



Teleunit

Interim results 2004

6 September 2004

TLU.L

14.5p

BUY (retained)

Key Data

Market Cap €m/£m	40.2/27.1
Enterprise Value €m/£m	34.3/23.1
Shares in Issue m	186.7
Est Free Float %	27.2
Gearing %	N/a
Net (Debt)/ Cash €m/£m	5.89/3.97
Next Results FY	Mar 05

Teleunit's (TLU) interim results to 30 June 2004 show a marked quarterly increase in revenues and profits, despite the impact of the price-capping of Premium Access services (known as Value Added Services in our previous note) introduced in September 2003 (previously disclosed in Admission documentation). Management has maintained good control over costs and identified and invested in new business opportunities to maintain profitable growth. Whilst the individual divisions are growing at different rates to those originally envisaged, this is to be expected in a rapidly changing business. We maintain our FY04 revenue and Ebitda forecasts, but upgrade our clean pre-tax figures from €5.83m to €6.33m to account for the greater level of balance sheet cash. Given the history of profitability and cash generation and prospects for revenue growth from existing and new business lines, we struggle to justify the 68% price discount to the UK Communications Services Sector. We maintain our BUY recommendation.

Description

Italian telecoms operator

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Year To:	Turnover	DS&C PBT*	DS&C EPS**	EV/EBITDA	PER	DPS	Yield
December	€'000	€'000	€	X	X	p	%
2003 A	44,271	3,979	N/a	8.01	N/a	0.0	0.0
2004 E	63,977	6,327	3.85	4.08	5.59	0.0	0.0
2005 E	94,120	8,492	3.10	2.73	6.94	0.0	0.0
2006 E	132,281	15,492	5.72	1.61	3.76	0.0	0.0

* Pre amortisation and exceptionals

** Weighted and fully diluted

Profit & Loss

Whilst revenues of €24.95m compare favourably with H2 2003, they are lower than the corresponding prior period of €26.44m. This earlier trading period reflected unlimited pricing in the Premium Access business. The introduction of price capping by the Italian Communications Ministry in September 2003 (previously disclosed in Admission documentation) led to a drastic reduction in revenues and profits for those present in this market, with TLU registering a 32.5% and 43% decline in overall revenues and Premium Access revenues respectively between H1 and H2 2003.

Thus we prefer to compare H1 2004 revenues with those in H2 2003 (€17.83m), which show management's adaptability in growing the business by 40% despite difficult trading conditions. This growth has come largely from the Premium Access (revenues up 30% on H2 2003 – see figure 1) and Pre-paid calling cards (revenues up 283% on H2 2003) businesses.

Management has also demonstrated good cost control during the period. H1 2004 gross profit came in at €6.17m (margin 24.7%), compared to €3.89m (margin 21.8%) in H2 2003 and €4.98m (margin 18.8%) in H1 2003. This represents an increase of 59% over H2 2003 and 24% over H1 2003, largely driven by improved supplier terms negotiated with Telecom Italia in the Premium Access business.

Operating profit came in €2.58m (margin 10.3%), compared to €1.11m (margin 6.2%) in H2 2003 and €2.90m (margin 10.9%) in H1 2003. Both the doubling in personnel costs and the 73% increase in marketing costs, necessary expenditure in advance of an expected rapid growth phase, impacted the year-on-year margin.

However, given that both these expense categories have increased significantly, the fact that the decline in year-on-year margin is small is encouraging and reflects both improved supplier terms in the Premium Access business mentioned above offset by the development of the lower margin pre-paid calling card business.

H1 2004 pre-tax profit came in at €2.58m, up 159% over H2 2003. The 10.3% pre-tax margin is only slightly below the prior period 10.5% and almost double the 5.6% margin achieved in H2 2003. EPS was 1.41 cents, compared to 1.17 cents in H1 2003 and 0.38 cents in H2 2003 on a like-for-like weighted average share basis.

Daniel Stewart & Co acts as broker and nominated advisor to Teleunit SpA.

Balance sheet

Fixed assets increased year on year from €3.5m to €7.2m and flotation proceeds have considerably strengthened the balance sheet. Net cash was €5.89m at the interim stage, compared to a prior period net debt of €971k, and gearing (interest bearing debt over shareholders funds) was 18%, compared to 76% in the prior year.

In terms of working capital management, debtor days have increased year-on-year from 77 to 90, although this is largely due to a €6.8m receivable from Telecom Italia, 80% of which has been subsequently collected since the balance sheet date, and reflects the normal process of post period billing clarification between the two parties.

Creditor days have increased year-on-year from 74 to 85. Whilst this slightly increases the cash to cash cycle (TLU does not hold stock), we believe this is easily supported by the strong cash balances and the cash generative business lines.

Divisional analysis

Looking at the results across the divisions, we see the following breakdown:

Figure 1: Divisional analysis – revenues in €'000s

	H1 2004	H2 2003	H1 2003
Fixed Line	4,223	3,856	3,956
Premium Access	16,742	12,896	22,480
Pre-paid calling cards	3,694	964	0
Wireless Local Loop	294	115	4
Total	24,953	17,831	26,440

Source: Teleunit

Figure 1 shows that year-on-year revenue growth has been achieved across all divisions, except Premium Access. We have discussed above the impact of price capping on the Premium Access business, but highlight that this division has witnessed 30% growth in revenues in the six months to June 2004 i.e. under a like-for-like price cap scenario. The growth in the WLL operations is solely from the existing region of Umbria, where continual customer take-up has been encouraging.

Figure 2: Divisional analysis – gross profit in €'000s and gross margins

	H1 2004		H2 2003		H1 2003	
	€'000	%	€'000	%	€'000	%
Fixed Line*	2,030	48.1	1,839	47.7	1,876	47.4
Premium Access*	4,069	24.3	2,427	18.8	3,434	15.3
Pre-paid calling cards*	424	11.5	109	11.3	0	-
Wireless Local Loop*	237	80.6	90	78.3	3	75.0
Total*	6,760	27.1	4,465	25.0	5,313	20.1

Source: Teleunit

*before amortisation and depreciation

Figure 2 shows the good management of costs across the business lines, with all divisions recording higher gross margins than both halves of 2003.

Divisional commentary

Fixed Line

Whilst lower than expected revenues from the co-operative marketing agreement with Italian insurance company Zuritel have given interim revenues slightly below budget, the 9.5% revenue growth over H2 2003 and 6.7% growth over H1 2003 is still encouraging in this, the most mature of the business divisions. New customers have increased steadily from 8,700 at the end of 2003 to over 10,000 by the end of June. Nevertheless, we expect the full-year results to be below our original €10.1m, due to lower than expected average monthly spend per client (Investors should note that the recent average customer spend per month has remained in line with that in 2003). We forecast FY 2004 fixed line revenues of approximately €8.5m.

Premium Access (previously called Value Added Services)

Whilst Premium Access revenues have declined year-on-year, this is comparing apples with oranges. The price capping introduced by the Italian Communications Ministry in September 2003 had a drastic

impact on divisional revenues and profits, thus making a like-for-like comparison inappropriate. Of more relevance is the comparison of H1 2004 to H2 2003, with TLU reporting 30% revenue growth.

In addition to the existing business, TLU launched new international access numbers in March and new access numbers for voice content in May. Growth from these two areas has been impressive, with June revenue for voice numbers showing one-month growth alone of 32%.

Improved supplier terms helped raise the divisional gross margin from 18.8% in H2 2003 to 24.3% in H1 2004 and a new sales manager commenced employment on 1 September 2004. Management expects to employ an additional five to six sales agents within the next four months, which should generate additional top line growth.

Furthermore, the 30% acquisition post period of Starline SpA, one of Italy's largest providers of voice content across premium access phone lines, is expected to provide annual incremental revenues and pre-tax profits of €7.5m and €1.5m respectively (see post period events.) As a result of the above, we now expect FY Premium Access revenues of €43.5m, above our original forecast of €41.2m. We expect Starline to contribute €2.3m to revenues this year, with €0.5m of pre-tax profit.

Pre-paid calling cards

Whilst growth in the number of phone centres purchasing TLU's pre-paid numbers has been impressive (up from 17 at the end of 2003 to 71 at the end of June), these phone centres are buying fewer minutes than expected. The launch of the branded Teleunit Sunny Card in February had a positive impact on divisional revenues in the period.

In addition, negotiations with a major distributor of the new TLU point of sale (POS) platform were finalised in May, with rollout commencing in July, several months ahead of schedule. These POS systems are already in 500 tobacconists, with management expecting this number to reach 2,000 by the end of FY 2004. Investors should note that revenues and profits from the POS system were not included in our original forecasts. Management is also currently considering the sale of calling cards to the tourist industry, which, if successful, could generate further strong growth on the top line. We now expect FY revenues of €8.3m from pre-paid calling cards.

Wireless Local Loop

Bureaucratic delay in the tender process for the licenses has been wholly outside of company's control. However, management now expects to finalise the Tuscany license in late October and has been astute in putting the required infrastructure in place in the interim period, meaning that operations can commence immediately upon receipt of the license. An agreement with IBM post the balance sheet date has also been finalised to lease, as opposed to buy outright, WLL equipment for Tuscany, which should further shore up the balance sheet.

Management has also confirmed that licenses for the other target regions will remain available for a 12-month period at the price, terms and conditions originally expected. This offers a working capital benefit by allowing the licenses to be acquired when required, rather than upfront.

In the business' existing WLL operations in Umbria, customer take-up is reported to be steady, increasing from 56 customers at the end of 2003 to 153 by the end of June 2004. Revenues have grown 156% over H2 2003, boding well for the long-term performance of the network in Tuscany. In the shorter term, we expect FY revenues of €900k, below our original €1.7m forecast, resulting from the aforementioned auction delay and slower than expected take up of voice services.

Other post-period events

Recent trading

Management has reported good trading in both July and August with revenues growing 10% month over month. Good progress has also been made in the "5 digit" market (SMS mobile content), with contracts being finalised with two major mobile carriers and a major UK-based content supplier. A five-digit number has already been assigned to TLU and we expect SMS operations to start at the end of September.

Our original Intention to List note estimated a value for this market of €2.4bn by 2007, but did not include any revenue or profit contribution from this business line. Given the progress made since

flotation, we now expect “5 digit” business to generate €2.3m revenues this financial year, with operating profits approaching €0.5m.

Acquisition of Starline

We discussed the acquisition of a 30% stake in Starline SpA, a Rome-based provider of premium rate telephony voice content, in our morning flash of 9 August 2004. Under the agreement TLU will pay €1.125m for the stake and issue a €0.3m loan to Starline at 1.5% over EURIBOR. Starline has, in turn, agreed to migrate its premium access numbers traffic progressively to TLU until 2007. A key term of the deal is that at least 85% of Starline’s traffic will be passed through TLU within eight months from the date of agreement.

Starline is in the top three Italian Service Centres in the “voice” sector, reporting 2003 revenues of €4.95m and pre-tax profits of €0.1m. Recent growth has been exceptional, with volume of minutes sold up c.80% in Q1 2004 year-on-year. Management estimates that, based on Starline’s current business levels of c.550,000 minutes per month, that the deal (ex interest from the loan and profits from the 30% stake) will add an annual €7.5m revenues to TLU’s Premium Access division at no additional administrative cost. Incremental annual pre-tax profits are expected to be €1.5m, giving an estimated payback on investment under one year. TLU will take a seat on Starline’s board and is expected to benefit from Starline’s expertise in the voice content market, an area TLU has recently entered.

Full year forecasts and valuation

Whilst delays have occurred in the license auction for WLL operations and fixed line customers have been acquired at lower than expected revenue contribution, we, nevertheless, believe that management will meet our FY revenue forecast, given the expected €2.3m revenue forecast from the “5 digit” SMS mobile content operations, contribution from Starline and rollout of the POS platform, none of which were originally included in our analysis.

WLL operations in Tuscany are now expected to commence in late October and strong growth is being seen in the Premium Access business. The company is currently invoicing €5m per month and management expects this to increase to €9m per month by December 2004. Investors should also note that the good H1 2004 results were achieved largely without the benefit of the flotation proceeds. Whilst the divisional growth rates are currently different than originally envisaged, this is to be expected in a rapidly changing business. Key is that management has swiftly adapted to changes in the business environment by identifying and investing in new revenue and profit generating opportunities.

We, therefore, maintain our full year revenue and Ebitda forecasts of €63.98m and €8.41m respectively, but are upgrading our clean pre-tax profit figure from €5.83m to €6.33m solely to account for the reduction in interest payable post receipt of the flotation proceeds. Our fully diluted 2004 EPS forecast also increases from 3.54 cents to 3.85 cents.

On the current share price, TLU is trading on a current year EV/Ebitda of 4.1x and P/e of 5.6x. Our estimated FY05 weighted and diluted P/e and EV/Ebitda is 6.9x and 2.7x respectively, representing a sizeable and unwarranted discount to the UK Communications Services sector, which is currently trading on a 2004 PER of 17.5x, falling to 14.7x in 2005.

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Sector

Telecoms

Italian telecoms operator focused on SMEs

Profit & Loss Forecast

Year To:	2003 A	2004 E	2005 E	2006 E
December	€'000	€'000	€'000	€'000
Turnover	44,271	63,977	94,120	132,281
Gross Profit	9,778	17,050	27,608	44,621
Gross Margin %	22.1	26.7	29.3	33.7
Operating Profit	4,000	6,171	8,237	15,087
Operating Margin %	9.0	9.6	8.8	11.4
Goodwill Amort.	0	-156	-156	-156
Depreciation	-976	-2,086	-4,157	-6,097
EBITDA	4,976	8,413	12,549	21,339
Exceptionals	-203	0	0	0
Net Interest	-224	0	100	250
FRS 3 PBT	3,776	6,171	8,337	15,337
DS&C PBT	3,979	6,327	8,492	15,492
Tax	-1,504	-1,487	-2,548	-4,648
Earnings	2,272	4,685	5,789	10,689
Ave No of Shares (weighted)	0.842	121.6	186.7	186.7
Ave No of Shares (diluted)	0.842	121.6	186.7	186.7
FRS 3 EPS c	N/a	2.51	3.10	5.72
DS&C EPS (weighted) c	N/a	3.85	3.10	5.72
DS&C EPS (diluted) c	N/a	3.85	3.10	5.72
Dividends	0	0	0	0

Cash Flow Forecast

Year To:	2003 A	2004 E	2005 E	2006 E
December	€'000	€'000	€'000	€'000
Operating Profit	4,000	6,171	8,237	15,087
Depn & Amort	976	2,242	4,312	6,252
Working Capital	4,841	-2,000	-2,000	-2,000
Net Interest	-224	0	100	250
Tax Paid	-957	-1,504	-1,487	-2,548
Other	203	0	0	0
Gross Cash Flow	8,839	4,909	9,162	17,042
Net Capex	-3,182	-10,280	-15,010	-8,972
Use of Prv's	0	0	0	0
Free Cash Flow	5,657	-5,371	-5,848	8,070
Div's	0	0	0	0
Acq. & Invest	0	0	0	0
Disposals	0	0	0	0
Financing	1,000	13,520	0	0
Other, FX	0	0	0	0
Change in Cash	6,657	8,149	-5,848	8,070
Op. Net Cash (Debt)	-2,843	3,814	11,963	6,116
Cl. Net Cash (Debt)	3,814	11,963	6,116	14,186
Gearing %	N/a	N/a	N/a	N/a
Interest Cover	17.9	N/a	N/a	N/a

Key Events

Sep 04 – Interim 2004 results

Aug 04 – acquisition of Starline

May 04 – Flotation on AIM

Major Shareholders

	% of Ord. Share Capital
Family – Gianfranco Cimica	33.6
Family – Francesco Cimica	36.9
Framlington Inv Mngt	6.2
Fidelity Inv Int'l	3.6
Julius Baer AM Ltd	2.7
3i Asset Mngt	1.3

Total **84.3**

Business Analysis

	Sales € '000		
	H1 04	H1 03	H2 03
Fixed Line	4,223	3,956	3,856
Premium Access	16,742	22,480	12,896
Pre-paid calling cards	3,694	-	964
Wireless Local Loop	294	4	115
Total	24,953	26,440	17,831