11 May 2015 | 17 pages

Telecommunications Operators
CEEMEA | Czech Republic

O2 Czech Republic (SPTT.PR)

World leading move on structural separation, high minority risk

- Estimate Change
- Target Price Change

- **O2 CZ is the world's first telecom incumbent to voluntarily structurally separate its (fixed-line/mobile) infrastructure business from the service part of its business into two separate companies (by June this year).** This revolutionary move has been driven by management's desire to address the inherent inefficiencies of the legacy telecom incumbent business model (also see our November 2014 report Re-birth of telecom monopoly: Is the industry broken and heading towards its monopolistic roots?). Management believes that the business will be run more efficiently in two separate entities with different management style, length of investment cycles, risk and funding profile. The new setup should also reduce the potential for internal conflicts of interests, regulatory and legal risks. Finally, it should allow for better use of in-market infrastructure synergies while freeing up the service company from regulation so that it can become a new age consumer digital service company with the freedom to bundle services. The move is also in line with the spirit of the EU policies on open infrastructure access and it is supported by local regulators, who in turn tolerate major network sharing in mobile.
- **Ahead of the 1Q15 results announcement we expect material improvement in the underlying operating trends, including return to revenue and EBITDA growth this year.** Management said that it expects both separated businesses to grow and 1Q15 EBITDA to materially exceed consensus estimate, driven by revenue recovery, cost savings and simplification of the operating model. If confirmed, this would add further credibility to the structural separation story.
- **Following the above-mentioned performance improvement expectations we have raised our 12m ex-div TP to Kc249 (prev. Kc225), maintaining our Neutral/High Risk rating.** Although we endorse structural separation as the right strategy for the company, the planned spin-off of unlisted CETIN (the infrastructure company) in context of the currently low free float and minority squeeze out rules, in our view creates significant risk to minority shareholders. We therefore find it proper to continue valuing the company for the purpose of determining our TP and recommendation based on discounted peer multiples.

O2 Czech Republic (CZK)

Year to 31 Dec	2013A	2014A	2015E	2016E	2017E
Sales (KcM)	47,895.0	44,688.5	45,414.2	45,552.9	45,983.1
Net Income (KcM)	5,695.0	3,998.0	4,698.5	4,922.7	5,491.9
Diluted EPS (Kc)	18.04	12.67	14.89	15.60	17.40
Diluted EPS (Old) (Kc)	18.04	12.70	14.56	15.56	17.44
PE (x)	11.8	16.8	14.3	13.7	12.2
EV/EBITDA (x)	3.6	4.3	4.0	3.8	3.6
DPS (Kc)	18.00	13.00	14.89	15.60	17.40
Net Div Yield (%)	8.5	6.1	7.0	7.3	8.2

Neutral/High Risk	2H
Price (07 May 15)	Kc213.00
Target price	Kc249.00
from Kc225.00	
Expected share price return	16.9%
Expected dividend yield	7.0%
Expected total return	23.9%
Market Cap	Kc67,233M
	US$2,768M

Price Performance
(RIC: SPTT.PR, BB: TELEC CP)

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SPTT.PR: Fiscal year end 31-Dec

Price: Kc213.00; TP: Kc249.00; Market Cap: Kc67,233m; Recomm: Neutral/High Risk

Profit & Loss (Kcm)	2013	2014	2015E	2016E	2017E
Sales revenue	47,895	44,689	45,414	45,553	45,983
Cost of sales	-12,589	-12,821	-13,875	-14,209	-14,285
Gross profit	35,306	31,867	31,539	31,344	31,699
Gross Margin (%)	73.7	71.3	69.4	68.8	68.9
EBITDA (Adj)	18,477	16,010	17,199	16,877	17,052
EBITDA Margin (Adj) (%)	38.6	35.8	37.9	37.0	37.1
Depreciation	-8,545	-8,324	-8,077	-7,302	-6,856
Amortisation	-2,487	-2,412	-3,027	-2,948	-2,847
EBIT (Adj)	7,445	5,274	6,095	6,627	7,350
EBIT Margin (Adj) (%)	15.5	11.8	13.4	14.5	16.0
Net interest	-175	-105	-102	-63	-27
Associates	-6	9	0	0	0
Non-op/Except	0	0	0	0	0
Pre-tax profit	7,264	5,178	5,993	6,564	7,323
Tax	-1,569	-1,180	-1,294	-1,641	-1,831
Extraord./Min.Int./Pref.div.	0	0	0	0	0
Reported net profit	5,695	3,998	4,699	4,923	5,492
Net Margin (%)	11.9	8.9	10.3	10.8	11.9
Core NPAT	5,695	3,998	4,699	4,923	5,492
Per share data	**2013**	**2014**	**2015E**	**2016E**	**2017E**
Reported EPS (Kc)	18.04	12.67	14.89	15.60	17.40
Core EPS (Kc)	18.04	12.67	14.89	15.60	17.40
DPS (Kc)	18.00	13.00	14.89	15.60	17.40
CFPS (Kc)	54.81	41.11	48.84	48.55	48.10
FCFPS (Kc)	37.12	2.91	28.39	25.72	25.18
BVPS (Kc)	176.62	171.56	173.45	174.16	175.96
Wtd avg ord shares (m)	316	316	316	316	316
Wtd avg diluted shares (m)	316	316	316	316	316
Growth rates	**2013**	**2014**	**2015E**	**2016E**	**2017E**
Sales revenue (%)	-5.2	-6.7	1.6	0.3	0.9
EBIT (Adj) (%)	-10.8	-29.2	15.6	8.7	10.9
Core NPAT (%)	-15.9	-29.8	17.5	4.8	11.6
Core EPS (%)	-14.2	-29.8	17.5	4.8	11.6
Balance Sheet (Kcm)	**2013**	**2014**	**2015E**	**2016E**	**2017E**
Cash & cash equiv.	3,952	3,280	5,493	6,881	11,560
Accounts receivables	7,001	7,170	7,492	7,640	7,648
Inventory	536	470	506	529	546
Net fixed & other tangibles	42,443	37,077	33,541	31,753	30,469
Goodwill & intangibles	20,008	26,276	25,163	23,907	22,721
Financial & other assets	10	17	17	17	17
Total assets	73,949	74,290	72,211	70,726	72,961
Accounts payable	12,199	10,135	10,106	10,428	10,441
Short-term debt	4	4,004	2,358	328	1,981
Long-term debt	3,000	3,000	2,000	2,000	2,000
Provisions & other liab	2,997	2,998	2,998	2,998	2,998
Total liabilities	18,200	20,137	17,463	15,754	17,420
Shareholders' equity	55,749	54,153	54,748	54,972	55,541
Minority interests	0	0	0	0	0
Total equity	55,749	54,153	54,748	54,972	55,541
Net debt (Adj)	-948	3,724	-1,134	-4,553	-7,579
Net debt to equity (Adj) (%)	-1.7	6.9	-2.1	-8.3	-13.6

Valuation ratios	2013	2014	2015E	2016E	2017E
PE (x)	11.8	16.8	14.3	13.7	12.2
PB (x)	1.2	1.2	1.2	1.2	1.2
EV/EBITDA (x)	3.6	4.3	4.0	3.8	3.6
FCF yield (%)	17.4	1.4	13.3	12.1	11.8
Dividend yield (%)	8.5	6.1	7.0	7.3	8.2
Payout ratio (%)	100	103	100	100	100
ROE (%)	9.8	7.3	8.6	9.0	9.9
Cashflow (Kcm)	**2013**	**2014**	**2015E**	**2016E**	**2017E**
EBITDA	18,477	16,010	17,199	16,877	17,052
Working capital	879	-1,898	-386	150	-13
Other	-2,054	-1,136	-1,397	-1,704	-1,858
Operating cashflow	17,302	12,976	15,416	15,323	15,182
Capex	-5,584	-12,057	-6,454	-7,206	-7,233
Net acq/disposals	72	27	0	0	0
Other	-206	5	0	0	0
Investing cashflow	-5,718	-12,025	-6,454	-7,206	-7,233
Dividends paid	-6,191	-5,585	-4,103	-4,699	-4,923
Financing cashflow	-10,891	-1,585	-6,749	-6,729	-3,270
Net change in cash	846	-634	2,213	1,388	4,679
Free cashflow to s/holders	11,718	919	8,962	8,117	7,949

For definitions of the items in this table, please click here.

Structural separation

Structural separation to be implemented in June, some shareholders will be entitled to sell their shares in the infrastructure company CETIN

Based on resolution of its last month's AGM, O2 CZ will spin off its telecom infrastructure into a separate legal entity called CETIN (infrastructure company) by June this year. Apart from keeping their shares in the listed O2 CZ entity (the service company) the current shareholders will be entitled to shares in CETIN, which will however not be listed. Shareholders, who voted against the separation at the last month's AGM, will be entitled to sell their CETIN shares to the company for a price determined by an expert. For the purpose of the separation approval, the company published the expert valuation of CETIN at Kc150/share. This in our view provides an indication of the buyout price, although there is no guarantee that the future expert valuation will be the same.

The infrastructure company CETIN will own physical infrastructure having practically zero net debt

Assets to be spun off into CETIN entail all the company's fixed-line and mobile telecom infrastructure, such as 20m of copper cables, 38,000km of optic cables, 5,300 macro sites, 750 micro sites and 2,000 shared locations. The company will have 1,241 FTEs (full time equivalent employees) and practically zero net debt. The company claims that it will offer the best wholesale services in central and Eastern Europe. It plans to radically simplify its operations and IT processes, gradually migrate to all-IP, upgrade its copper network (vectoring, bonding, remote DSLAMs, G.fast), further enhance its fiber backbone, selectively invest into fiber and expand its international business.

Non-infrastructure assets to remain in O2 CZ

Meanwhile, the new O2 CZ, which remains listed, will among others keep the following key assets and liabilities:

- wireless spectrum
- the O2 brand
- customer contracts
- IT systems, data centers
- O2 Slovakia (the entire mobile asset)
- stakes in smaller subsidiaries (pay TV, MVNOs etc)
- approximately Kc7bn gross debt (the 2014 cash balance adjusted for dividend paid in 2013 is not significant)

O2 CZ is the first incumbent in the world to voluntarily structurally separate its entire telecom infrastructure . . .

Although the concept of structural separation and wholesale-only infrastructure operators companies is not new (in certain ways this concept has already been adopted for example in the UK, New Zealand, Sweden etc.), O2 CZ is the first incumbent telecom operator in the world to voluntarily separate its entire (fixed-line and mobile) infrastructure. Separation in the other mentioned countries has been limited to fixed-line and involuntary (New Zealand, UK), only functional as opposed to legal (UK) or not applicable to the incumbent and the entire market (Sweden). The business case for structural separation is based on removal of inherent inefficiencies facing the legacy incumbent telecom operators (also see our report Re-birth of telecom monopoly: Is the industry broken and heading towards its monopolistic roots? from November 2014).

. . . creating a model, which may be quite well suited for the future digital economy

We also believe that attraction of the structural separating business case (particularly in Europe where network openness is conceptually strongly rooted into telecom policies) has recently grown due to growing importance of content as network traffic generator; expected boom in Internet of Things opportunities (causing a need for market for connectivity with differentiated parameters); replacing of old technologies by all-IP; and increasing importance of digital services on global economic growth.

Business case for structural separation outlined

Based on management's presentation and our own analysis we can briefly summarize the business case for structural separation as follows:

1. **Opportunity to manage the business more efficiently**

Infrastructure	**Service**
separated business should better handle the following differences:	
conservative management	innovation-driven management
longer-technology cycles	shorter product cycles/contracts
long-term investment horizon	short to mid-term investment horizon
capex heavy	selective capex with fast returns
broader wholesale opportunities	service not linked to infrastructure

the separated business is also less prone to:

- conflicts of interests between management and shareholders
- conflicts between short-term and long-term shareholder interests
- internal conflicts of interests
- potentially value-destructive 'empire-building'

2. **Softening of regulation and legal risks**

Infrastructure	**Service**
regulation to encourage investment	freeing the business from regulation
equal access reduces legal risk	service competition reduces legal risk
better in-market synergies exploitation	
less complex regulation	
less disruptive regulation	
easier to accept infrastructure subsidies	
addresses some of the net neutrality concerns	

3. **More efficient funding of business**

Infrastructure	**Service**
cheaper funding due to low risk	funding from growth-investors
longer-term funding	shorter-term funding

Concerns about potential value losses from structural separation addressed

Although in general we see the structural separation positively in terms of value creation, as a revolutionary concept it of course also brings risks, which in our view include:

- **Loss of synergies between infrastructure and service.** Based on the spirit of the EU regulatory policies such synergies in fact should not exist.

The incumbents should be offering fair wholesale access into their networks to external parties. However, such concepts are practically not always applied. For example fiber-to-the home networks are sometimes (temporarily) exempt from such regulation.

- **Loss of opportunity to create quasi-monopolies, which are not subject to monopolistic regulation.** Large incumbents often create quasi-monopolies (e.g. materially superior networks), which are not subject to monopolistic regulation due to a view that they operate in competitive markets. As the Turkcell example shows, such opportunities are not always sustainable, monopolistic regulation may be applied at some stages.

- **Possible loss of implicit (regulatory) state support.** Telecom incumbents including key mobile operators are strategically important for national governments. This for example practically almost rules out their bankruptcies. Service companies resulting from the structural separation are on the other hand prone to competition from a wide range of entities including potentially the global internet companies. While their successful ability to innovate may give the major growth opportunities, failure to do so may also bring new risks. The new O2 CZ story (excluding infrastructure) is therefore clearly riskier than the previous one (with infrastructure). Success of the service company's innovation-driven strategy is crucial for preservation of its value.

- **Loss of perception of a stable infrastructure-driven dividend yielding business.** Investors often perceive telecom incumbents including their service parts as relatively stable dividend yielding businesses. This argument cannot be made about the service businesses any more.

- **Execution risks.** Implementation of structural separation, especially where there is limited industry precedent for it, naturally brings execution risks as well.

- **Regulatory risks stemming from imperfections of the implemented structural separation.** Although the proposed O2 CZ structural separation goes further than any other similar project in the world so far, the proposed setup may not be seen as ideally fitting the theoretical open networks concept. Issues may include for example retained ownership of mobile spectrum by the service company, which leaves some regulatory responsibilities with that company. It is also possible that regulators may not see the separated structure in the same way as the company does in terms of creating fair room for service competition. Control of both companies by the same entity, PPF, could be an issue as well. Hence the assumption of the service company being entirely freed from regulation entails risks.

Why is O2 CZ the world's first operator to voluntarily and fully separate?

As we already mentioned, O2 CZ is the world's first telecom incumbent (ex-monopoly) to voluntarily separate its infrastructure and create a wholesale-only infrastructure company open to external parties. It is also the world's first integrated operator, which is separating both fixed-line and mobile infrastructure. This in our view implies that the company's management and controlling shareholder see benefits of the above-mentioned business case for structural separation outweighing the above mentioned concerns. The following are in our view reasons why structural separation may be particularly attractive for O2 CZ vs. other European and global telecom incumbents:

- **Unique private equity shareholder.** PPF is a highly commercial and internationally successful private equity group, controlled by Peter Keller, self-made richest Czech according to Forbes. O2 CZ is PPF's first telecom investment. Based on its actions so far, the group is clearly intending to create value in telecoms by non-traditional approaches. Given PPF's control over nearly 85% of O2 CZ shares (according to Bloomberg) and its hands-on approach towards managing its assets, we think that conflicts of interests between the majority shareholder and management are extremely low compared to other incumbent operators. As a leading business group in the Czech Republic, PPF may also have an advantage (vs. other telecom incumbents) in its ability to restructure local businesses, trade with local counterparts as well as use synergies with its local assets in other industries. All this may be potentially helpful in building a successful digital age ready service company. Given the earlier announced plans for shareholder loans and spin-off of unlisted infrastructure company (CETIN), it also appears that PPF's actions are driven more by strategic interests as opposed to desire to maximize short-term share price.

- **Market structure and relatively low regulatory risk.** Conceptually the EU policies aim at open infrastructure, which is consistent with structural separation. Based on the recent history of local regulatory decisions we think that it is unlikely that the company would face any major regulatory challenges locally, particularly in a near-term. It is also hard to identify any major rival company with sufficient strength and influence to change regulation against O2 CZ's interests.

- **Infrastructure sharing opportunity.** The Czech authorities are tolerating an infrastructure sharing deal between O2 CZ and T-Mobile, which effectively creates dominant mobile infrastructure player in the country. Opening of mobile infrastructure may provide additional ammunition to the argument that such dominance should be tolerable.

- **Absence of 'protected' products and retail quasi-monopolies.** On the retail side, the fixed-line business of O2 CZ is clearly dominant while the mobile business is reasonably competitive (instead of quasi-monopolistic). FTTH is currently immaterial for O2 CZ, hence the risk of losing potential 'regulatory holidays' when separating the fixed-line infrastructure is not an issue. Meanwhile, despite its solid network, O2 CZ does not stand out as a quasi-monopoly in mobile, i.e. an operator with materially superior coverage and network capacity. This means that the company does not face much risk of losing its unique mobile offering when it opens up its mobile network.

- **Wholesale opportunities.** Significant part of the Czech mobile broadband market is now covered by local providers, which use WiFi technology. As demand for broadband speeds and reliability continue to grow, the case for use of WiFi (unlicensed wireless spectrum) for broadband access is weakening, which opens up wholesale opportunities for CETIN. Management also sees growth in international wholesale opportunities given the country's geographical location.

O2 CZ gave a first approximate guidance about how financials of the two companies would look like after the split

The company has indicated the following approximate split of the key financial indicators (for 2014 retrospectively) between O2 CZ (new) and CETIN:

- revenue: 75% and 50% (this adds to more than 100% due to de-consolidation)

- EBITDA: 50% and 50%
- operating cash flow: 50% and 50%
- Capex/revenue (7% vs. 11%)
- net profit: 80% vs 20%

Free cash flow should be split broadly half by half

Subsequently, free cash flow (EBITDA-capex) split is approximately 50% vs. 50%. Adjusting for taxes (likely to be higher in the service company due to lower depreciation), the free cash flow split may favor the infrastructure company by single percentage points. However, this reflects a situation of relatively significant current investments for example into IT systems in the service company and still relatively low investments in the infrastructure company. All in all, we think that the after tax free cash flow split in medium-term (assuming no material change in revenue and EBITDA dynamics between the two companies) is roughly 50/50 too.

Valuation and minority shareholder issues

We do not think that it is yet possible to model the two separated companies; our Kc249 12m ex-div target price is based on our the same conservative peer comparison driven valuation methodology that we used before

Despite the above discussed split of the company's financials we believe that uncertainties remain too high for us to meaningfully model and value the two separate companies, the new O2 CZ and CETIN. Technically, all shareholders will be entitled to keep shares in both companies. Hence valuation of the combined company still makes some sense. Our revised model shows DCF fair value as Kc363 (prev. Kc354), with the upgrade driven by improvement in operating performance being partially offset by the company going ex-div. However, similarly to our previous reports, for the purpose of setting our 12m ex-div target price we use peer benchmarking at lower parts of the peer ranges, more precisely average fair value across the following 2015E benchmarking ratios (PER, EV/EBIITDA, FCF yield, div yield) and the following groups (minimum for CEEMEA, average for CEEMEA and minimum for Western Europe). On this metric, our fair value of Kc256 implies a 29% discount to our DCF fair value of Kc363. Adjusting the fair value for time value of money and dividend we then estimate our 12m ex-div target price at Kc249 (see Fig 1).

Figure 1. Fair value calculation of O2 Czech with Industry multiples

EV/EBITDA multiple		
	EV/EBITDA-2015 (x)	FV per share (Kc)
CEEMEA minimum	3.3	184
CEEMEA Average	4.9	270
WE minimum	5.3	292
PE multiple		
	PE-2015 (x)	FV per share (Kc)
CEEMEA minimum	10.2	151
CEEMEA Average	19.0	284
WE minimum	13.2	196
FCFE yield multiple		
	FCFE yield-2015	FV per share (Kc)
CEEMEA minimum	15.0%	189
CEEMEA Average	6.1%	466
WE minimum	8.2%	344
Dividend yield multiple		
	Dividend yield-2015	FV per share (Kc)
CEEMEA minimum	9.4%	159
CEEMEA Average	5.2%	288
WE minimum	5.9%	252
Fair Value of O2 Czech - Average of fair values from above four ratios (Kc per share)		
CEEMEA minimum	171	
CEEMEA average	327	
WE minimum	271	
Fair value - average of the above	256	
% discount to adjusted PPF offer price	-8%	
% discount to DCF fair value	-29%	
Implied 12m ex-div target price	249	

Source: Citi Research

Based on the split and valuation logic outlined by the company, CETIN would be worth Kc150/share and the new O2 CZ in our estimate around Kc87/share

Shareholders, who voted against the structural separation at the last months' AGM, will be entitled to sell their CETIN shares in June for an expert-derived valuation. For the purpose of the separation the company recently published CETIN value of Kc150/share (estimated 11x of underlying 2014 FCF), provides an indication (although not a guarantee) of the potential buyout price. Assuming that this is fair and using 8x of underlying 2014 FCF for the service company (to reflect the fact that it is riskier) and taking into account the Kc7bn debt at the service company, our estimated value of the service company would be Kc87/share, i.e. the total fair value would be Kc237.

Although we think that the underlying DCF fair value is high based on low cost of capital and improving performance . . .

Our above-mentioned DCF fair value of Kc363 is significantly above the mentioned valuation, which is attributable both to our WACC assumption as well as assumption of improving business trend (the 3-4Q14 results exceeded our expectations and the company suggested that 1Q15 EBITDA is materially above consensus).

. . . there are significant risks of minority shareholders not being able to reach to such value

Despite our optimism about the fundamentals of the company, we believe that investors should not look at fundamental value only when investing into O2 CZ. This is due to the following material minority risks:

- **PPF shareholder loan.** Last year the company was discussing an arrangement in which it would lend up to Kc25bn to its controlling

shareholder, PPF. Although such plan was suspended while the structural separation of the company is pending, management does not rule out that the new O2 CZ (the listed entity) may provide part of this loan to its controlling shareholder. That said we note that CETIN's cost of capital will be lower compared to that of O2 CZ (due to infrastructure backing) and the shareholder loan has to provide positive return to the company. Hence, PPF may find it more logical to draw as much of these funds as it can from CETIN.

- **Minority buyout and potential squeeze out at CETIN.** The minority buyout price of the non-listed CETIN has not been firmed yet. However, given the lack of listing, it is in our view likely that material number of minority shareholders will use their minority buyout right at CETIN. It is therefore possible (or even likely) that this will lead to PPF exceeding 90% ownership threshold in CETIN (it is not far from it anyway) and use its right to squeeze out the remaining minorities. This in our view means significant risk that minority shareholders at CETIN may not fully benefit from the company's underlying value.

- **Potential for minority squeeze out at O2 CZ.** Acquisition of several percent of the company would allow PPF to exceed 90% and trigger minority squeeze out there at a price potentially far below our DCF valuation.

- **Low free float, liquidity and weak minority shareholders' position.** Given the low (15%) free float, which includes long-term investors, and the loss of CETIN, liquidity of O2 CZ is likely to be low. The low free float also implies fairly weak position of minority shareholders.

- **Dividend and M&A uncertainty.** Unlike its predecessor, the new O2 CZ will be a digital service company able to freely expand into any adjacent business areas, potentially becoming a consumer-like growth business (as opposed to relatively stable dividend generating telecom). Despite its seemingly healthy free cash flows right now, it is therefore hard to predict the company's strategy, possible M&A activity and therefore dividend payments.

- **Transfer pricing between O2 CZ and CETIN.** Although the company sees its wholesale offer as the most attractive in the CEE region, which leaves significant free cash flow generation potential to the new O2 CZ, it is not possible to rule out that in its effort to limit market competition in the future, PPF could make an effort to set the offer in a way that generates profit mainly in CETIN. This would obviously be subject to regulatory scrutiny.

Changes in our assumptions

Operating trends are set to improve compared to previous expectations

The key changes in our assumptions include the following:

- **Revenue:** We have increased total revenue by 0-3% in 2015E-24E due to upgrades both in fixed-line and mobile, also considering better than expected 4Q14 and 1Q15 guidance. Mobile revenue should benefit from improved monetization from residential consumers (postpaid is now fully migrated to unlimited bundles), lower decline in B2B, and higher equipment revenues. Fixed-line revenue should benefit from increase in

low-margin segments such as wholesale and ICT (including delayed government projects).

- **Profitability:** The 2015 EBITDA should benefit from strong revenue as well as cost cutting (employee, marketing, network and admin costs). In longer-term EBITDA margin is subject to pressure coming from increasing share of low-margin businesses in the revenue mix.

- **Capex:** Increase of 1-4% in organic capex over our forecast period is mainly linked to 0-3% increase in revenue. We also assume estimated Kc5.5bn one-off capex payment to extend rights to the O2 brand in 2020.

- **Free cash flow:** We have increased our FCF forecast by 10-17%. Significant part of this is due to the pre-paid O2 branding fee last year, the underlying increase would be just 2-7%, driven mainly by EBITDA upgrade.

- **Dividend:** Given the structural separation this is a rather theoretical assumption. Given the uncertainties and for the sake of simplicity we now assume 100% payout of net profit as in the past two years. This implies 5-25% dividend cut compared to our previous forecast during 2015E-18E.

1Q15 results preview

Figure 2. O2 CZ 1Q15 results preview

Kcm	1Q15E	1Q14	*% y-o-y*	4Q14	*% q-o-q*
Fixed revenues	4,911	4,763	*3.1%*	5,004	*-1.9%*
Mobile revenues	4,597	4,713	*-2.5%*	4,966	*-7.4%*
Slovakia revenues	1,526	1,364	*11.9%*	1,753	*-13.0%*
Intersegment elimination	(51)	(48)	*7.4%*	(52)	*-2.2%*
Revenues	10,983	10,792	*1.8%*	11,670	*-5.9%*
EBITDA	3,937	3,447	*14.2%*	4,205	*-6.4%*
EBITDA margin	*35.8%*	*31.9%*		*36.0%*	
EBIT	1,232	758	*62.5%*	1,365	*-9.7%*
EBIT margin	*11.2%*	*7.0%*		*11.7%*	
Net Profit	962	558	*72.3%*	967	*-0.6%*
Capex	1,647	4,533	*-63.7%*	5,053	*-67.4%*
Capex/Sales	*15.0%*	*42.0%*		*43.3%*	
KPIs					
Mobile subs (m)	5.1	5.1	*0.1%*	5.1	*0.0%*
Mobile ARPU (Kc)	273	282	*-3.3%*	288	*-5.1%*
PSTN lines (m)	0.8	0.9	*-10.1%*	0.9	*-2.2%*
ADSL lines (m)	0.8	0.8	*-0.1%*	0.8	*0.2%*

Source: Company data, Citi Research

Variance between our old and new forecasts

Figure 3. O2 Czech – Variance between our previous and current forecasts (Kc mn)

	FY15E	FY16E	FY 17E	FY 18E	FY 19E	FY 20E	FY 21E	FY 22E	FY 23E	FY 24E
Mobile Revenue										
New	19,232	19,724	20,261	20,826	21,355	21,885	22,420	22,957	23,493	24,036
Old	18,995	19,291	19,893	20,532	21,119	21,703	22,292	22,875	23,449	24,029
% change	*1.2%*	*2.2%*	*1.8%*	*1.4%*	*1.1%*	*0.8%*	*0.6%*	*0.4%*	*0.2%*	*0.0%*
Fixed-line revenue										
New	19,858	19,242	18,867	18,750	18,794	18,895	19,003	19,117	19,242	19,373
Old	18,839	18,292	18,131	18,122	18,287	18,498	18,707	18,913	19,122	19,329
% change	*5.4%*	*5.2%*	*4.1%*	*3.5%*	*2.8%*	*2.1%*	*1.6%*	*1.1%*	*0.6%*	*0.2%*
Slovakia revenue										
New	6,657	6,918	7,187	7,394	7,552	7,918	8,260	8,580	8,877	9,154
Old	6,572	6,857	7,139	7,356	7,511	7,896	8,251	8,578	8,878	9,154
% change	*1.3%*	*0.9%*	*0.7%*	*0.5%*	*0.5%*	*0.3%*	*0.1%*	*0.0%*	*0.0%*	*0.0%*
Group - Revenue										
New	45,414	45,553	45,983	46,634	47,359	48,352	49,331	50,296	51,248	52,194
Old	44,077	44,113	44,833	45,674	46,575	47,748	48,893	50,003	51,079	52,135
% change	*3.0%*	*3.3%*	*2.6%*	*2.1%*	*1.7%*	*1.3%*	*0.9%*	*0.6%*	*0.3%*	*0.1%*
EBITDA										
New	17,199	16,877	17,052	17,252	17,443	17,917	18,414	18,931	19,377	19,751
Old	16,557	16,392	16,812	17,026	17,273	17,794	18,319	18,848	19,375	19,733
% change	*3.9%*	*3.0%*	*1.4%*	*1.3%*	*1.0%*	*0.7%*	*0.5%*	*0.4%*	*0.0%*	*0.1%*
EBITDA margin										
New	37.9%	37.0%	37.1%	37.0%	36.8%	37.1%	37.3%	37.6%	37.8%	37.8%
Old	37.6%	37.2%	37.5%	37.3%	37.1%	37.3%	37.5%	37.7%	37.9%	37.8%
ppt change	*30.8*	*(11.0)*	*(41.5)*	*(28.3)*	*(25.6)*	*(21.2)*	*(14.0)*	*(5.5)*	*(12.1)*	*(0.8)*
EBIT										
New	6,095	6,627	7,350	7,891	8,352	9,018	9,646	10,479	10,996	11,395
Old	6,215	6,665	7,494	7,947	8,357	8,990	9,586	10,383	10,941	11,293
% change	*-1.9%*	*-0.6%*	*-1.9%*	*-0.7%*	*-0.1%*	*0.3%*	*0.6%*	*0.9%*	*0.5%*	*0.9%*
Net profit										
New	4,699	4,923	5,492	5,951	6,347	6,861	7,286	7,928	8,338	8,654
Old	4,597	4,912	5,504	5,818	6,128	6,624	7,094	7,709	8,134	8,396
% change	*2.2%*	*0.2%*	*-0.2%*	*2.3%*	*3.6%*	*3.6%*	*2.7%*	*2.8%*	*2.5%*	*3.1%*
Dividend per share (Kc)										
New	14.9	15.6	17.4	18.9	20.1	21.7	23.1	25.1	26.4	27.4
Old	20.0	20.0	20.0	20.0	19.4	21.0	22.5	24.4	25.8	26.6
% change	*-25.6%*	*-22.0%*	*-13.0%*	*-5.7%*	*3.6%*	*3.6%*	*2.7%*	*2.8%*	*2.5%*	*3.1%*
Capex										
New	6,454	7,206	7,233	7,294	7,328	12,919	7,597	7,684	7,770	7,858
Old	6,201	7,004	7,075	7,233	7,251	7,372	7,489	7,602	7,712	7,819
% change	*4.1%*	*2.9%*	*2.2%*	*0.8%*	*1.1%*	*75.2%*	*1.4%*	*1.1%*	*0.8%*	*0.5%*
FCF										
New	8,962	8,117	7,949	7,958	8,064	2,744	8,348	8,576	8,848	9,071
Old	7,978	6,921	6,947	6,917	7,037	7,245	7,505	7,714	7,979	8,189
% change	*12.3%*	*17.3%*	*14.4%*	*15.0%*	*14.6%*	*-62.1%*	*11.2%*	*11.2%*	*10.9%*	*10.8%*

Source: Citi Research

O2 Czech Republic

Company description

O2 Czech Republic is the incumbent integrated provider of telecoms services in the Czech Republic with 2nd largest mobile market share. It has also provided mobile services in Slovakia since 2007. The company is 83% owned and controlled by PPF group.

Investment strategy

We rate O2 Czech Republic Neutral/High Risk. Revenue from fixed line and the mobile segment performance has been challenging in past few years. Mobile revenue had been under constant pressure due to a series of MTR cuts in the past couple of years, pricing pressure in B2B segment and slow adoption of mobile data usage. Fixed-line voice has continued to decline with muted support from broadband business. Historically, the dividend has been one of the stock's most attractive drivers but this is expected to remain under pressure in the mid-term due to weaker operating performance.

Valuation

We have calculated our fair value based as an average across the following 2015F benchmarking ratios (PER, EV/EBIITDA, FCF yield, div yield) and the following groups (minimum for CEEMEA, average for CEEMEA and minimum for Western Europe). On these metrics, our fair value of Kc256 implies 7.5% discount to the previous adjusted mandatory minority offer made in June 2014. Adjusting the fair value for time value of money and dividend we then estimate our 12m ex-div target price at Kc249.

Risks

We rate the shares High Risk (H) is due to the current strategic and execution uncertainties, but most importantly PPF's uncertain mid-term intentions regarding minority ownership of the company.

We see the following risks to our target price for O2 Czech Republic.

Downside risks: Prolonged stiff competition in the mobile B2B business; slower adoption of LTE; continued pressure in Fixed Broadband net additions; and slow recovery in ICT business.

Upside risks include: cost restructuring, macroeconomic recovery and higher-than-expected up selling to "Free Tariff" plan.If the impact of these risk factors is more/less negative than we anticipate, then the share price might fail to reach/rise above our target price.

Appendix A-1

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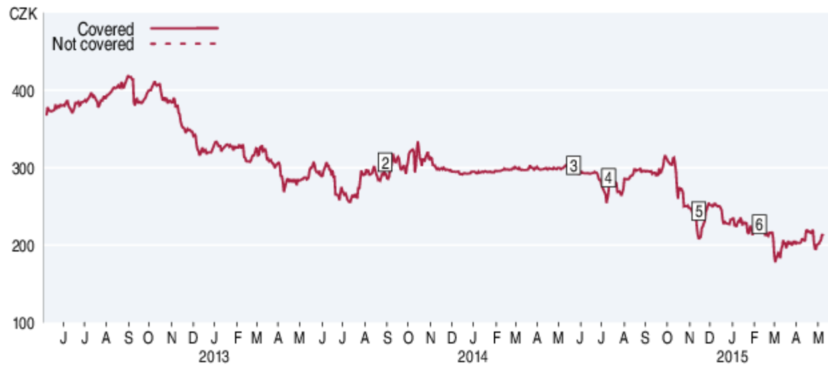
IMPORTANT DISCLOSURES

O2 Czech Republic (SPTT.PR)
Ratings and Target Price History
Fundamental Research
Analyst: Dalibor Vavruska

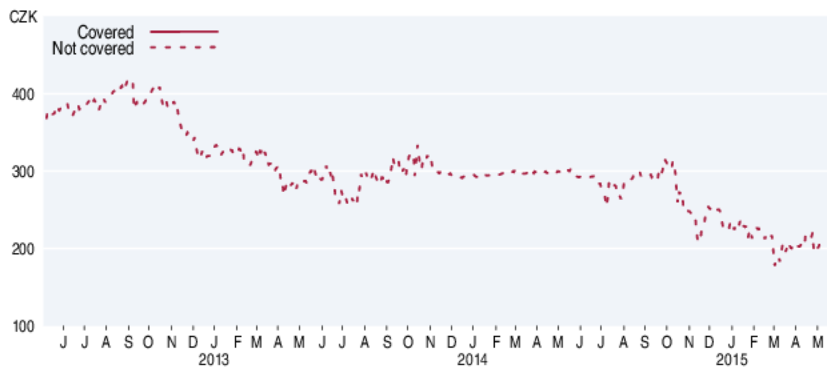


	Date	Rating	Target Price	Closing Price
1	7-Oct-11	Stock rating system changed		
2	29-Aug-13	*2	*296.00	291.00
3	22-May-14	2	*304.00	294.90
4	10-Jul-14	*2H	*306.00	267.50
5	14-Nov-14	2H	*233.00	208.00
6	9-Feb-15	2H	*225.00	225.60

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

O2 Czech Republic (SPTT.PR)
Ratings and Target Price History
Best Ideas Research
Relative Call (3 Month)
Analyst: Dalibor Vavruska



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Data current as of 31 Mar 2015	Buy	Hold	Sell	Buy	Hold	Sell
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% of companies in each rating category that are investment banking clients	65%	64%	54%	0%	63%	0%

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