

## Equities

11 May 2012 | 13 pages

# Freenet (FNTGn.DE)

## On track for stability, dividend upside, retain Buy

- Company Update
- Estimate Change

■ **Retain Buy** — Freenet delivered another strong set of results in 1Q12, management remains confident in guidance implying revenue growth and positive post-pay net adds for the remaining 9 months of 2012. The dividend for 2011 was increased to €1.20 at the AGM – a 10% yield; we see further upside to dividends towards the equity FCF yield of 14% once leverage is below the target rate in Dec-12. Freenet remains a strong self-help story, benefiting from an increased use of service providers by the mobile network operators. We retain a Buy, Freenet trades on 14% 2012 equity FCF yield vs the sector on 12.6%.

■ **Positive post-pay net adds for remaining 9 months of 2012** — Management remains confident in guidance for stable post-pay customers over 2012 despite net losses of -60k in 1Q12 (-46k 4Q11). This implies positive net adds for Q2-Q4, management said this was due to seasonal variations and the planned re-branding launch in 2Q12 for which marketing spend was delayed from Q1. This is a significant improvement from a year ago and provides confidence in management's ability to sustain FCF longer term.

■ **Further upside to dividends** — At the AGM on 9<sup>th</sup> May a shareholder successfully proposed a €1.20/share dividend, which was narrowly passed (above the board's recommendation for €1.0/share). While management wanted to retain greater financial flexibility we argue, Freenet can comfortably pay €1.20/share and we see further upside to future dividends. We forecast Freenet will have 1.4x 2012 net debt/EBITDA, below target leverage of 1.5x, we therefore see the potential for dividends to rise towards the equity FCF €1.6/share, 14% equity FCF yield.

■ **Forecast changes** — We modestly reduce our revenue forecasts leaving EBITDA broadly unchanged. We increase our dividend forecasts in-line with the recent AGM decision. We leave 2012 EPS flat and reduce 2013 -1.3%.

<b>Buy</b>	<b>1</b>
Price (11 May 12)	€11.92
Target price	€13.50
Expected share price return	13.3%
Expected dividend yield	10.9%
<b>Expected total return</b>	<b>24.2%</b>
Market Cap	€1,526M
	US\$1,974M

### Price Performance (RIC: FNTGn.DE, BB: FNTN GR)



### Freenet (EUR)

Year to 31 Dec	2010A	2011A	2012E	2013E	2014E
Sales (€M)	3,339.5	3,217.9	3,149.5	3,150.3	3,166.5
Net Income (€M)	222.3	224.5	233.0	237.8	244.6
Diluted EPS (€)	1.74	1.75	1.82	1.86	1.91
Diluted EPS (Old) (€)	1.74	1.75	1.82	1.88	1.94
PE (x)	6.9	6.8	6.6	6.4	6.2
EV/EBITDA (x)	6.1	5.6	5.5	5.3	5.2
DPS (€)	0.80	1.20	1.30	1.43	1.57
Net Div Yield (%)	6.7	10.1	10.9	12.0	13.2

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

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**Freenet (FNTGn.DE)**

11 May 2012

FNTGn.DE: Fiscal year end 31-Dec						Price: €11.92; TP: €13.50; Market Cap: €1,526m; Recomm: Buy					
Profit & Loss (€m)	2010	2011	2012E	2013E	2014E	Valuation ratios	2010	2011	2012E	2013E	2014E
Sales revenue	3,340	3,218	3,149	3,150	3,166	PE (x)	6.9	6.8	6.6	6.4	6.2
Cost of sales	-3,190	-3,049	-2,944	-2,854	-2,856	PB (x)	1.3	1.3	1.3	1.2	1.2
Gross profit	150	169	206	296	311	EV/EBITDA (x)	6.1	5.6	5.5	5.3	5.2
Gross Margin (%)	4.5	5.2	6.5	9.4	9.8	FCF yield (%)	10.2	14.7	13.5	13.7	13.9
<b>EBITDA</b>	<b>335</b>	<b>337</b>	<b>346</b>	<b>344</b>	<b>346</b>	Dividend yield (%)	6.7	10.1	10.9	12.0	13.2
EBITDA Margin (%)	10.0	10.5	11.0	10.9	10.9	Payout ratio (%)	46	68	71	77	82
Depreciation	-21	-14	-13	-14	-14	ROE (%)	10.3	12.5	14.6	18.7	19.1
Amortisation	-168	-155	-126	-34	-21	<b>Cashflow (€m)</b>	<b>2010</b>	<b>2011</b>	<b>2012E</b>	<b>2013E</b>	<b>2014E</b>
<b>EBIT</b>	<b>146</b>	<b>169</b>	<b>206</b>	<b>296</b>	<b>311</b>	EBITDA	335	337	346	344	346
EBIT Margin (%)	4.4	5.2	6.5	9.4	9.8	Working capital	-83	-46	-40	-40	-40
Net interest	-45	-53	-40	-36	-34	Other	-70	-44	-74	-70	-68
Associates	2	2	2	2	2	<b>Operating cashflow</b>	<b>182</b>	<b>247</b>	<b>232</b>	<b>234</b>	<b>238</b>
Non-op/Except	0	0	0	0	0	Capex	-27	-22	-25	-25	-25
<b>Pre-tax profit</b>	<b>103</b>	<b>117</b>	<b>167</b>	<b>262</b>	<b>279</b>	Net acq/disposals	21	1	0	0	0
Tax	16	27	5	-34	-34	Other	2	1	0	0	0
Extraord./Min.Int./Pref.div.	-6	0	0	0	0	<b>Investing cashflow</b>	<b>-4</b>	<b>-20</b>	<b>-25</b>	<b>-25</b>	<b>-25</b>
<b>Reported net profit</b>	<b>112</b>	<b>144</b>	<b>172</b>	<b>228</b>	<b>245</b>	Dividends paid	-26	-102	-154	-166	-183
Net Margin (%)	3.4	4.5	5.5	7.2	7.7	<b>Financing cashflow</b>	<b>-480</b>	<b>-171</b>	<b>-207</b>	<b>-208</b>	<b>-213</b>
Core NPAT	222	225	233	238	245	<b>Net change in cash</b>	<b>-301</b>	<b>55</b>	<b>0</b>	<b>0</b>	<b>0</b>
<b>Per share data</b>	<b>2010</b>	<b>2011</b>	<b>2012E</b>	<b>2013E</b>	<b>2014E</b>	<b>Free cashflow to s/holders</b>	<b>156</b>	<b>225</b>	<b>207</b>	<b>208</b>	<b>213</b>
Reported EPS (€)	0.88	1.12	1.34	1.78	1.91						
Core EPS (€)	1.74	1.75	1.82	1.86	1.91						
DPS (€)	0.80	1.20	1.30	1.43	1.57						
CFPS (€)	1.42	1.93	1.81	1.82	1.86						
FCFPS (€)	1.22	1.75	1.61	1.63	1.66						
BVPS (€)	8.86	9.14	9.29	9.77	10.25						
Wtd avg ord shares (m)	128	128	128	128	128						
Wtd avg diluted shares (m)	128	128	128	128	128						
<b>Growth rates</b>	<b>2010</b>	<b>2011</b>	<b>2012E</b>	<b>2013E</b>	<b>2014E</b>						
Sales revenue (%)	-8.5	-3.6	-2.1	0.0	0.5						
EBIT (%)	21.5	15.8	22.1	44.1	4.9						
Core NPAT (%)	-49.3	1.0	3.8	na	2.8						
Core EPS (%)	-49.3	1.0	3.8	2.1	2.8						
<b>Balance Sheet (€m)</b>	<b>2010</b>	<b>2011</b>	<b>2012E</b>	<b>2013E</b>	<b>2014E</b>						
Cash & cash equiv.	174	186	186	186	186						
Accounts receivables	452	465	505	545	585						
Inventory	52	52	52	52	52						
Net fixed & other tangibles	38	29	33	36	40						
Goodwill & intangibles	1,695	1,602	1,484	1,458	1,445						
Financial & other assets	132	195	235	237	238						
<b>Total assets</b>	<b>2,542</b>	<b>2,528</b>	<b>2,494</b>	<b>2,514</b>	<b>2,546</b>						
Accounts payable	514	546	546	546	546						
Short-term debt	215	200	174	163	156						
Long-term debt	585	515	488	457	435						
Provisions & other liab	94	96	96	96	96						
<b>Total liabilities</b>	<b>1,408</b>	<b>1,357</b>	<b>1,304</b>	<b>1,262</b>	<b>1,233</b>						
Shareholders' equity	1,134	1,171	1,190	1,251	1,312						
Minority interests	0	0	0	0	0						
<b>Total equity</b>	<b>1,134</b>	<b>1,171</b>	<b>1,190</b>	<b>1,251</b>	<b>1,313</b>						
<b>Net debt</b>	<b>626</b>	<b>529</b>	<b>477</b>	<b>435</b>	<b>405</b>						
Net debt to equity (%)	55.2	45.2	40.0	34.7	30.9						

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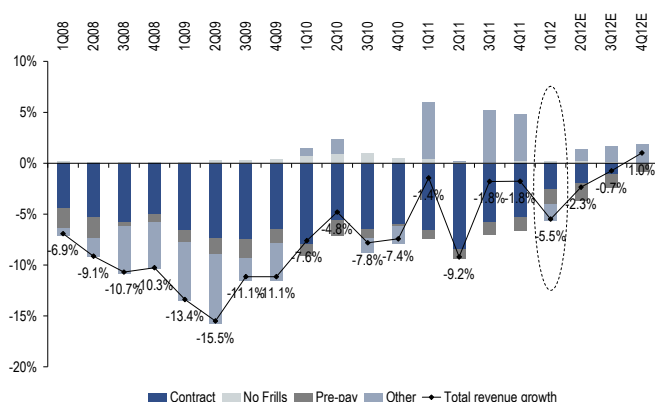


## Results in charts

### Service revenue improvement in 1Q12

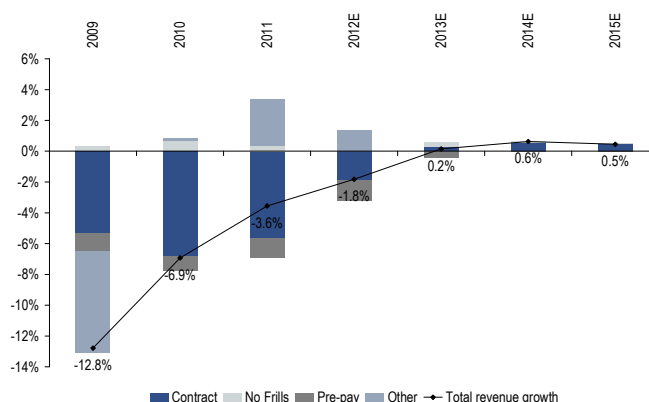
Mobile growth worsened in 1Q12 to -5.5% however this was due to a tough comp on other revenue due to significant bonus payments in 1Q11. Service revenue decline improved to -5.7% 1Q12 from -9.6% 4Q11 driven by reducing customer losses over the last year. On the results call management were confident in guidance for flat revenue in FY12, implying a significant improvement through the remaining quarters. One reason given for the expected improvement was that hardware sales had been low in Q1 due to delays from Samsung, this should correct through the year. In addition Freenet plans a branding re-launch in Q2.

Figure 1. Mobile revenue growth contribution, by quarter



Source: Citi Investment Research and Analysis

Figure 2. Mobile revenue growth contribution, by year

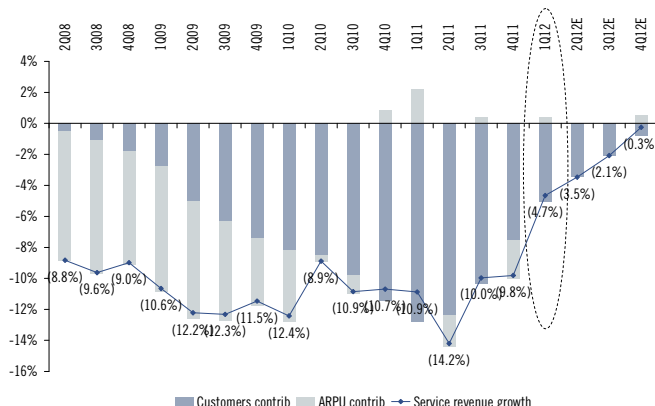


Source: Citi Investment Research and Analysis

### Management confident on positive post-pay net adds for remaining 9m

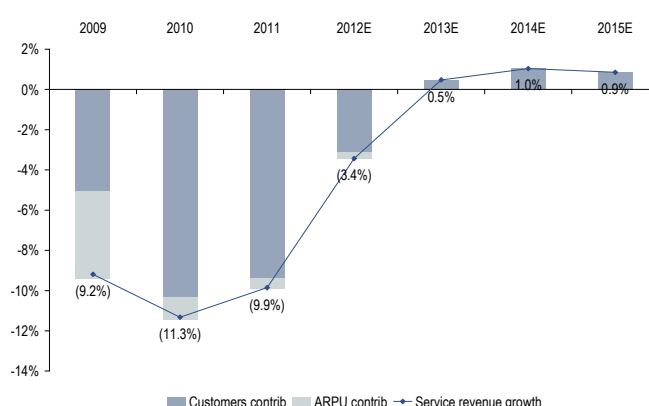
Post-pay is 80% of Freenet's revenue. Post-pay revenue decline improved to -4.7% 1Q12 from -9.8% 4Q11 driven by lower customer losses. Management remains confident on a flat post-pay customer base during 2012, which given losses of -60k in 1Q12 implies positive net adds for Q2-Q4. Aiding this improvement will be seasonality and the planned branding re-launch planned for 2Q12.

Figure 3. Post-pay revenue growth contribution, by quarter



Source: Company Reports and Citi Investment Research and Analysis

Figure 4. Post-pay revenue growth contribution, by year

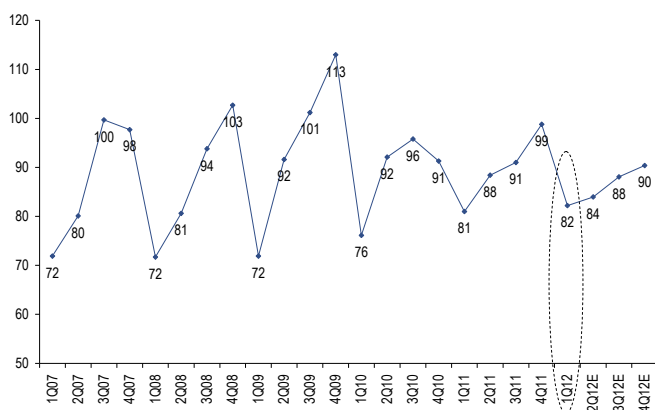


Source: Company Reports and Citi Investment Research and Analysis

### Upside to EBITDA forecasts and guidance

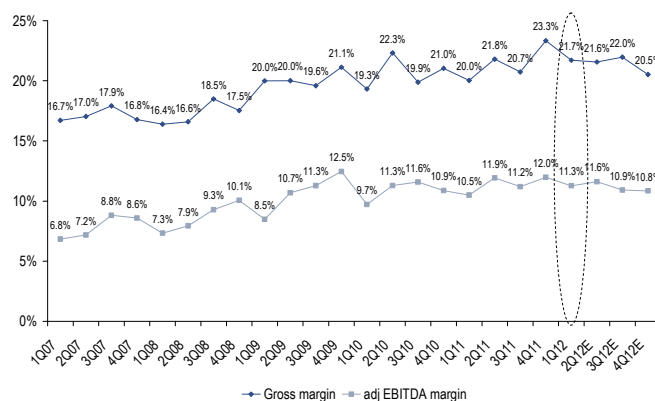
EBITDA in 1Q12 benefited from delayed marketing expense, beating consensus forecasts by 5.5%. We therefore don't forecast the normal seasonal jump from Q1 to Q2. We now forecast €346m 2012 group EBITDA vs guidance of €340m, however this still looks conservative given normal seasonality as shown in, Figure 5.

Figure 5. Recurring mobile EBITDA by quarter



Source: Citi Investment Research and Analysis

Figure 6. Mobile recurring EBITDA margin and gross margin

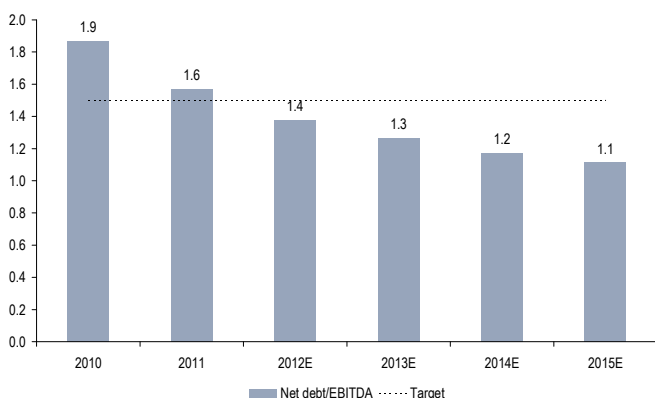


Source: Citi Investment Research and Analysis

### Upside to dividends

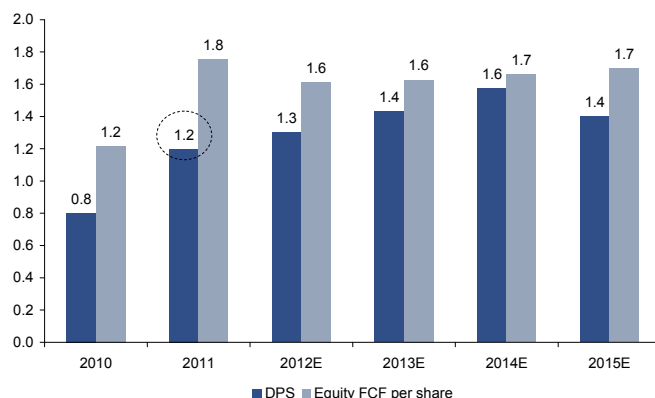
At the AGM on 9<sup>th</sup> May a shareholder successfully proposed a dividend of €1.20/share an increase from the board's proposal of €1.0/share. We still see further upside to dividends. We forecast 1.4x 2012 net debt/EBITDA, below the target rate of 1.5x, we therefore argue that once the company reaches this point dividends could increase towards equity FCF of c.€1.6 going forwards.

Figure 7. Net debt/EBITDA



Source: Company Reports and Citi Investment Research and Analysis

Figure 8. DPS and equity FCF per share (€/share)



Source: Company Reports and Citi Investment Research and Analysis

## Forecast changes

We update forecasts for the 1Q12 results and higher dividend of €1.20 from the AGM rather than the €1.0 proposed by the board. We have reduced our revenue forecasts primarily due to no-frills and pre-pay. We now forecast -2.1% revenue decline in 2012 which is on the conservative side given management confidence in flat revenue in 2012. We leave our EBITDA forecasts broadly unchanged. EPS reduced due to the higher interest costs as a result of the higher dividend. We leave 2012 EPS unchanged, 2013 -1.3%.

Figure 9. Forecast changes (€m)

	New Forecasts			Delta.			Diff.		
	2012	2013	2014	2012	2013	2014	2012	2013	2014
Revenue	3,149	3,150	3,166	(58)	(65)	(60)	(1.8%)	(2.0%)	(1.9%)
EBITDA recurring	346	344	346	1	(0)	1	0.3%	(0.1%)	0.3%
margin	11.0%	10.9%	10.9%				0.2ppt	0.2ppt	0.2ppt
EBITDA	346	344	346	1	(0)	1	0.3%	(0.1%)	0.3%
margin	11.0%	10.9%	10.9%				0.2ppt	0.2ppt	0.2ppt
D&A	(140)	(47)	(35)	0	0	0	(0.0%)	(0.2%)	(0.4%)
EBIT	206	296	311	1	(0)	1	0.5%	(0.1%)	0.3%
Share of associates	1.7	1.7	1.7	0	0	0	0.0%	0.0%	0.0%
Interest	(40)	(36)	(34)	(1)	(3)	(6)	2.6%	9.5%	19.8%
PBT	167	262	279	(0)	(3)	(5)	(0.0%)	(1.3%)	(1.6%)
Taxation	5	(34)	(34)	0	0	1		(1.1%)	(1.4%)
Net Income Discnt.	0	0	0	0	0	0	n/a	n/a	n/a
Minorities	0	0	0	0	0	0	n/a	n/a	n/a
Attrib to freenet	172	228	245	(0)	(3)	(4)	(0.0%)	(1.3%)	(1.6%)
EPS	1.34	1.78	1.91	(0.00)	(0.02)	(0.03)	(0.0%)	(1.3%)	(1.6%)
EPS clean	1.82	1.86	1.91	(0.00)	(0.02)	(0.03)	(0.0%)	(1.3%)	(1.6%)
DPS	1.30	1.43	1.57	0.20	0.22	0.24	18.2%	18.2%	18.2%
Net debt	(477)	(435)	(405)	(25)	(53)	(85)	5.6%	14.0%	26.7%
CFO	272	270	271	1	(0)	1	0.3%	(0.0%)	0.5%
FCF (Freenet def)	247	245	246	1	0	2	0.6%	0.2%	0.8%
Equity FCF	207	208	213	0	(3)	(4)	0.2%	(1.3%)	(1.7%)

Source: Citi Investment Research and Analysis

## Forecasts

Figure 10. Income statement (€m)

	2009A	2010A	2011A	2012E	2013E	2014E	2015E
<b>Revenue</b>	<b>3,651</b>	<b>3,340</b>	<b>3,218</b>	<b>3,149</b>	<b>3,150</b>	<b>3,166</b>	<b>3,178</b>
growth	31.5%	-8.5%	-3.6%	-2.1%	0.0%	0.5%	0.4%
<b>EBITDA recurring</b>	<b>393</b>	<b>365</b>	<b>360</b>	<b>346</b>	<b>344</b>	<b>346</b>	<b>350</b>
margin	10.8%	10.9%	11.2%	11.0%	10.9%	10.9%	11.0%
margin change yoy	1.6ppt	0.2ppt	0.3ppt	-0.2ppt	-0.1ppt	0.0ppt	0.1ppt
growth	54.2%	-7.2%	-1.3%	-4.1%	-0.5%	0.6%	1.1%
non-recurring items	(70)	(30)	(23)	0	0	0	0
<b>EBITDA</b>	<b>324</b>	<b>335</b>	<b>337</b>	<b>346</b>	<b>344</b>	<b>346</b>	<b>350</b>
margin	8.9%	10.0%	10.5%	11.0%	10.9%	10.9%	11.0%
D&A	(204)	(189)	(169)	(140)	(47)	(35)	(33)
<b>EBIT</b>	<b>120</b>	<b>146</b>	<b>169</b>	<b>206</b>	<b>296</b>	<b>311</b>	<b>317</b>
Share of associates	2	2	2	2	2	2	2
Interest	(90)	(45)	(53)	(40)	(36)	(34)	(32)
<b>PBT</b>	<b>32</b>	<b>103</b>	<b>117</b>	<b>167</b>	<b>262</b>	<b>279</b>	<b>287</b>
Taxation	(19)	16	27	5	(34)	(34)	(35)
<b>Net Income Cont.</b>	<b>13</b>	<b>119</b>	<b>144</b>	<b>172</b>	<b>228</b>	<b>245</b>	<b>252</b>
Net Income Discnt.	244	(6)	0	0	0	0	0
<b>Net Income</b>	<b>257</b>	<b>112</b>	<b>144</b>	<b>172</b>	<b>228</b>	<b>245</b>	<b>252</b>
Minorities	1	0	(0)	0	0	0	0
<b>Attrib to freenet</b>	<b>257</b>	<b>112</b>	<b>144</b>	<b>172</b>	<b>228</b>	<b>245</b>	<b>252</b>
<b>EPS (calc)</b>	<b>2.01</b>	<b>0.88</b>	<b>1.12</b>	<b>1.34</b>	<b>1.78</b>	<b>1.91</b>	<b>1.96</b>
<b>Clean EPS</b>	<b>3.42</b>	<b>1.74</b>	<b>1.75</b>	<b>1.82</b>	<b>1.86</b>	<b>1.91</b>	<b>1.96</b>
<b>DPS</b>	<b>0.20</b>	<b>0.80</b>	<b>1.20</b>	<b>1.30</b>	<b>1.43</b>	<b>1.57</b>	<b>1.40</b>

Source: Company Reports and Citi Investment Research and Analysis

Figure 11. Cash flow statement (€m)

	2009A	2010A	2011A	2012E	2013E	2014E	2015E
<b>EBITDA</b>	<b>324</b>	<b>335</b>	<b>337</b>	<b>346</b>	<b>344</b>	<b>346</b>	<b>350</b>
Tax expense	(21)	(10)	(30)	(34)	(34)	(34)	(35)
Working Capital	(22)	(83)	(46)	(40)	(40)	(40)	(40)
Other Adjustments	15	(6)	0	0	0	0	0
<b>Cashflow from Operations</b>	<b>296</b>	<b>236</b>	<b>262</b>	<b>272</b>	<b>270</b>	<b>271</b>	<b>275</b>
Purchase of PPE	(19)	(3)	(3)	(15)	(15)	(15)	(15)
Purchase on intangible assets	(51)	(24)	(19)	(10)	(10)	(10)	(10)
Disposals and Acquisitions	371	23	2	0	0	0	0
Interest received	7	4	4	4	4	4	4
<b>Cashflow from Investing</b>	<b>308</b>	<b>0</b>	<b>(16)</b>	<b>(21)</b>	<b>(21)</b>	<b>(21)</b>	<b>(21)</b>
Dividends Paid	0	(26)	(102)	(154)	(166)	(183)	(201)
Acquisition of minority interests	0	0	0	0	0	0	0
Issuance/repayment of debt	(156)	(454)	(69)	(53)	(42)	(29)	(16)
Cash payments in connection with capital increases	0	0	0	0	0	0	0
Buyback	0	0	0	0	0	0	0
Cash payments to minority interests	0	0	0	0	0	0	0
Interest Paid	(96)	(58)	(19)	(44)	(41)	(38)	(36)
<b>Cashflow from Financing</b>	<b>(252)</b>	<b>(538)</b>	<b>(190)</b>	<b>(251)</b>	<b>(249)</b>	<b>(250)</b>	<b>(253)</b>
Firm FCF	226	210	240	247	245	246	249
Equity FCF	136	156	225	207	208	213	217
Equity FCF (adj)	136	156	197	207	208	213	217
Net Debt	(790)	(626)	(529)	(477)	(435)	(405)	(389)

Source: Company Reports and Citi Investment Research and Analysis

## Freenet

### Company description

Freenet has been in transition for the last few years and has now emerged as a pure German mobile service provider. This is after acquiring Debitel and selling its DSL business, Strato and Debitel Netherlands. Freenet is now essentially a wholesale mobile operator, running distribution and customer service without owning any network assets. Freenet has 17m subscribers, 16% of the German mobile market.

### Investment strategy

We rate Freenet Buy. In its new form Freenet is a stable and highly cash generative business. This should allow Freenet to deliver significant shareholder returns. However, the lack of any history of stability and current customer losses means that this potential has not been reflected in the valuation. Freenet trades on a significant discount to its peers. We argue that as evidence comes through of Freenet's stable cash generation and high dividends, the stock should re-rate. Catalysts include a formal dividend policy and a reduction in customer losses as Freenet finishes clearing out the customer base of low profitability customers.

### Valuation

We calculate an €13.5 target price based on a DCF, using an 11.1% WACC and -1% perpetuity growth rate. Freenet trades on a significant discount to its peers. We use a DCF methodology due to the cash-generative nature of the business.

### Risks

The main risks to the investment case and our target price are: 1) a continuation of post-pay customer losses, reducing revenue growth; 2) further price declines in the German mobile market; 3) increased SAC spend depressing cash flows in the short term; 4) higher restructuring charges from the integration with Debitel; and 5) Freenet may be involved in M&A activity that could affect investor perception of its overall risk profile. If the impact of these risk factors is more or less negative than we anticipate, then the share price could fail to reach or rise above our target price.

## Appendix A-1

### Analyst Certification

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#### Ratings and Target Price History Fundamental Research

Analyst: Laurie Fitzjohn-Sykes, CFA  
Covered since June 28 2010



	Date	Rating	Target Price	Closing Price
1	22-Jun-09	Coverage terminated		
2	28-Jun-10	*1H	*11.50	8.44

\* Indicates change

	Date	Rating	Target Price	Closing Price
3	7-Oct-11	Stock rating system changed		
4	8-Oct-11	*1	11.50	8.91

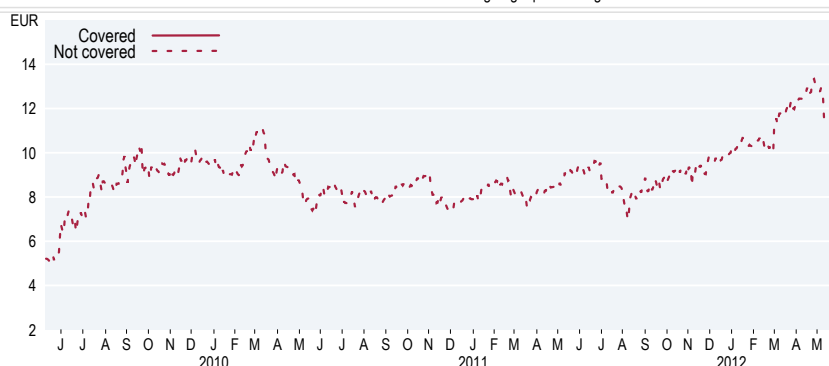
	Date	Rating	Target Price	Closing Price
5	1-Mar-12	1	*12.50	11.35
6	18-Apr-12	1	*13.50	12.79

Rating/target price changes above reflect Eastern Standard Time

### Freenet (FNTGn.DE)

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

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##### Data current as of 31 Mar 2012

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

12 Month Rating			Relative Rating		
Buy	Hold	Sell	Buy	Hold	Sell
52%	37%	11%	10%	79%	10%
44%	42%	40%	47%	42%	43%

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