US\$69.03; 1)

Valuation

To value Liberty Global, we begin with 2014 "core" free cash flow of \$4.54 per share and apply a 15x multiple to arrive at "core" equity value of about \$68. We then remove the 20% equity stake in VTR not owned by Liberty Global (about \$1). We add \$10 for the mark-to-market equity stakes of TNET and Ziggo. We also add the NPV of VMED and LBTYA NOLs of about \$10 per share. This gives us a fair equity value of \$88.

Risks

Specific risks that may cause the stock to trade below our target price include:

- **Deceleration of "core" revenue growth:** In 2009, the "core" organic revenue growth of Liberty Global (that of its 100%-owned assets) slowed considerably. 2010 saw an upswing in "core" growth. While we expect this growth to continue, any meaningful decline in core revenue growth could adversely affect the stock.
- **High leverage:** LGI's debt levels are higher than its U.S. peers, at 4-5x gross debt-to-EBITDA. A material compression to EV-EBITDA multiples among U.S. peers could have an adverse affect on LGI's equity value.
- **M&A poses risks:** It is possible that LGI could make an acquisition(s) that prove to be less beneficial, or pose more challenges than we expect. While Liberty Global has demonstrated a disciplined approach to M&A, there can be no assurance that it will be disciplined with M&A in the future. If the firm pays a higher multiple for slower growing assets, it could have an adverse affect on LGI's equity value.

Appendix A-1

Analyst Certification

The research analyst(s) primarily responsible for the preparation and content of this research report are named in bold text in the author block at the front of the product except for those sections where an analyst's name appears in bold alongside content which is attributable to that analyst. Each of these analyst(s) certify, with respect to the section(s) of the report for which they are responsible, that the views expressed therein accurately reflect their personal views about each issuer and security referenced and were prepared in an independent manner, including with respect to Citigroup Global Markets Inc and its affiliates. No part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this report.

IMPORTANT DISCLOSURES

TalkTalk Telecom Group PLC (TALK.L)

Ratings and Target Price History Fundamental Research

Analyst: Simon Weeden

Covered since February 2 2011



	Date	Rating	Target Price	Closing Price
1	14-Oct-10	2H	*1.45	1.40
2	18-Jan-11	2H	*1.70	1.62

* Indicates change

	Date	Rating	Target Price	Closing Price
3	5-Aug-11	2H	*1.55	1.33
4	7-Oct-11	Stock rating system changed		

	Date	Rating	Target Price	Closing Price
5	8-Oct-11	*2	-	1.26

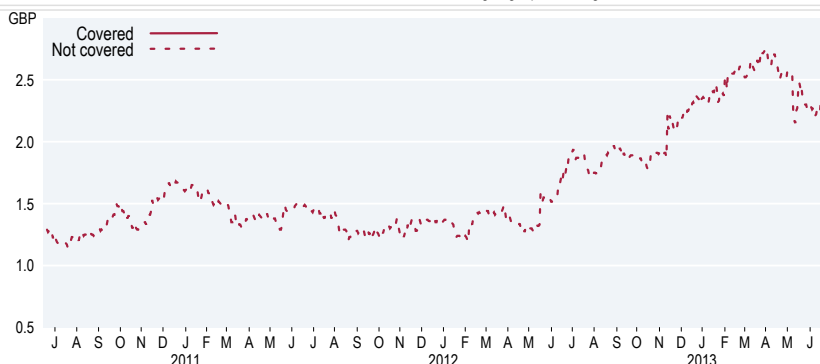
Rating/target price changes above reflect Eastern Standard Time

TalkTalk Telecom Group PLC (TALK.L)

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

Analyst: Simon Weeden

Covered since February 2 2011



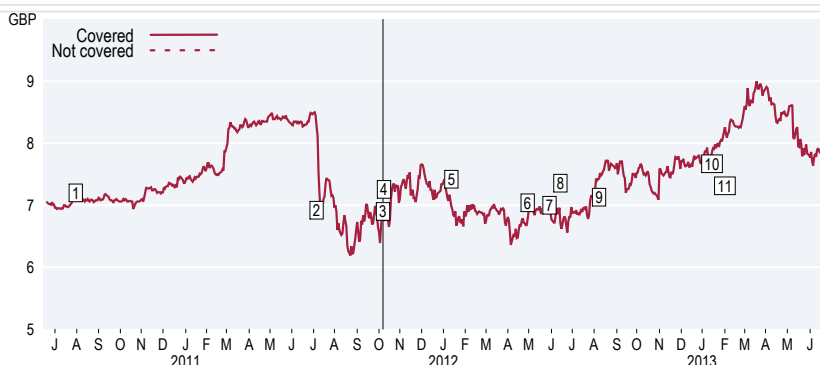
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

British Sky Broadcasting Group PLC (BSY.L)

Ratings and Target Price History Fundamental Research

Analyst: Thomas A Singlehurst, CFA



	Date	Rating	Target Price	Closing Price
1	30-Jul-10	1M	*8.00	7.11
2	6-Jul-11	1M	*9.99	8.27
3	7-Oct-11	Stock rating system changed		
4	8-Oct-11	*1	9.99	6.75

* Indicates change

	Date	Rating	Target Price	Closing Price
5	12-Jan-12	*2	*7.50	6.98
6	30-Apr-12	*1	7.50	6.78
7	30-May-12	1	*8.50	6.95
8	14-Jun-12	1	*8.00	6.71

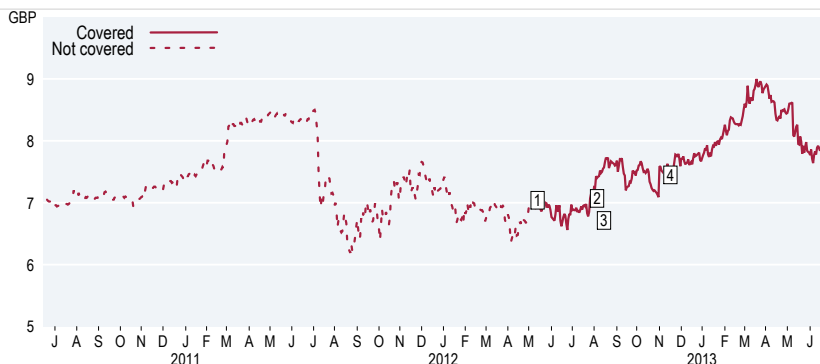
	Date	Rating	Target Price	Closing Price
9	8-Aug-12	1	*8.50	7.43
10	15-Jan-13	1	*9.00	7.86
11	1-Feb-13	1	*9.50	8.26

Rating/target price changes above reflect Eastern Standard Time

British Sky Broadcasting Group PLC (BSY.L)

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

Analyst: Thomas A Singlehurst, CFA



	Date	Rating	Target Price	Closing Price
1	14-May-12	*ADD MP	-	6.94
2	6-Aug-12	*REM MP	-	7.40

	Date	Rating	Target Price	Closing Price
3	15-Aug-12	*ADD MP	-	7.57
4	16-Nov-12	*REM MP	-	7.45

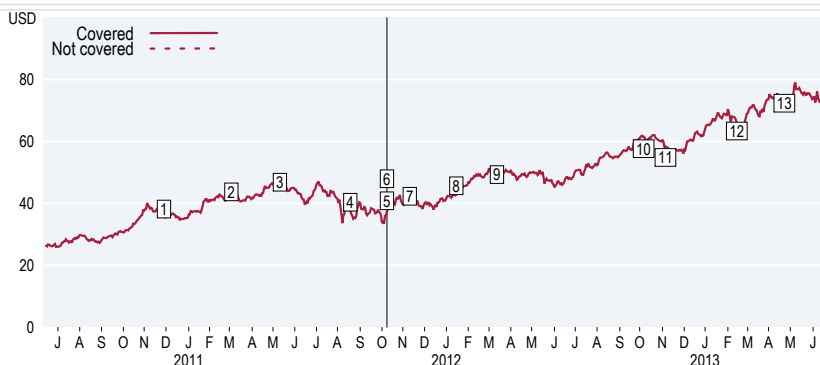
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Liberty Global Inc. (LBTYA)

Ratings and Target Price History Fundamental Research

Analyst: Jason B Bazinet



	Date	Rating	Target Price	Closing Price
1	29-Nov-10	1H	*46.00	36.32
2	3-Mar-11	*1M	*49.00	43.74
3	11-May-11	1M	*55.00	46.65
4	18-Aug-11	1M	*50.00	37.47
5	8-Oct-11	Stock rating system changed		

	Date	Rating	Target Price	Closing Price
6	8-Oct-11	*1	50.00	36.09
7	10-Nov-11	1	*47.00	40.30
8	16-Jan-12	1	*50.00	42.59
9	13-Mar-12	1	*59.00	51.59
10	5-Oct-12	1	*73.00	61.63

	Date	Rating	Target Price	Closing Price
11	6-Nov-12	1	*70.00	58.59
12	14-Feb-13	1	*77.00	66.10
13	23-Apr-13	1	*88.00	73.00

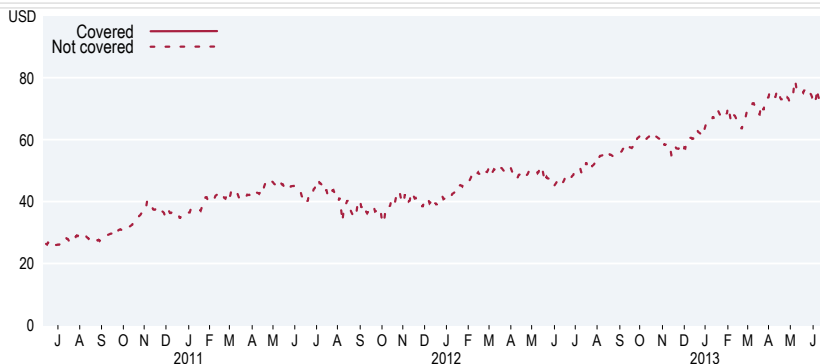
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Liberty Global Inc. (LBTYA)

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

Analyst: Jason B Bazinet

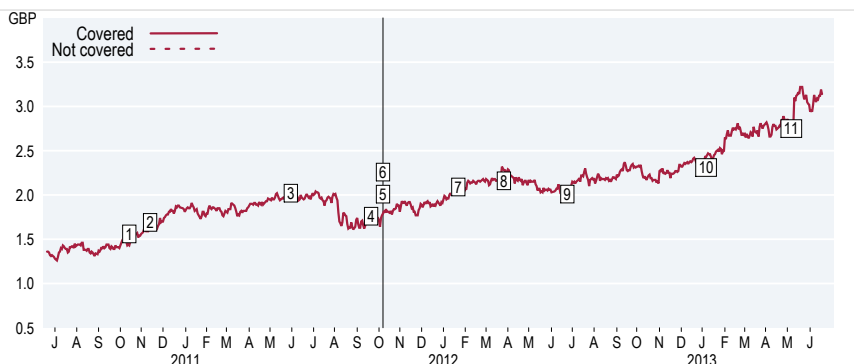


* Indicates change

Rating/target price changes above reflect Eastern Standard Time

BT Group PLC (BT.L) **Ratings and Target Price History** **Fundamental Research**

Analyst: Simon Weeden



	Date	Rating	Target Price	Closing Price
1	14-Oct-10	*1M	*1.65	1.43
2	12-Nov-10	1M	*2.10	1.68
3	31-May-11	1M	*2.30	2.01
4	21-Sep-11	1M	*2.05	1.76

* Indicates change

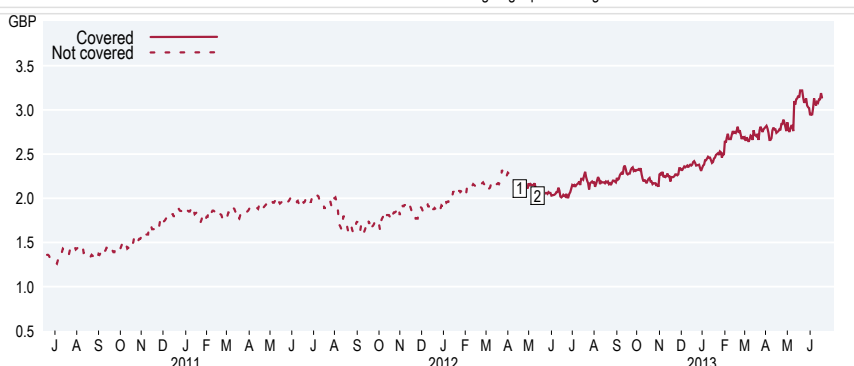
	Date	Rating	Target Price	Closing Price
5	7-Oct-11	Stock rating system changed		
6	7-Oct-11	*1	2.05	1.79
7	23-Jan-12	1	*2.30	2.06
8	27-Mar-12	1	*2.60	2.28

	Date	Rating	Target Price	Closing Price
9	25-Jun-12	*2	*2.20	2.01
10	7-Jan-13	2	*2.50	2.43
11	7-May-13	2	*3.00	2.82

Rating/target price changes above reflect Eastern Standard Time

BT Group PLC (BT.L) **Ratings and Target Price History** **Best Ideas Research** **Relative Call (3 Month)**

Analyst: Simon Weeden



	Date	Rating	Target Price	Closing Price
1	18-Apr-12	*ADD MP	-	2.17

* Indicates change

	Date	Rating	Target Price	Closing Price
2	14-May-12	*REM MP	-	2.05

Rating/target price changes above reflect Eastern Standard Time

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Data current as of 31 Mar 2013	12 Month Rating			Relative Rating		
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Citigroup Global Markets Inc	Jason B Bazinet
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