

## Interim Results 19 September 2005

# Teleunit TLU.L

**23.75p**

**BUY**

### Market Data

<b>Listing</b>	<b>AIM</b>
<b>Sector</b>	<b>Telecoms</b>
<b>Market Cap</b>	<b>£44.3m</b>
<b>Enterprise Value</b>	<b>£36.9m</b>
<b>12-month high/low</b>	<b>29p/18p</b>
<b>Next results</b>	<b>Mar 2006</b>

Source: DS&C/Proquote

### Company Statistics

<b>Shares in Issue</b>	<b>186.7m</b>
<b>Net cash</b>	<b>£7.4m*</b>
<b>Gearing</b>	<b>Cash</b>
<b>Interest cover</b>	<b>N/a</b>
<b>NAV per share</b>	<b>9.7p</b>

Source: DS&C/Proquote

\*excludes interest bearing debt

### Share price performance



Source: Bigcharts.com

### Analyst

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- The H12005 results announced today highlight consolidation in key markets during the period (e.g. Premium Access), entrance into new markets (5 digit SMS and ADSL-VoIP) and good growth in both revenues and gross profit. Key management was also strengthened during the period with the external appointment of a new COO;
- Revenues increased 61% year on year to €40.1m (H104: €25.0m). Gross profit post amortisation, depreciation and staff costs rose 27% from €6.2m to €7.8m, although the gross margin declined from 24.7% to 19.5%, with the formal launch of high margin ADSL-VoIP occurring in September post market testing;
- EBITDA was broadly flat year on year (€3.12m against €3.25m) and operating profit of €1.975m (margin 4.9%) was below the prior year €2,582m (margin 10.3%), influenced by €858k of overheads in the 5-digit business (the economics of which mean that revenues lag up front expenditure) and acceptance of some lower margin business to grow the top line. However, higher interest income of €562k gave flat pre-tax profit of €2.537m compared to €2.583m in the prior year, resulting in diluted EPS of 0.96 €cents compared to €1.4. On a like for like weighted number of shares (188.9m), H1 2004 diluted EPS reduces to €1.09;
- 2005 has been a transitional period for TLU during which the company has entered new markets to ensure ongoing future growth. In spite of the human and financial resource undertaken to broaden the product portfolio, management must take considerable credit for maintaining profitable growth and (as we expect) full year market expectations. We expect the new COO to add fresh impetus and experience to the business;
- We are leaving our FY05 forecasts unchanged. Whilst the numbers are H2 weighted this was previously anticipated. We expect clean pre-tax of €6.5m and f.d.w EPS of 2.76 €cents, putting the stock on a 2005 P/e of 12.4x. For FY06 we expect f.d.w EPS of 5.19 €cents, putting the stock on a 2006 P/e of 6.6x.

Year End	Turnover (€m)	EBITDA (€m)	DS&C PBT* (€m)	Tax (%)	DS&C EPS* (€c)	DPS (€c)	EV/EBITDA (x)	PER (x)	Yield (%)
12/03A	44.3	5.0	3.8	40	3.4	-	12.2	10.1	-
12/04A	60.8	8.2	5.7	15	2.9	-	7.4	11.8	-
12/05E	90.7	9.9	6.5	20	2.8	-	6.2	12.4	-
12/06E	120.7	17.7	12.2	20	5.2	-	3.5	6.6	-

\* pre goodwill amortisation and exceptional charges.

Source: Daniel Stewart & Co.

## Profit and Loss

Revenues increased 61% year on year to €40.1m (H104: €25.0m) driven by a strong performance in the Premium Access division, which reported revenues up 92% to €32.2m. 5-digit revenues reached €764k in the period, largely from a standing start.

Gross profit post amortisation, depreciation and staff costs rose 27% from €6.2m to €7.8m, although the gross margin declined y-o-y from 24.7% to 19.5%, dragged down by lower y-o-y margins in Premium Access Services as management accepted some lower margin business to grow the top line strongly, and launch of the high margin ADSL-VoIP service post the period end. We previously anticipated lower y-o-y margins in Premium Access and the 18.3% H1 margin is above our full year forecast of 17%. Strong margin growth was seen in Pre Paid Services and Wholesale (formerly International Calling Cards), up from 11.5% to 21.0%.

EBITDA was broadly flat year on year (€3.12m against €3.25m) and operating profit of €1.975m (margin 4.9%) was below the prior year €2,582m (margin 10.3%). This was due to €858k of marketing overheads in the 5-digit business, the economics of which mean that revenues lag up front expenditure on advertising, which is a necessary business driver. However, higher interest income of €562k from €/US\$ hedging gave flat pre-tax profit of €2.537m compared to €2.583m in the prior year, resulting in diluted EPS of 0.96 €cents compared to €1.4. On a like for like weighted number of shares, H1 2004 diluted EPS reduces to €1.09.

Figures 1 and 2 show divisional revenues and gross profit for H1 2005 and 2004.

**Figure 1: Revenue by division**

	H1 2005		H1 2004	
	€'000	% of revenue	€'000	% of revenue
Fixed Line	4,016	10.0	4,223	16.9
Premium Access	32,180	80.2	16,742	67.1
Pre paid services/Wholesale*	2,378	5.9	3,694	14.8
Wireless Local Loop	775	2.0	294	1.2
5 Digit	764	1.9	-	-
<b>Total</b>	<b>40,113</b>	<b>100.0</b>	<b>24,953</b>	<b>100.0</b>

Source: Company \* formerly called International Calling Cards

**Figure 2: Gross profit by division**

	H1 2005		H1 2004	
	€'000	Margin %	€'000	Margin %
Fixed Line#	1,593	39.7	2,030	48.0
Premium Access#	5,894	18.3	4,069	24.3
Pre paid services/Wholesale#*	499	21.0	424	11.5
Wireless Local Loop#	586	75.6	237	80.6
5 Digit#	420**	55.0	-	-
<b>Total</b>	<b>8,992</b>	<b>22.4</b>	<b>6,760</b>	<b>27.1</b>

Source: Company

\*\* 5-digit gross profit of €420k is before marketing overhead of €838k

# Before amortisation, depreciation and staff costs

\* Formerly called International Calling Cards

## Balance sheet and cash flow

Capex was €6.7m in the period, including €2.6m relating to new office premises and €2.9m relating to equipment for the ADSL-VoIP business, WLL equipment and switching systems. The €14m of trade receivables at the period end includes €9.3m from Telecom Italia. €6.3m of this has been paid since the period end, with €3m remaining. €0.8m of this €3m relates in part to trading in June (e.g. mobile traffic paid by Telecom Italia after 60 days) with the remaining €2.2m being the normal business practice between the

two operators, whereby per minute rates are investigated, reconciled and subsequently paid. The €4.3m of non-trade receivables includes €4m of prepayments for items including sponsorship (€1.3m), Tuscany WLL licence (€0.4m), 5-digit advertising (€0.4m), leasing instalments (€0.4m).

Cash inflow from operations was €3.2m compared to a €3.9m outflow in the prior period and in the accounts net cash and cash equivalents (defined as cash and cash equivalents less bank overdraft) increased from €3.0m at December 2004 to €10.7m at June 2005.

This is somewhat confusing, with the €3.0m figure ignoring €6.6m of monetary funds purchased for resale as at 31 December 2004. The correct underlying picture is that net cash and cash equivalents increased from €9.6m in December 2004 (cash/equivalents of €3.8m plus monetary funds acquired for resale of €6.6m less overdraft of €0.8m) to €10.7m as at end of June 2005 (cash/equivalents including proceeds of €6.6m from sale of the monetary funds of €21.5m less overdraft of €10.9m). This increase is after a €6.7m outflow for purchase of fixed assets, but includes €4.8m of cash inflow from new borrowings, which can be broken down as follows: €2.1m for new offices + €2.9m for new VoIP, WLL, switch equipment + €0.55m for new software less an instalment of €0.78m already paid in the period. Net assets increased from €24m to €26m or from 12.9 €cents per share to 13.9 €cents per share.

## **Divisional Analysis**

### **1. Fixed Line (H105 revenue €4.0m; Gross profit €1.6m)**

Whilst sales of €4m were broadly flat year on year, this is still a credible performance in this mature and competitive division. Recognising this, management developed a new service during the period - VoIP through ADSL (see our note on 30 March 2005) in line with advances in VoIP technology and greater accessibility to Telecom Italia's switches. From the customers' viewpoint bypassing Telecom Italia's last mile connectivity saves costs. Call quality and reliability is very high through guaranteed bandwidth and customers do not need to change their existing telephone number to use the service with calls made through a normal home telephone in the usual manner.

From TLU's side, the main advantages of this service are the minimum two-year contract, which reduces customer volatility historically witnessed in the Fixed Line business and the higher margins possible, both through acquiring lower cost calls through ADSL and through using existing spare capacity in the Fixed Line sales force to sweat the overhead more effectively.


A four-month sales trial led to contracts being signed with over 2,000 customers and formal launch of the service throughout Italy took place earlier in September. Whilst this is later than planned (and, therefore, divisional revenues are likely to fall short of our forecast €12.6m in the current year) we do expect the service to rejuvenate the divisional top line post launch.

TLU is also planning to launch a new software called "GoVoIP", which can be downloaded free from the Internet and used by residential users to call between PCs via the Internet at no cost or from a PC to mobile and land lines at very competitive rates.

### **2. Premium Access Services (H105 revenue €32.2m; Gross profit €5.9m)**

The 92% growth in Premium Access Services' revenue for the year to H1 2005 has been driven by increased traffic from existing customers and significant, new customer gains. Starline, a Rome-based provider of premium rate telephony voice content in which TLU acquired a 30% stake in August 2004 performed as expected.

At the time of the deal Starline agreed to migrate its premium access numbers traffic progressively to TLU until 2007. Approximately 85% of Starline's traffic is currently passing through TLU, with management expecting payback on the initial €1.125m investment by the end of 2005.



We previously commented on TLU's overdependence on a small number of customers (Service Centres) in this division. Management has been actively addressing this by securing agreements with approximately 30 new smaller Service Centres in the period and through the 50% acquisition post the period end of Pro Advertising S.r.l. ("Pro"). Pro is a profitable and cash generative, privately owned provider of Internet content for sale to Webmasters and customer of Teleunit since 2002 (see our note of 8<sup>th</sup> August).

This was an important, defensive acquisition, allowing TLU to maintain an ongoing revenue stream, whilst benefiting from vertical integration economies, new routes to market and an increased product offering. Based on forecasts by Banca Nazionale del Lavoro S.p.A., return on the €4m investment should equate to c.21% in the first full year post integration (PAT of €1.7m for Pro).

### **3. Pre Paid Services and Wholesale (H105 revenues €2.4m; Gross profit €499k)**

The focus of this division switched in 2004 from the sale of pre-paid calling cards to the selling of national and international prepaid traffic to the wholesale market. Management hired a dedicated team from another Italian operator, to focus on developing opportunities such as termination of traffic in Italy for non-Italian carriers who do not have an Italian network and termination of traffic in overseas markets, by becoming a link between two non-Italian carriers who route their traffic through Italy.

Wholesale business is higher margin than pre-paid calling cards, witnessed by the jump in gross margin from 11.5% to 21% year over year to H1 2005, and helped by direct carrier-to-carrier agreements with other telcos. An example of such was a wholesale agreement with Albania Online SP Limited in May, under which both parties agreed to exchange international voice traffic (Voice over Internet Protocol), using a new Teleunit IP gateway direct to Albania.

This agreement allowed Teleunit to offer other Italian operators high quality and competitively priced voice termination to Albania, a destination with high traffic volume resulting from the level of migrant workers in Italy. TLU's traffic to Albania is approximately 1.2m minutes at present, representing 50% of the total traffic currently flowing between Italy and Albania. This is approximately €75k per month in revenue terms with margins approaching 20%. Direct connections with other countries are expected to come on line soon.

Whilst H1 turnover is approximately 32% of our full year forecast, Telecom Italia has been slow in implementing Direct Interconnection in Italy and technical changes to TLU's switches and billing systems have added to the delay, thus preventing a number of the 19 Carriers/Resellers connected to TLU from contributing. Once these delays are overcome, we would expect a step up in business, although we now expect the division to fall well short of our forecast €16.2m revenues, albeit with a gross margin likely to be in excess of the 18% we forecasted.


### **4. Wireless Local Loop (H105 Revenue €775k; Gross profit €586k)**


Whilst management's original intention was to purchase a Wireless Local Loop licence through the Italian Telecommunications Ministry, delays in the auction process left the company with an underutilised sales network for Tuscany.

Accordingly, management signed an agreement in February with Tuscan telecoms operator, Wirlink S.r.l., to buy capacity from their existing WLL license for the provision of WLL services in Tuscany. The deal is for 18 years, costs €425k and covers over half the total available frequency in Tuscany, providing sufficient coverage for TLU's WLL plans.

This allowed seven base stations, which the company had already installed in the region to be activated, with customer numbers doubling to 400 by the end of June.

Following the strong year over year growth, H1 revenues were 26% of our fully year forecast. However, Computer VAR (an IBM business partner) has been recently signed as a reseller and should help H2 revenues to pick up, although the timing of new business will mean that revenues will be below our forecast €2.9m.





Other last mile solutions are currently being mooted in Europe. In particular, WIMAX could represent a credible alternative last mile solution to WLL, operating on a lower 3.5 Ghz (compared to 26.0 Ghz for WLL), but without the line of sight requirement, and with the ability to transmit over a distance of 30km, compared to 5km for WLL. Installation equipment for WIMAX is cheaper than WLL and such a solution could be used instead of WLL in Emilia and Marche or complement existing WLL regions by “piggybacking” on existing WLL base stations to serve the residential market. Management is currently assessing such new technology and will decide the best course of action over the coming months.

#### **5. 5 digit SMS (H105 revenues €764k; Gross profit €420k before marketing overhead)**

Lower expenditure on television advertising in favour of advertising in magazines and SMS channels meant lower revenue than planned, but this should lead to higher FY margins. Monthly growth in subscribers to TLU’s SMS service has averaged 30% since launch, with numbers increasing from 20,000 at the start of the year to the current 180,000, whilst the average subscription period has lengthened to 12 weeks.

New products such as “True Tones” and “Sound Effects” have aided growth, and we expect product development to continue – for example, management launched a new SMS product targeting people keen on football in late August, the attractions of which have already encouraged 8,000 subscribers.


SMS is a fast-growing market in Italy, estimated recently at €1bn, with demand for downloaded mobile content (including advertisements, ring tones and screen savers) and higher spend per customer being driven by an increasing penetration of mobile phones and technological advance. Recent strong results from Monsternob (MOB.L) show the opportunities worldwide.

A new service will shortly allow customers to subscribe for content through a fixed line telephone, saving mobile phone call charges (according to management 95% of mobiles in Italy are “pay as you go”), with the cost charged to a customer’s monthly telephone bill.

#### **Management strengthened**

Management was strengthened during the period with the appointment of Ezio Peri as Chief Operating Officer. Mr Peri brings over twenty years experience at board level in telecoms, IT and electronic engineering, including previous positions at Telecom Italia Mobile (Vice President of Business Marketing), H3G (Business Sales Director), Nodalis (Director in the Commercial Department), Sun Microsystems and Olivetti Research.

The appointment of Mr Peri allowed Francesco Cimica to move from COO to CEO and Gianfranco Cimica to move from CEO to Executive Vice Chairman.



## Conclusion

We are leaving our FY05 forecasts unchanged, although the divisional results are likely to be split differently from what we previously expected. Whilst management has work to do to meet the full year numbers – figure 4 shows H105 results as a percentage of our full year forecasts - the H2 weighting was previously anticipated, given the transitional nature of this year.

**Figure 4: Interim results expressed as a percentage of FY2005 forecasts**

	Revenues			Gross profit*		
	H105 €'000	FY05 €'000	%	H105 €'000	FY05 €'000	%
Fixed Line	4,016	12,555	32	1,593	7,403	22
Premium Access	32,180	53,136	61	5,894	9,033	65
Pre paid services/Wholesale	2,378	16,218	15	499	2,919	17
Wireless Local Loop	775	2,938	26	586	2,406	24
5 Digit	764	5,818	13	(438)**	197**	N/a
<b>Total</b>	<b>40,113</b>	<b>90,667</b>	<b>44</b>	<b>8,134</b>	<b>21,958</b>	<b>37</b>

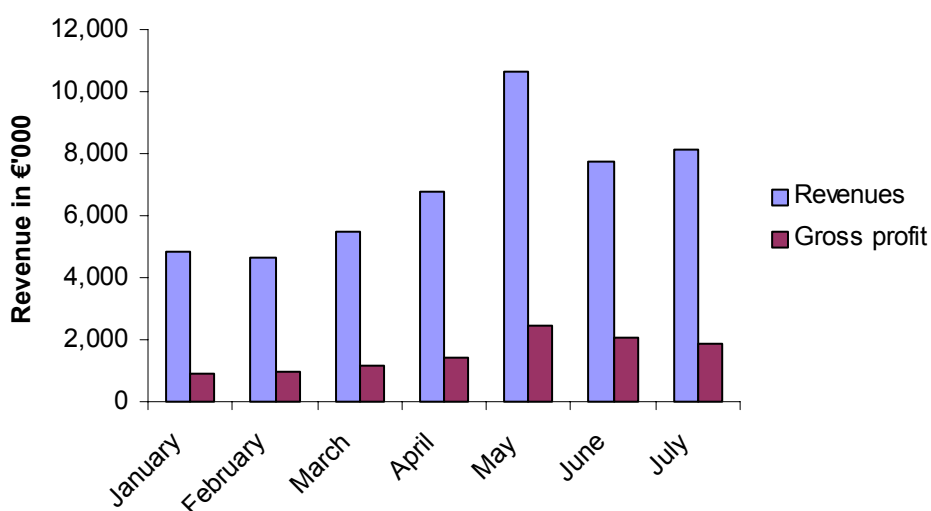
Source: Analyst

\* Gross profit before amortisation, depreciation and staff costs

\*\* 5-digit gross profit stated after marketing overhead

Figure 5 shows the monthly run rate up to and including July and figure 6 extrapolates July's actual figures for H2 2005. This is somewhat conservative, given that July is a traditionally quiet month, but gives investors some comfort even in the highly unlikely event of no growth in the H2 run rate beyond July.

**Figure 5: Monthly revenue and gross profit performance 2005**



Source: Company

**Figure 6: July run rate compared to FY2005 forecasts**

	<b>H1 2005</b>	<b>July 2005</b>	<b>July 2005 x 6</b>	<b>DS&amp;C FY 2005</b>
	<b>€'000 Actual</b>	<b>Actual €'000</b>	<b>months €'000</b>	<b>€'000</b>
<b>Revenue</b>				
Fixed Line	4,016	690	4,140	12,555
Premium Access	32,180	6,700	40,200	53,136
Pre paid services/Wholesale	2,378	320	1,920	16,218
Wireless Local Loop	775	170	1,020	2,939
5 Digit	764	270	1,620	5,818
<b>Total</b>	<b>40,113</b>	<b>8,150</b>	<b>48,900</b>	<b>90,666</b>
<b>Gross profit</b>				
Fixed Line	1,593	275	1,650	7,403
Premium Access	5,894	1,233	7,398	9,033
Pre paid services/Wholesale	499	66	396	2,919
Wireless Local Loop	586	128	768	2,406
5 Digit	(438)**	115**	690**	197**
<b>Total</b>	<b>8,134*</b>	<b>1,817</b>	<b>10,902</b>	<b>21,958*</b>
Gross Margin	20.3%	22.3%	22.3%	24.2%

\*Before amortisation, depreciation and staff expenses

\*\* 5-digit is shown after marketing overhead

2005 has been a transitional period for TLU during which the company has entered new markets to ensure ongoing future growth. In spite of the time and monetary investment undertaken to broaden the product portfolio, management must take considerable credit for maintaining profitable growth and (as we expect) full year market expectations. We expect the new COO to add fresh impetus and experience to the business.

We expect clean pre-tax of €6.5m and f.d.w EPS of 2.76 €cents. This puts the stock on a 2005 P/e of 12.4x. For FY06 we expect f.d.w EPS of 5.19 €cents, putting the stock on a 2006 P/e of 6.6x.

One caveat to these figures is (as previously noted) whilst we assume a tax rate of 20% in our 2005 and 2006 forecasts (which is based on law 269/2003 relating to the flotation of Italian companies on specific Exchanges prior to 31 December 2004), the EU Commission has subsequently given a negative ruling on this tax benefit. Should the Italian government follow the Commission's opinion, management has calculated that, in the worse case scenario, the cumulative additional tax charge as at the end of June 2005 would be €1.107m

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