RESEARCH RELEASE

27 May 2008

Erste Bank Analysts: CEE telecoms sector offers modest growth, but rich returns

- **CEE incumbents remain attractively valued**
- **Telefónica O2 is our top pick**
- **Incumbents dominate all market segments**
- **2008 outlook looks subdued, but balanced with high dividend**

"*The CEE incumbents remain attractively valued compared to their Western European peers. They trade in line with their western European peers in terms of EV/EBITDA and at premiums of around 2-13% in terms of P/E. However, CEE incumbents offer superior earnings growth, 30-50% higher dividend and 50-70% higher free cash flow yields"*, states Vera Sutedja, the CEE telecoms analyst at Erste Bank.

Overview of target prices and recommendations

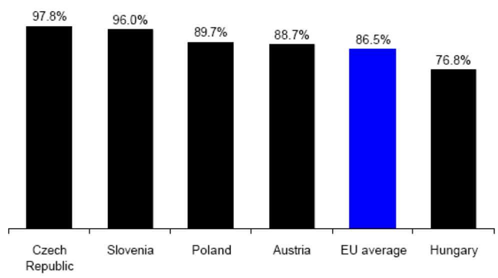
Companies	Currency	Current price	Target price	Potential upside	Recommendation
Telefónica O2 CR	CZK	505.0	700.0	39%	Buy
T-Hrvatski Telekom	HRK	279.0	330.0	18%	Accumulate
Magyar Telekom	HUF	790.0	910.0	15%	Accumulate
Telekom Austria	EUR	16.3	17.5	7%	Hold
TPSA	PLN	21.0	23.0	10%	Hold
Telekom Slovenije	EUR	246.5	270.0	10%	Hold

Source: Erste Bank estimates

The Erste Bank analysts see Telefónica O2 as a top pick. Since the recent share price correction, the shares are now trading in line with CEE averages. Its dividend yield of about 10% is among the highest in the industry. The company's fundamentals are nevertheless better than the CEE average, if not amongst the best. The company offers above-average margins (more than 43%), double-digit earnings growth, strong balance sheet, strong domestic mobile performance, relatively resilient domestic fixed line performance and a new growth source, which is the Slovakian mobile start-up. *"We confirm our Buy recommendation on the stock and target price of CZK 700",* suggests Vera Sutedja.

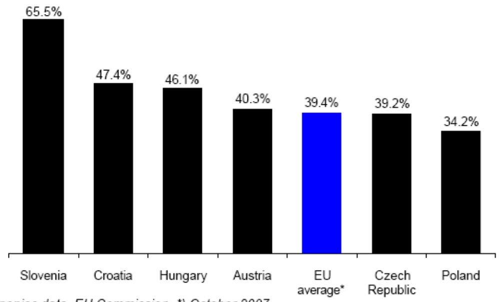
Incumbents continue to dominate both fixed and mobile markets in their respective countries. In fixed access, incumbents in the countries covered by Erste Bank, held more than 75% of the market in July 2007. In the fixed broadband market, incumbents dominate with market shares ranging from 38% (Telefónica O2) to 94.5% (T-Hrvatski Telekom). In the mobile market, the incumbents market share ranges from 33.6% (TP) to 65.5% (Telekom Slovenije). With the exception of Telefónica O2, incumbents have the highest market share in their domestic mobile markets.

Subscribers using incumbent for direct access, July 2007



Source: EU Commission

Incumbents' mobile market share at the end of 2007



*Source: Companies data, EU Commission. *) October 2007*

Overall, incumbents remain the clear market leaders in their respective countries. Nevertheless, they continue to face challenges in growing their revenues. This is evident in their subdued 2008 outlooks. The main reason for such a subdued revenue growth forecast is the rapid decline in fixed lines, driven by fixed-to-mobile substitution. This leads to declining fixed access and voice revenues, which make up 17% to 37% of group revenues. Fixed line subscribers generally generate higher revenues than mobile subscribers. Therefore, even when an incumbent's mobile subscriber growth is sufficient to compensate for fixed access decline, mobile revenue growth may not necessarily be enough to offset the fixed line revenue decline. Additionally, incumbents enjoy stronger market share in the fixed line business than in the mobile business. Therefore, when incumbents lose their fixed line subscribers, these customers may churn to other mobile operators and leave incumbents for good.

Incumbents generally expect to compensate for the continuous decline in their fixed line telephony revenues with mobile, broadband and IT services revenue growth. Mobile revenue growth has dropped back to a single-digit rate, due to more slower subscriber growth, falling prices and lower mobile termination rates. Broadband revenue growth has decelerated, driven by slower subscriber growth and lower prices. IT services continue to grow at 10-20% annual rate, but its margin at about 20% is lower than traditional fixed or mobile EBITDA margins of about 30-40%.

As revenue and earnings growth is hard to come by, it is important therefore for incumbents to offer attractive shareholder remuneration. Telefónica O2, Magyar Telekom and T-Hrvatski Telekom offer dividend yields of 9-10%.

Vera Sutedja summarises:

- *“We **reduce the target price for T-Hrvatski Telekom** from HRK 380 to HRK 330 after considering the share overhang risk. The company could balance this risk by distributing excess net cash and/or making earnings-accretive acquisitions. We maintain our Accumulate recommendation on the stock.”*
- *“We maintain our **Hold recommendation on Telekom Austria**, while increase the target price from EUR 16.5 to EUR 17.5. We raise our EBIT assumptions for Telekom Austria, following the better than expected 1Q08 results.”*
- *“We maintain our **Accumulate recommendation on Magyar Telekom**, while reduce the target price from HUF 980 to HUF 910 after considering the higher risk free rate assumption.”*
- *“We initiate coverage on **Telekom Slovenije with a Hold recommendation** and target price of EUR 270. Our target price does not include any takeover premium, which could materialise if the government restarts its privatisation programme and sells more than its 25% stake in the company.”*
- *“We maintain our **Hold recommendation on TPSA** and keep the target price unchanged at PLN 23.”*

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