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Wednesday, November 05, 2014 | update

Orange Polska: reduce (upgraded)

OPL PW; OPL.WA | Telecommunications, Poland

Heated Mobile B2B Competition, Dividend Pressure

Orange Polska logged a 15.9% drop in share price in the past month, but this does not change our bearish outlook on its business prospects shaped by continuing price pressure on the market for B2B mobile services combined with intensified competition in broadband coming from cable operators and Netia, and increasing costs of interconnection driven by mass customer defections to rival calling plans. According to our calculations, combined, all these factors can drive Orange's EBITDA down by 6.8% to PLN 3,627m in 2015 (the consensus estimate is PLN 3,806m). The shrinking EBITDA next year is expected to be accompanied by increased capital expenditures on LTE frequencies and fiber-optic infrastructure, with the total 2015 CAPEX projected at PLN 3.4bn. Orange could pay PLN 0.50 per-share dividends to its shareholders on the condition that it raises its debt ratio from 1.1x at year-end 2014 to 1.4x by the end of 2015. It is worth noting the September acquisition by Orange's parent company Orange France of the Spanish telecom Jazztel for EUR 3.4bn, paid in hybrid bonds (classified as equity under IFRS), and its current focus on bringing the net debt/EBITDA ratio slightly down to 2.0x. Given that Orange France practices centralized group financing through cash pooling, it is probably not too concerned about whether or not the subsidiaries pay dividends if such distributions should entail increased debt. In the baseline scenario, we assume that Orange will reduce next year's DPS to PLN 0.25 (vs. consensus expectation of PLN 0.52). We are raising our price target for OPL to PLN 8.90 and we are upgrading our rating from sell to reduce.

Deregulation of wholesale broadband

A reduction by Orange Polska in the retail prices of fixed-line broadband services was met with a counter-offer from cable operators and the rival fixed-line provider Netia applied to slower connections. The Polish telecoms authority recently deregulated wholesale broadband access in 76 areas in Poland (housing 3.9 million households), and we expect Orange to take steps to boost the sales and competitiveness of its services in thesa areas though investment in fiber-optic infrastructure.

Apparent EBITDA stabilization

Orange Polska reported 2% y/y contraction in its adjusted EBITDA results in the past two quarters, suggesting certain stabilization, however, we must note that the reported figures had received a boost of over PLN 150m following a change of the accounting approach to sales of mobile devices; the adjusted EBITDA shows year-on-year shrinkage of 9%. The change of accounting approach is also reflected in CFO and lower receivables. In the quarters ahead, Orange's EBITDA will be under pressure from low prices of mobile B2B services stemming from intense competition combined with the fact that the prices are higher than charged from individuals and with the popularity of SIM only deals and mass switchovers to unlimited calling plans.

(PLN m)	2012	2013	2014E	2015E	2016E
Revenue	14,141.0	12,923.0	12,143.7	11,830.6	11,666.4
EBITDA	4,857.0	3,904.0	4,011.6	3,627.0	3,484.5
EBITDA margin	34.3%	30.2%	33.0%	30.7%	29.9%
EBIT	1,574.0	788.0	951.8	778.1	807.0
Net profit	855.0	296.0	503.8	438.7	462.1
DPS	1.50	0.50	0.25	0.50	0.50
P/E	15.4	44.2	26.0	29.8	28.3
P/CE	1.0	1.0	1.1	1.0	1.1
P/BV	1.0	1.0	1.1	1.0	1.1
EV/EBITDA	3.7	4.3	4.4	4.8	5.0
DYield	15.03%	5.03%	5.01%	2.51%	5.01%

Current Price	PLN 9.98
Target Price	PLN 8.90
MCap	PLN 13.1bn
Free Float	PLN 6.5m
ADTV (3M)	PLN 80.58m

Ownership

Orange S.A. (f. France Telecom S.A.)	50.67%
Others	49.33%

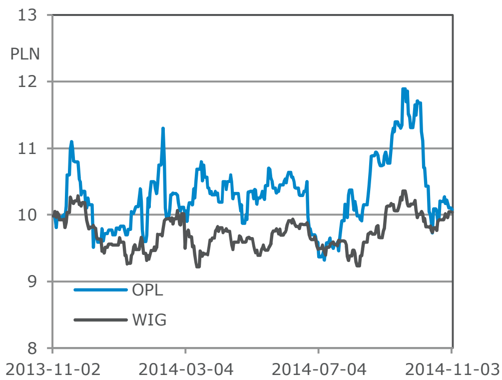
Sector Outlook

The value of the Polish telecommunications market is estimated at PLN 39 billion, including PLN 26bn in mobile telephony with a penetration rate greater than 145%. The mobile market has been hurt by MTR cuts and intense competition (the Polish market is divided between four leading operators). In 2013, the fixed-line penetration rate in Poland was 23.0% after a decline of 0.8ppt from 2012. which also affected lines rented on a wholesale basis (WLR, LLU).

Company Profile

Orange Poland is the leader in telecommunications services. At the end of 2012, it had over 20 million customers, and in 2013 its market shares (measured according to subscriber numbers) amounted to 27% in mobile and 54% in fixed-line telephony. As well as in voice, Orange is also the leader in broadband Internet with a 30% market share and the most extensive infrastructure in the country.

OPL vs. WIG



	9M TP		Rating	
	new	old	new	old
Orange	8.90	8.10	reduce	sell

	Current Price	Target Price	Downside
Orange	9.98	8.90	-10.8%

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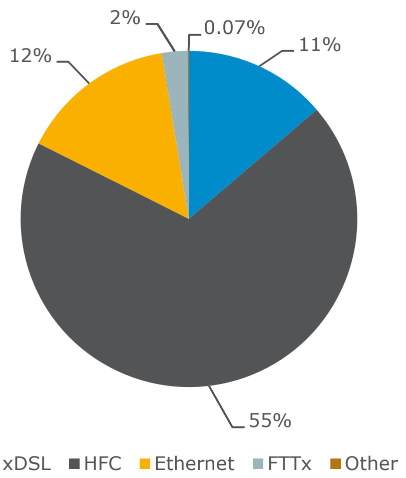
Deregulation of Wholesale Broadband

On October 8th, 2014, Poland's telecom regulator UKE released Orange Polska from the obligation of having to make available its fixed-line broadband infrastructure to competition via wholesale access in 76 areas in Poland (the so-called 'market 5.'). The so-called Bitstream Access rule is the provision of broadband internet service, usually via telephone lines (xDSL), by an alternative operator using the network infrastructure of the incumbent (Orange Poland). For the end users, this means that they actually access the incumbent's network under agreements signed with alternative carriers who lease lines from Orange The 76 deregulated areas represent 24% of the Polish population and approximately 3 million broadband users (37% of all users in Poland). Looking at the competitive landscape in these areas (as painted by the UKE), we can see that the main challengers there to both Orange and its main fixed-line rival Netia are cable operators with HFC networks.

Broadband technology available in market 5.



Source: UKE

The dominant providers in market 5. are UPC in total subscriber numbers and Multimedia Polska when measured in average market share. A free market spanning the 76 districts has two-fold implications for the local players: one, they have to engage in more intense price competition and, two, they are poised to gain new customers by investing in a more wide-reaching access infrastructure.

Short-term implications of deregulation

Under the current regulatory regime, the incumbent telecom is constrained by certain price restrictions on services provided to retail customers stemming from the stiff price correlations between wholesale Internet access and retail access. The near-term benefits of the deregulation from the point of view of Orange include freedom to set prices of fixed-line broadband as low as it wants (under the former arrangement any cut in retail prices had to be followed by a cut in wholesale prices, facilitating counter-offers from rivals). And so Orange's newly-revised post-deregulation broadband plans start at PLN 39.9 a month for 24 months for connections up to 80 Mbps (after a 33% price cut) and PLN 49.9 a month under 12-month contracts. Prices of service bundles have gone down as well, with the 'FunPack' package (broadband+TV+landline) offered at PLN 59.90 a month (down 25%). Note that all Orange customers still have to pay fixed-line maintenance fees of PLN 29.24 per month. At these prices, Orange's new fixed-line broadband is not likely to become a hit in market 5. For example, Netia has recently launched a 'Dropss' service provided on Orange lines offering unlimited data at PLN 49.90 a month (vs. PLN 69.14 paid for a similar plan by Orange customers). Netia has also launched an attractive high-speed B2C service via the revamped and upgraded cable infrastructure of the former Aster allowing for maximum download speeds up to 300 Mbps. The price under a 12-month contract is PLN 49.90 a month. Finally, cable providers as well are introducing their own attractively-priced broadband plans at around PLN 50 a month.

Long-term implications of deregulation

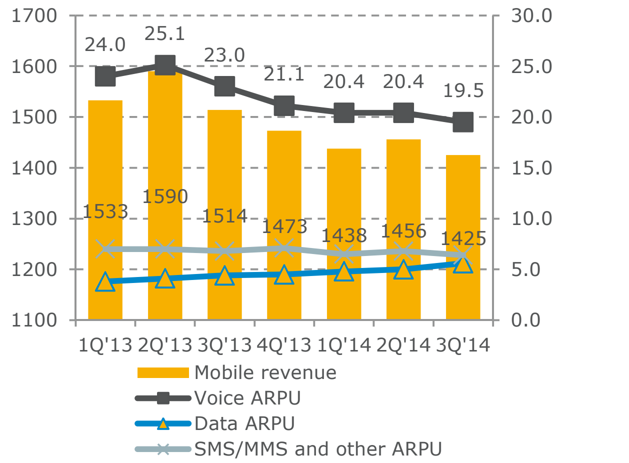
Free from the obligation to make its lines accessible to competition at regulated prices, Orange may feel encouraged to invest in expanding and upgrading its infrastructure in market 5. as a way of gaining edge over local cable operators currently using more advanced technology. The development of FTTH/FTTB infrastructure requires considerable capital investment, and once the network is in place even more expenditures are needed to market and sell the services. In case of Orange, a bundling of broadband with mobile plans can prove the key to success. Note that after the deregulation Orange's main fixed-line rival Netia will still be able to compete with the incumbent on an LLU basis and that the LLU infrastructure does not reach all the homes formerly covered under BSA arrangements (the overlap ratio ranges from 60 to 90 percent depending on the area). Our valuation model for Orange does not account for the potential long-term benefits of the market 5. deregulation.

2014 third-quarter results and future outlook

Q3 2014 results

Orange Polska generated revenue of PLN 3,046m in Q3 2014. By segment, revenue from retail mobile services fell short of our PLN 1,301m forecast at PLN 1,236m due to reduced roaming prices and stiff competition in Poland. Retail mobile ARPU fell by over 11% y/y to PLN 27.3, and post-paid voice ARPU showed a drop of 17% from Q3 2013.

Quarterly mobile revenues (PLN m) and ARPU (PLN)

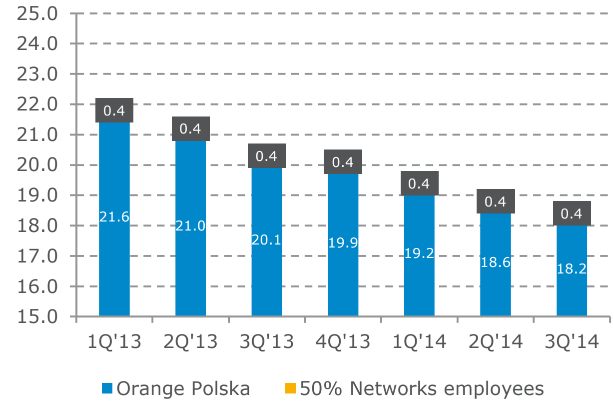


Source: Orange Polska

Quarterly revenue from fixed line was better than expected (PLN 1,349m)) at PLN 1,373m thanks to strong sales of wholesale access. The churn rate in fixed-line voice lines amounted to 4.7% compared to Q3 2013, marking slower line losses than suffered in the previous quarter.

Orange sold PLN 128m-worth of mobile devices in Q3 2014, adding to the quarterly revenue and EBITDA (noncurrent trade receivables were PLN 104m in Q3). Costs totaled PLN 1,977m in Q3 after adjustment for legal claims. Costs of interoperator billing and payroll exceeded our PLN 425m estimate at PLN 446m, but at the same time the employee headcount was reduced by 7.6% compared to Q3 2013.

Orange Polska employee headcount (1000)



Source: Orange Polska

SAC continued to decrease in Q3 thanks to a new accounting method applied to device sales plans and increased demand for SIM-only offers. All told, orange Polska's Q3 2014 EBITDA came in at PLN 1,040m, with EBITDA margin down by 2.6ppts to 34.1%. After higher-than-expected D&A, EBIT for the period amounted to PLN 277m. Net financing costs amounted to PLN 85m.

Summary of quarterly results

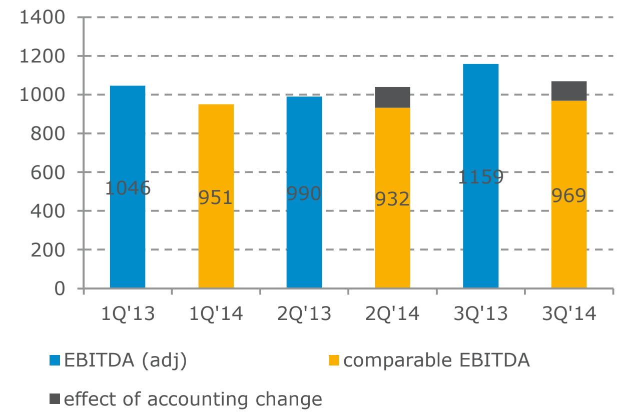
(PLN m)	4Q'13*	1Q'14	2Q'14	3Q'14	y/y
Revenue	3,112.0	2,995.0	3,084.0	3,046.0	-3.6%
Mobile Telephony	1,473.0	1,438.0	1,456.0	1,425.0	
Sales of mobile devices	41.0	43.0	110.0	128.0	
Fixed Voice Services	1,488.0	1,420.0	1,386.0	1,373.0	
Other	110.0	94.0	132.0	120.0	
EBIT	-72.0	391.0	200.0	277.0	-28.8%
Margin	-2.3%	13.1%	6.5%	9.1%	
EBITDA	689.0	1142.0	996.0	1,040.0	-10.3%
Margin	22.1%	38.1%	32.3%	34.1%	
EBITDA (adjusted)	851.0	951.0	1,040.0	1,069.0	-7.8%
Margin	27.3%	31.8%	33.7%	35.1%	
Net financing costs	-118.0	-119.0	-118.0	-85.0	
Tax	79.0	-1.0	12.0	-52.0	
Net profit	-111.0	271.0	94.0	140.0	-41.2%

Source: Orange Polska

Free Cash Flow

Orange Polska's CFO for Q3 2014 amounted to PLN 789m, marking a drop of 19.7% from the same period last year caused among others by a higher payment for UMTS license. Adjusted for PLN 358m expenditures on 900 MHz frequencies, third-quarter CAPEX totaled PLN 1.15bn (the annual budget is PLN 1.8bn). Even so, FCF for the nine months through September 2014 came in at PLN 851m, equivalent to 77% of the annual target which, as it looks right now, will not be exceeded. It is worth noting the discrepancies between Orange's EBITDA results and CFO: the adjusted EBITDA for 9M 2014 was 4.2% lower than in 9M 2013 while at the same time CFO decreased by 10%. One of the reasons for the variation were changes in working capital which in 9M 2014 amounted to –PLN 226m vs. –PLN 23m last year as a result the new accounting policy in respect of sales of mobile devices. Orange has switched from recognizing the revenues over the effective term of each contract to recognizing the whole revenue at the time of sale. As a consequence, its EBITDA received a boost over PLN 150m. At the same time, Orange has to adjust the amount of cash stemming from changes in receivables in its cash flow statements, resulting in lower quarterly CFO. Another reason behind the CF/EBITDA variations are UMTS license payments to the tune of PLN 120m a year.

EBITDA reconciliation to account for accounting changes

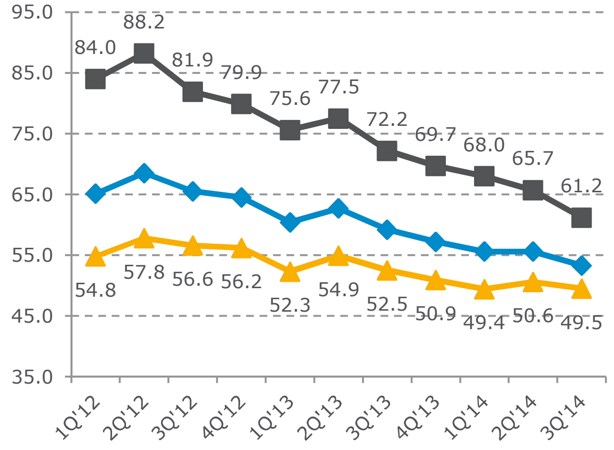


Source: Orange Polska

Outlook for future quarters

Orange confirmed that it was experiencing downward pressure on prices of mobile B2B services stemming from intense competition combined with the fact that the prices are higher than charged from individuals and, with the growing popularity of SIM-only deals and mass switchovers to unlimited calling plans. Using the data provided by the Company, we calculated the post-paid ARPU generated on non-business customers. Since the beginning of 2012, the difference between business and non-business ARPU has nearly halved from 53% in Q1 2012 to 24% in Q3 2014, and we believe it is set to contract further in the quarters ahead. Relative to 2013, the business ARPU fell by 15.2% in Q2 2014 and by the same amount in Q3 2014. The non-business ARPU has been contracting at a slightly lower pace (-7.8% in Q2, -5.7% in Q3), but to say that it is stabilizing would be premature at this point given rival offers cropping up on the market, including Cyfrowy Polsat's "SmartFirma" and Play's "Formula 4G LTE unlimited" (marketed as unlimited broadband, in reality offering six months free followed by monthly limits of 25 GB). Most recently Orange France has removed all limits on LTE data transmissions until the end of March 2015. On the one hand, unlimited Internet is a good way of establishing mobile broadband as a fixture in the everyday life of Polish smartphone users, but on the other hand how successful the different telecoms are in monetizing 4G in a fiercely competitive market remains to be seen.

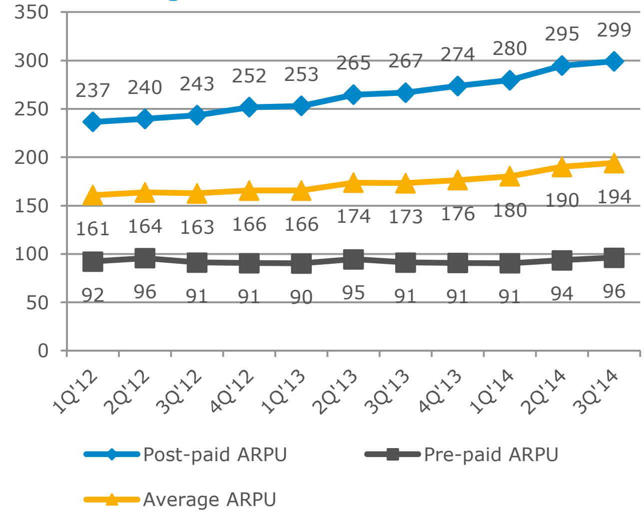
Post-paid ARPU of Orange Polska



Source: Dom Maklerski mBanku

Orange's remedy against falling ARPU is to increase customer dependence by tying telecommunications services with other services, but we do not factor in the unpredictable results of such cross-sales in our valuation model for the Company. As for broadband, competitive pressures here according to Orange are coming mainly from cable operators able to offer increasing speeds, and from cheap DSL following the BSA deregulation: Netia and cable providers did not wait for Orange to introduce new cheaper plans and they preemptively launched their own attractive offers so as not to lose customers. Our 2015 projection for Orange is continued revenue erosion, though at a slower rate of 2.6% compared to 6.0% predicted in 2014. We anticipate 4.0% shrinkage to PLN 5,494m in mobile revenues, with ARPU falling as Orange fights to retain customers. Retail APRU is expected to decrease from PLN 30.3 in 2013 and PLN 27.8 in 2014 to PLN 26 in 2015. with falling post-paid and pre-paid voice ARPU partly offset by data ARPU (we anticipate PLN 7.0 in 2015 vs. PLN 4.2 in 2013) and revenues from text and other services. Fixed-line revenue is set to fall by an estimated 3.1% in 2015, led by continuing churn in POTS, ISDN, WLR, LLU, and BSA. At the same time, fixed-line Internet line additions are expected to mitigate somewhat the downturn in voice services. Our long-term projections for Orange Polska assume continued revenue contraction in mobile as well as fixed-line services, with the 2015 topline depressed by high interconnection costs (expected to increase 10%) driven by strong demand for SIM-only offers and continued user migration to unlimited calling plans.

AUPU at Orange Polska



Source: Orange Polska

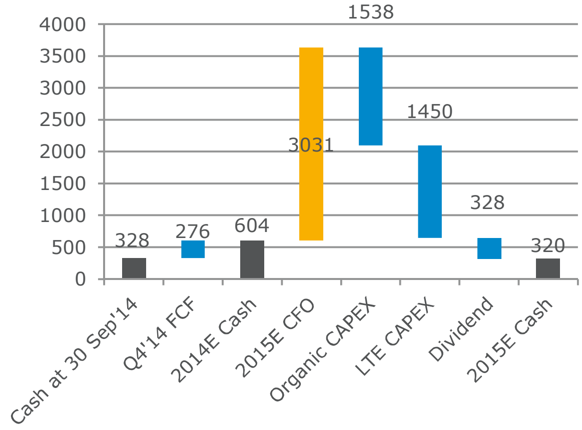
Orange France

When it comes to dividends, the main deciding factor at Orange Polska is the balance-sheet situation of its parent company Orange France. In September, Orange France acquired a 100% stake in the Spanish telecom Jazztel in consideration of a per-share cash payment of EUR 13 (i.e. at 33% premium to the weighted average of the 30 closing prices preceding the transaction). The total price of the 100% stake has been set at EUR 3.4 billion. The deal has to be approved by a majority of at least 50.01% of Jazztel's equity holders. To keep a stable balance sheet, Orange France decided to issue a combination of securities consisting of equity securities worth up to EUR 2bn and long-term subordinated hybrid bonds. The bonds will be granted equity credit by rating agencies in an amount equivalent to the total amount issued to acquire Jazztel. This is evidence of Orange's determination to maintain its net debt/EBITDA ratio as low as possible. As of 30 September, this ratio returned to a level closer to the medium-term target of 2.0x. At the same time, Orange France has recently stated that it would like to bid for the 700 MHz French frequencies poised for allocation in the near future, and given that it uses cash pooling with subsidiaries, including Orange Polska, we do not think dividends are its main priority at this time.

CAPEX

Orange Polska's capital expenditures in the near future will include financing of organic growth, acquisition of 800 MHz and 2600 MHz frequencies, and investment in fiber-optic infrastructure. Our 2015 total CAPEX projection for the Telecom is PLN 3 billion (not including potential FTTH/FTTB expenditures). In addition, Orange has been ordered to pay EUR 127.5m as penalty for abusing its dominant position on the broadband Internet market which we assume will be effected in 2016.

2015 cash flow projection

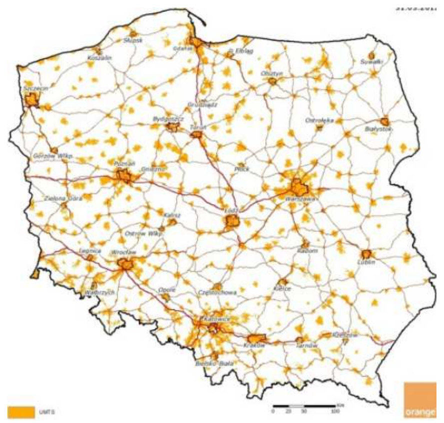


Source: Dom Maklerski mBanku

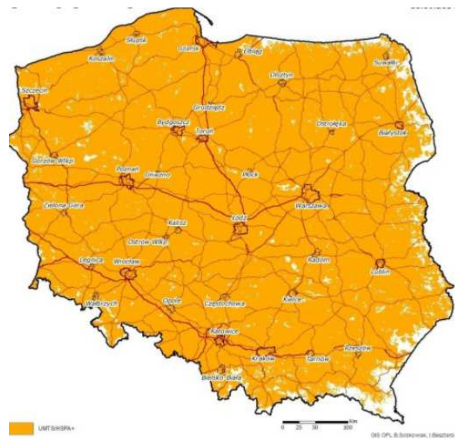
Organic CAPEX

We estimate Orange Polska's organic CAPEX in 2014 at PLN 1.7bn, which would be less than the Company's own projection stated at the beginning of the year. The difference stems from lower investment in mobile infrastructure, related in part to the completion of 3G network upgrades jointly with T-Mobile which gave Orange coverage of 99% of the Polish population and 90% of geographically at the end of September, up from earlier ratios of 63% and 12%, respectively. As a result, Orange has caught up with the former mobile coverage leader Polkomtel.

3G coverage at 31 March 2012



3G coverage at 30 September 2014



Source: Orange Polska

Further, Orange has cut back its fixed-line infrastructure CAPEX pending the deregulation of market 5, as well as lowering expenses on customer devices.

CAPEX summary

CAPEX (PLN m)	1-3Q'13	1-3Q'14
CPE	142	117
MOBILE NETWORK	335	303
CORE NETWORK	219	210
FIXED-LINE NETWORK	284	245
IT SYSTEMS	284	292
total	1,290	1,166

Source: Estimates by Dom Maklerski mBanku

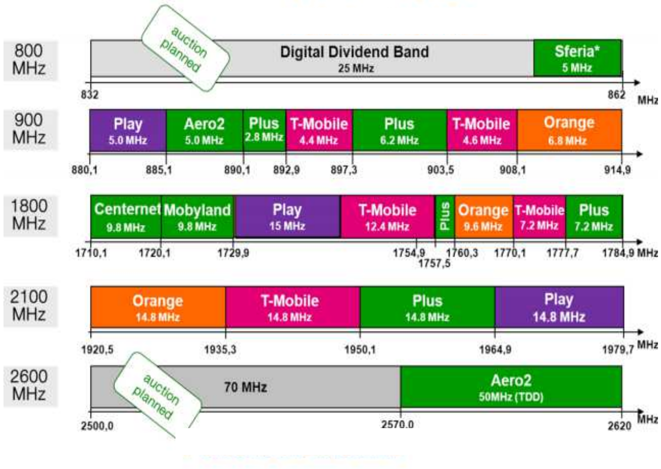
LTE CAPEX

The Polish 800 MHz and 2600 MHz frequency auction is for five 2 x 5 MHz blocks in the 800 MHz band at an asking price of PLN 250m a block, plus 14 2 x 5 MHz blocks in the 2600 MHz band at an asking price of PLN 25m a block. The bids can be submitted until 24 November, after which the UKE has a month to review them.The terms of the auction can be summarized as follows:

- The telecoms can bid for up to two bookings in the 800 MHz band each.
- Related parties and cooperating telecoms can share up to 15 MHz within the 800 MHz bad.
- Each bidder can request the allocation of frequency reservations up to 20 MHz within the 800 MHz band.
- The regulator allows for the possibility of sharing more than 15 MHz bands within the 800 MHz frequency subject to participation by all holders of allotments in the band.
- The sample bidding documentation indicates a possibility of making wholesale offers.

The announcement by the telecoms regulator UKE that it was launching the auction of 800 and 2600 MHz frequency bands came as a big surprise to us in light of an earlier memo issued by the Polish Administration and Digitization Ministry (MAIC) stating that the ministry favored the utilization of the 800 MHz frequencies to build a single Radio Access Network using 30 MHz FDD with 15MHz+15MHz channel aggregation. Such an LTE RAN shared by all commercial operators would be the most technically and economically viable option according to the Ministry. MAiC also recommended that the frequencies be allocated through a tender procedure rather than an auction, leading some to expect relatively low costs to be incurred by the bidders. However, the UKE showed its determination to have the LTE frequencies allocated and providing broadband access to Poles as soon as possible by standing its ground with an auction. An auction implies higher costs for the bidding telecoms in our view than a tender would, especially given that all the players had over six months to accumulate extra cash while the auction was on hold.

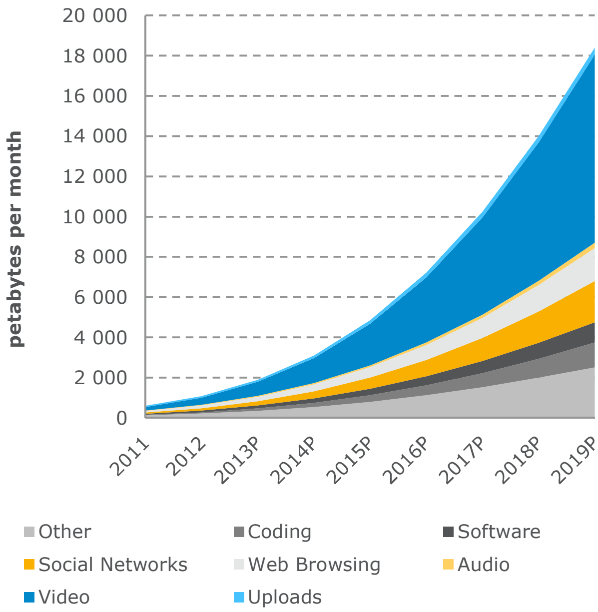
Digital Dividend spectrum auctions



Source: Orange Polska

All major Polish telecom players have declared an intention to participate in the digital dividend auction including Orange Polska which claims that it can spend between 1 and 2 billion zlotys on frequencies. We assume for valuation purposes that the price of one band will approximate PLN 600m. We expect all mobile carriers to take part, though P4 has huge debt after a EUR 900m debt issue followed by another EUR 415m issue designed to raise cash to make a payout to shareholders; we estimate P4's net debt/EBITDA ratio at 5.5x). Orange has a lot riding on securing the 800 MHz frequencies as a way of gaining competitive advantage. In addition, if T-Mobile wins the third 2 x 5 MHz band, this would provide a springboard for the NetWorkS! vehicle formed by the two telecoms to start building shared LTE coverage (we assume in the end two LTE networks will be built in Poland). Further, we anticipate aggressive bidding from Emitel, the leading operator of media broadcasting infrastructure which consists of several hundred broadcasting and communications towers (some over 300 meters high) in key locations across Poland. Last year, Emitel purchased two infrastructure operators, RS TV and another company owned by the Magna Polonia fund, thus increasing its radio mast and tower network. We expect Emitel to bid for the maximum allowed two frequency blocks. If it wins, it could build its own network and offer the 800 MHz frequencies to mobile carriers, especially those willing to share passive infrastructure. It is worth noting that retail operators stand to achieve higher rates of return on investment in LTE frequencies than Emitel, who is a wholesaler. On the other hand, there is a limit of what a retailer can do with a single frequency band, while Emitel stands to enjoy ever-growing demand for its wholesale services as mobile usage increases.

2011-2019 mobile data traffic projection



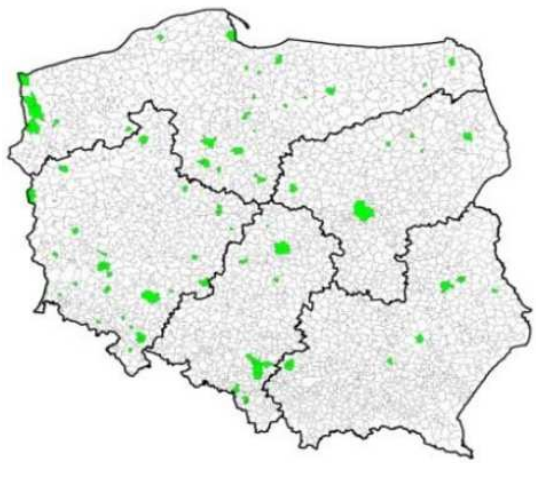
Source: Ericsson

The winning bidders for the 800 MHz band blocks are required within 24-48 months to deliver coverage with these frequencies to 83-89% minimum of the following municipalities selected by the telecom regulator UKE:

FTTH CAPEX

We expect that Orange will want to take advantage of the regulation-free market 5. by reaching out to the 3.9 million households located there. According to UKE statistics, market 5. accounts for 24% of the total Polish population and has about 3 million broadband users (37% of the whole market). Assuming Orange wants to reach half of these prospects, the required FTTH CAPEX will amount to PLN 1.1bn. The Telecom's Management said during the Q3 earnings conference that the investment will be made at a very measured pace, leading us to assume that the 2015 expenditure allocated to that purpose will approximate PLN 270m (we expect to hear more specifics after Q4). Note that this amount is not factored into the valuation model, but if confirmed it will affect future dividend.

Market 5. overview

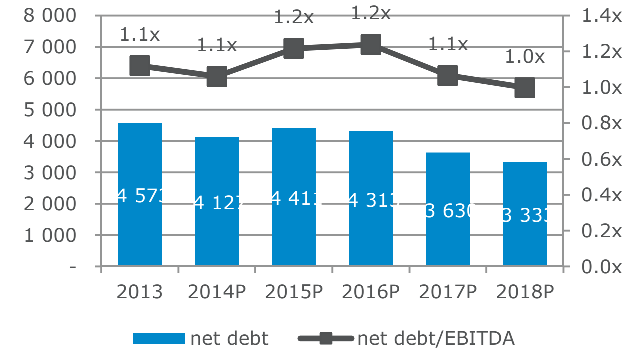


Source: Orange Polska

Dividends

As a reminder, Orange Polska reduced DPS to PLN 0.50 last year to reflect a considerable and growing market volatility, uncertainty as to future capital expenditures, including on 4G frequencies, and a need to retain a good balance-sheet position (the net debt/EBITDA ratio at the time of the announcement was 1.0x). Meanwhile, our 2014 net debt/EBITDA estimate is 1.1x. After projected 2015 CAPEX of PLN 3.1bn (incl. PLN 3.4bn spent on market 5. infrastructure), with DPS at PLN 0.50, Orange is set to see cash outflow of PLN 0.6bn next year (PLN 0.9bn counting in potential FTTH/FTTB spend), with the net debt/EBITDA ratio raised to 1.3x (1.4x). Orange's goal is to retain the debt ratio below 1.5x, but this will require a dividend cut given the cash needs of its parent, the competitive pressures experienced in mobile B2B, the rising costs of interconnection, and the uncertainty as to LTE costs. In a base-case scenario where DPS is cut to PLN 0.25, Orange will be able to avoid incurring additional debt in 2015. The fact that behind the lower payout stands the good cause of network expansion can mitigate the displeasure of investors. After 2015, we believe Orange will be able to raise dividends again despite the projected EBITDA contraction, to PLN 0.50 in 2016 and further up once the net debt/EBITDA ratio goes back below 1.0x (some time in 2017)

2013-2018 net debt projection (PLN m)



Source: Dom Maklerski mBanku

Note that our DPS projections for Orange Polska differ considerably from the consensus projections.

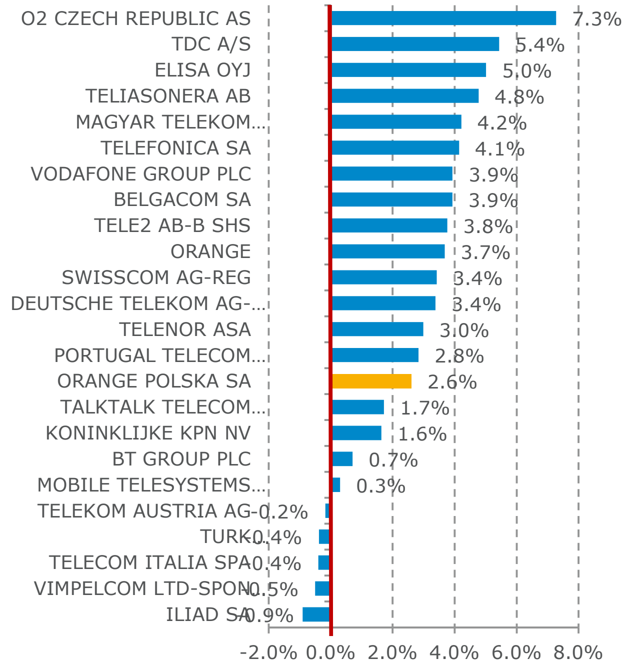
Orange Polska DPS expectations: mDM vs. consensus

(PLN)	2014	2015	2016	2017
consensus	0.52	0.65	0.76	0.77
mDM	0.25	0.50	0.50	0.75

Source: Dom Maklerski mBanku

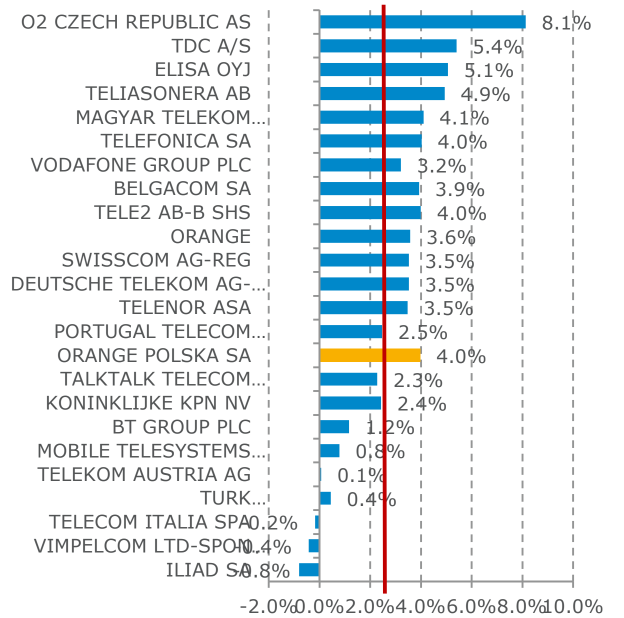
We would also like to point out the difference between Orange Polska and other operators in terms of the spread between dividend yields and risk-free rates. For Orange, the spread as calculated based on consensus estimates is 2.6% for 2014 earnings and 4.0% for 2015 earnings, compared to our respective assumptions of 0.0% and 2.5%.

Spread: 2014E DYield vs. RFR



Source: Bloomberg, Dom Maklerski mBanku

Spread: 2015E DYield vs. RFR



Source: Dom Maklerski mBanku, Bloomberg

Dom Maklerski

Valuation

Using DCF analysis and relative valuation, we set our nine-month price target for Orange Polska at PLN 8.90 per share.

(PLN)	weight	price
Relative Valuation	50%	7.8
DCF Analysis	50%	8.8
	price	8.3
	9M Target Price	8.9

DCF Analysis

DCF Model Assumptions:

- The forecast period is FY2014-FY2023.
- The risk-free rate in the forecast period is 4.25%.
- We assume FCF will grow at a rate of 0.0% after the forecast period.
- Net debt is as at year-end 2013 (PLN 4.6bn).
- CAPEX forecasted in the terminal period exceeds D&A expenses which include one-time expenditures.

DCF Model

(PLN m)	2014E	2015E	2016E	2017E	2018E	2019E	2020E	2021E	2022E	2023E	2023+
Revenue	12,144	11,831	11,666	11,578	11,505	11,452	11,417	11,397	11,389	11,391	
change	-6.0%	-2.6%	-1.4%	-0.8%	-0.6%	-0.5%	-0.3%	-0.2%	-0.1%	0.0%	
EBIT	952	778	807	858	885	902	909	905	907	921	
EBIT margin	7.8%	6.6%	6.9%	7.4%	7.7%	7.9%	8.0%	7.9%	8.0%	8.1%	
Tax on EBIT	181	148	153	163	168	171	173	172	172	175	
NOPLAT	771	630	654	695	717	731	736	733	735	746	
D&A	3,053	2,849	2,678	2,549	2,456	2,394	2,359	2,348	2,343	2,336	
CAPEX	-2,058	-2,988	-1,725	-1,563	-1,553	-1,546	-1,541	-1,539	-1,538	-1,538	
Working capital	-439	-273	-670	-156	-153	-151	-149	-148	-146	-145	
FCF	1,327	218	936	1,526	1,467	1,428	1,405	1,395	1,396	1,402	1,402
WACC	8.2%	8.1%	8.1%	8.3%	8.4%	8.4%	8.5%	8.6%	8.6%	8.7%	8.7%
Discount factor	98.7%	91.3%	84.4%	77.9%	71.9%	66.3%	61.1%	56.3%	51.8%	47.7%	51.8%
PV FCF	1 309	199	790	1 189	1 055	947	859	786	723	669	7 653

	2014E	2015E	2016E	2017E	2018E	2019E	2020E	2021E	2022E	2023E	2023+
WACC	8.2%	8.1%	8.1%	8.3%	8.4%	8.4%	8.5%	8.6%	8.6%	8.7%	8.7%
Cost of debt	5.3%	5.3%	5.3%	5.3%	5.3%	5.3%	5.3%	5.3%	5.3%	5.3%	5.3%
Risk-free rate	4.3%	4.3%	4.3%	4.3%	4.3%	4.3%	4.3%	4.3%	4.3%	4.3%	4.3%
Risk premium	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%
Effective tax rate	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%
Net debt / EV	24.0%	25.2%	24.8%	21.7%	20.3%	19.0%	17.9%	16.7%	15.5%	14.3%	14.3%
Cost of equity	9.4%	9.4%	9.4%	9.4%	9.4%	9.4%	9.4%	9.4%	9.4%	9.4%	9.4%
Risk premium	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%
Beta	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0

FCF after the forecast period	0.0%
Terminal value	16,050
Present value of terminal value	7,653
Present value of FCF in the forecast period	8,526
Enterprise value	16,179
Net debt (year-end 2013)	4,573
Other noncore assets	0
Minority interests	2
Equity value	11,604
Number of shares (millions)	1,312
Equity value per share (PLN)	8.8
9M cost of equity	7.1%
Target price	9.5
EV/EBITDA ('14) at target price	4.2
P/E ('14) at target price	24.7
TV / EV	47%

Sensitivity Analysis

	FCF growth in perpetuity				
	-2.0%	-1.0%	0.0%	1.0%	2,0%
WACC +1.0pp	7,4	7.9	8.4	9.0	9.8
WACC +0.5pp	7,9	8.3	8.9	9.6	10.5
WACC	8,3	8.8	9.5	10.3	11.3
WACC -0.5pp	9,0	8.8	10.1	11.0	12.3
WACC -1.0pp	9,6	9.3	10.8	11.9	13.4

Relative Valuation

We compared Orange Polska with other European telecoms based on forward EV/EBITDA and P/E multiples assigned respective weights of 50% each.

We applied a 15% discount to Orange's valuation to reflect the fact that it generates a major portion of annual EBITDA from fixed-line telephony, incurring higher risk than carriers who provide mostly mobile services. We assigned equal weights to each of the forecast years.

Multiples Comparison

	EV/EBITDA			P/E		
	2014	2015	2016	2014	2015	2016
Belgacom Sa	7.1	7.3	7.3	16.2	18.2	18.7
Bt Group Plc	6.2	6.0	5.9	13.6	12.7	11.9
Deutsche Telekom Ag-Reg	6.0	5.9	5.8	19.1	18.3	16.4
Elisa Oyj	8.9	8.8	8.8	15.5	15.2	14.9
Iliad Sa	8.9	7.7	6.7	32.7	25.1	19.8
Koninklijke Kpn Nv	8.1	8.5	8.6	41.8	34.7	28.9
Mobile Telesystems Ojsc	3.5	3.4	3.3	6.0	5.9	5.6
Orange	5.3	5.4	5.4	13.9	13.2	12.7
Portugal Telecom Sgps Sa-Reg	0.8	0.7	0.9	10.9	8.3	6.4
Rostelecom	4.4	4.3	4.2	10.8	9.9	9.1
Swisscom Ag-Reg	8.6	8.5	8.4	17.5	17.2	16.9
Talktalk Telecom Group	16.0	11.4	9.3	41.2	21.6	14.9
Tdc A/S	6.1	5.9	6.0	11.2	11.3	11.0
Tele2 Ab-B Shs	8.6	8.3	7.8	20.1	19.5	17.3
Telecom Italia Spa	5.7	5.8	5.8	13.5	12.9	12.7
Telefonica Sa	6.4	6.2	6.1	13.9	13.1	12.8
Telekom Austria Ag	5.1	4.9	4.7	35.7	15.1	12.1
Telenor Asa	7.1	6.9	6.6	17.6	14.8	13.4
Teliasonera Ab	8.3	8.1	8.0	13.0	12.2	12.0
Turk Telekomunikasyon As	5.4	5.2	5.1	10.5	9.6	9.0
Turkcell Iletisim Hizmet As	6.1	5.7	5.3	12.7	11.3	10.7
Vimpelcom Ltd-Spon Adr	4.1	4.3	4.3	12.5	8.9	7.7
Vodafone Group Plc	5.4	5.9	5.7	16.1	32.0	31.0
Magyar Telekom Telecommunica	3.9	3.9	3.9	12.8	14.2	11.3
Maximum	16.0	11.4	9.3	41.8	34.7	31.0
Minimum	0.8	0.7	0.9	6.0	5.9	5.6
Median	6.1	5.9	5.8	13.9	14.2	12.7
Orange Polska	4.4	4.8	5.0	26.0	29.8	28.3
premium / discount	-27.0%	-18.5%	-13.8%	87%	110%	123%

Source: Bloomberg, Dom Maklerski mBanku

Income statement

(PLN m)	2012	2013	2014E	2015E	2016E	2017E	2018E
Revenue	14,141	12,923	12,144	11,831	11,666	11,578	11,505
change	-5.2%	-8.6%	-6.0%	-2.6%	-1.4%	-0.8%	-0.6%
Mobile Telephony	6,847	6,110	5,717	5,494	5,433	5,428	5,430
Mobile Devices	141	149	409	503	524	543	561
Fixed Voice Services	560	607	476	481	486	490	495
Other	6,593	6,057	5,527	5,353	5,224	5,117	5,018
EBITDA	4,857	3,904	4,012	3,627	3,485	3,408	3,342
Margin	34.3%	30.2%	33.0%	30.7%	29.9%	29.4%	29.0%
EBITDA (adjusted)	4,857	4,084	3,894	3,627	3,485	3,408	3,342
Margin	34.3%	31.6%	32.1%	30.7%	29.9%	29.4%	29.0%
D&A	3267	3107	3053	2849	2678	2549	2456
EBIT	1,574	788	952	778	807	858	885
Margin	11.1%	6.1%	7.8%	6.6%	6.9%	7.4%	7.7%
Financing activity	-556	-476	-407	-237	-237	-237	-237
Pre-tax profit	1,018	312	545	542	570	622	649
Margin	7.2%	2.4%	4.5%	4.6%	4.9%	5.4%	5.6%
Tax	-163	-16	-41	-103	-108	-118	-123
Net profit	855	296	504	439	462	504	526
Margin	6.0%	2.3%	4.1%	3.7%	4.0%	4.3%	4.6%
Shares at year-end (millions)	1316	1312	1312	1312	1312	1312	1312
EPS	0.65	0.23	0.38	0.33	0.35	0.38	0.40
CEPS	3.13	2.59	2.71	2.51	2.39	2.33	2.27
ROAE	3.3%	1.3%	2.3%	2.0%	2.1%	2.4%	2.6%
ROAA	6.6%	2.3%	4.0%	3.5%	3.7%	4.1%	4.4%

Balance Sheet

(PLN m)	2012	2013	2014E	2015E	2016E	2017E	2018E
ASSETS	24,163	22,802	22,023	21,941	21,098	20,813	20,225
Fixed assets	21,953	20,725	19,479	19,621	18,657	17,665	16,756
Goodwill	4,016	3,940	3,940	3,940	3,940	3,940	3,940
Other intangible assets	2,967	3,081	3,185	3,206	3,063	2,915	2,779
Fixed assets	13,951	12,768	11,526	11,645	10,835	9,997	9,229
Derivative securities	127	4	7	7	7	7	7
Deferred tax assets	878	923	810	813	801	795	790
Other	14	9	11	11	11	11	11
Current assets	2,210.0	1,852.0	2,544.4	2,320.4	2,441.1	3,148.3	3,468.3
Inventory	194.0	200.0	187.9	184.2	183.7	183.5	183.3
Trade receivables	1,413.0	1,199.0	1,544.7	1,610.9	1,634.0	1,658.1	1,681.9
Prepayments	67.0	88.0	94.5	92.7	92.4	92.3	92.2
Other	130.0	167.0	113.0	113.0	113.0	113.0	113.0
Cash	406.0	198.0	604.2	319.6	417.9	1101.4	1397.8
Assets held for sale	0.0	225.0	0.0	0.0	0.0	0.0	0.0

(PLN m)	2012	2013	2014E	2015E	2016E	2017E	2018E
EQUITY AND LIABILITIES	24,163	22,802	22,023	21,941	21,098	20,813	20,225
Equity	12,958	12,631	12,412	12,522	12,329	12,176	11,718
Long-term liabilities	4,703.0	2,800.0	4,880.6	4,832.4	4,822.7	4,815.1	4,808.2
Trade creditors	751.0	921.0	865.3	848.1	845.9	844.9	844.1
Loans and bonds	2,990.0	1,236.0	3,225.0	3,225.0	3,225.0	3,225.0	3,225.0
Employee benefits	375.0	296.0	315.2	308.9	308.1	307.7	307.4
Reserves	263.0	313.0	299.4	287.6	281.1	275.1	269.4
Other	324.0	34.0	175.7	162.9	162.6	162.4	162.3
Current liabilities	6502.0	7333.0	4730.7	4586.3	3946.8	3821.7	3698.6
Trade creditors	2228.0	1921.0	1654.6	1521.7	1417.5	1315.5	1214.1
Loans and bonds	2195.0	3343.0	1370.0	1370.0	1370.0	1370.0	1370.0
Employee benefits	213.0	187.0	146.3	172.2	171.8	171.5	171.4
Reserves	953.0	899.0	1008.5	968.7	438.9	418.8	399.4
Deferred income	516.0	427.0	364.3	366.7	361.7	358.9	356.6
Deferred taxes payable	123.0	95.0	0.0	0.0	0.0	0.0	0.0
Other	274.0	461.0	187.0	187.0	187.0	187.0	187.0
Debt	5,453.0	4,771.0	4,731.0	4,731.0	4,731.0	4,731.0	4,731.0
Net debt	5,047.0	4,573.0	4,126.8	4,411.4	4,313.1	3,629.6	3,333.2
(Net debt / Equity)	0.4	0.4	0.3	0.4	0.3	0.3	0.3
(Net debt / EBITDA)	1.0	1.1	1.1	1.2	1.2	1.1	1.0
BVPS	9.8	9.6	9.5	9.5	9.4	9.3	8.9

Cash Flow

(PLN m)	2012	2013	2014P	2015P	2016P	2017P	2018P
Cash flow from operating activities	1,879	3,292	2,905	3,031	2,479	2,903	2,834
Net profit	855	296	504	439	462	504	526
D&A	3,267	3,107	3,053	2,849	2,678	2,549	2,456
Financing activity	489	376	-48	0	0	0	0
Change in working capital and other	-885	-68	-378	-221	-134	-130	-128
Other	-1,847	-419	-226	-35	-526	-21	-20
Cash flow from investing activities	-2,742	-2,166	-1,781	-2,988	-1,725	-1,563	-1,553
CAPEX	-2,334	-2,180	-2,183	-2,988	-1,725	-1,563	-1,553
Other	-408	14	402	0	0	0	0
Cash flow from financing activities	-1,620	-1,324	-717	-328	-656	-656	-984
Debt	248	-606	-68	0	0	0	0
Share issue	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Dividend/buyback	-2,204	-258	-656	-328	-656	-656	-984
Other	336	-460	7	0	0	0	0
Change in cash	-2,483	-198	406	-285	98	684	296
Cash at period-end	406	198	604	320	418	1,101	1,398
DPS (PLN)	1.50	0.50	0.25	0.50	0.50	0.75	0.75
FCF	-863	1,126	1,123	43	754	1,340	1,280
(CAPEX/Sales)	16.5%	16.9%	18.0%	25.3%	14.8%	13.5%	13.5%

Trading Multiples

	2012	2013	2014E	2015E	2016E	2017E	2018E
P/E	15.4	44.2	26.0	29.8	28.3	26.0	24.9
P/CE	1.0	1.0	1.1	1.0	1.1	1.1	1.1
P/BV	1.0	1.0	1.1	1.0	1.1	1.1	1.1
P/S	0.9	1.0	1.1	1.1	1.1	1.1	1.1
FCF/EV	-4.7%	6.4%	6.5%	0.2%	4.3%	8.0%	7.8%
EV/EBITDA	3.7	4.3	4.4	4.8	5.0	4.9	4.9
EV/EBIT	11.6	22.4	18.1	22.5	21.6	19.5	18.6
EV/S	1.3	1.4	1.4	1.5	1.5	1.4	1.4
DYield	15.0%	5.0%	5.0%	2.5%	5.0%	5.0%	7.5%

Price (PLN)	9.98	9.98	9.98	9.98	9.98	9.98	9.98
Shares at year-end (millions)	1,316.0	1,312.0	1,312.0	1,312.0	1,312.0	1,312.0	1,312.0
MC (PLN m)	13,134	13,094	13,094	13,094	13,094	13,094	13,094
EV (PLN m)	18,181	17,667	17,221	17,505	17,407	16,723	16,427

List of abbreviations and ratios contained in the report:
EV – net debt + market value
EBIT – Earnings Before Interest and Taxes
EBITDA – EBIT + Depreciation and Amortisation
P/CE – price to earnings with amortisation
MC/S – market capitalisation to sales
EBIT/EV – operating profit to economic value
P/E – (Price/Earnings) – price divided by annual net profit per share
ROE – (Return on Equity) – annual net profit divided by average equity
P/BV – (Price/Book Value) – price divided by book value per share
Net debt – credits + debt papers + interest bearing loans – cash and cash equivalents
EBITDA margin – EBITDA/Sales

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A recommendation is valid for a period of 6-9 months, unless a subsequent recommendation is issued within this period. Expected returns from individual recommendations are as follows:
BUY – we expect that the rate of return from an investment will be at least 15%
ACCUMULATE – we expect that the rate of return from an investment will range from 5% to 15%
HOLD – we expect that the rate of return from an investment will range from –5% to +5%
REDUCE – we expect that the rate of return from an investment will range from -5% to -15%
SELL – we expect that an investment will bear a loss greater than 15%
Recommendations are updated at least once every nine months.

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Relative – based on a comparison of valuation multipliers of companies from a given sector; simple in construction, reflects the current state of the market; weak points include substantial variability (fluctuations together with market indices) as well as difficulty in the selection of the group of comparable companies.

Previous ratings issued for Orange Polska

rating	Sell
rating day	2014-04-22
price on rating day	10.32
WIG on rating day	51510.98

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