28 May 2010

Special comment

BRE Bank Securities

Media

Poland

Cyfrowy Polsat Accumulate

CPSM.WA; CPS.PW

(Reiterated)

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An In-Line Quarter

Current Price: PLN 15.05; Target price: PLN 16.60

The first quarter of 2010 turned out very well for Cyfrowy Polsat. The Company achieved record-high results at all levels of the income statement, which was greatly facilitated by the expansion of the subscriber base towards the end of 2009, more advantageous F/X rates, renegotiation of agreements with content suppliers and with Nagravision, which provides conditional access modules. In addition, since April Cyfrowy Polsat has been manufacturing HD set-top boxes in-house, which should help it reduce costs. On the other hand, earnings for Q2'10 will be negatively impacted by the depreciation of the zloty. According to our estimates, of the current exchange rates persist through the end of the quarter, CP will incur ca. PLN 9.3m in additional licensing and signal transmission expenses. Still, we believe that the good news related to developments in the broadband offer outweigh the impact of the depreciating zloty. We are reiterating an accumulate rating.

First-Quarter Results

Cyfrowy Polsat's first-quarter earnings were in line with our expectations. A slight discrepancy appeared at the top line (PLN 374.0m vs. PLN 358.5m), which is a consequence of the much higher-than-forecasted ARPU (PLN 36.1 vs. PLN 34.8). The subscriber base expanded less than we expected: by 37.4k rather than 50k. In fact, the number of Family Package subscribers shrank by 1.5k. We believe this is a consequence of natural adjustments affecting all the DTV providers following the rapid growth observed towards the end of last year (elimination of double-counted users who have switched providers). Also, the introduction of changes to service terms and conditions late last year gave subscribers the opportunity to terminate their contracts early without penalties.

In consequence, subscription revenues figured to PLN 352.6m in Q1'10, while we had expected PLN 338.9m. This represents a 12.9% increase vs. last year. Revenues from set-top box sales declined slightly from PLN 12.0m to PLN 10.8m, mostly due to the lower-than-expected average price. Throughout the first quarter, the Company continued to offer new set-top boxes for PLN 1 to subscribers who were still using old equipment (from early 2000s). Revenue from telecommunication services increased to PLN 3.4m from PLN 1m in Q4'09, mostly thanks to the launch of the broadband service.

Earnings for Q1 2010 vs. forecasts, consensus

(PLN m)	Q1 2010	Q1 2009	Change	Q1 2010F	Difference	Consensus	Difference	2010F	2009	Change
Revenue	374.0	336.9	11.0%	358.5	4.3%	364.0	2.7%	1456.4	1266.1	15.0%
EBITDA	122.9	93.6	31.3%	121.2	1.4%	118.0	4.1%	426.2	327.4	30.2%
margin	*32.9%*	*27.8%*	-	*33.8%*	-	*32.4%*	-	*29.3%*	*25.9%*	--
EBIT	106.9	85.4	25.2%	104.2	2.6%	101.5	5.3%	362.0	285.5	26.8%
Pre-tax profit	106.4	89.9	18.4%	105.2	1.2%	-	-	363.2	293.7	23.7%
Net profit	86.1	72.6	18.6%	85.2	1.1%	83.1	3.7%	294.2	237.9	23.7%

Source: Cyfrowy Polsat, estimates by BRE Bank Securities, PAP

As far as expenses are concerned, the increase in subscription fees came at a cost of slightly higher-than-expected content licensing expenses (PLN 92.7m vs. PLN 90.5m), higher distribution and marketing expenses (PLN 67.5m vs. PLN 60.0m) and higher other expenses (PLN 34.3m vs. PLN 30.0m).
Year-on-year, content-licensing costs declined by 5.0% despite the higher subscriber base (the number of subscribers to the Family Package, which generates most content-licensing costs, expanded by 337.5k).
This reduction was brought about primarily through the renegotiation of agreements with content providers, and to a certain extent also by more advantageous F/X rates.
Distribution and marketing expenses increased by 37.2% y/y, driven by the costs of the call center (higher number of subscribers to serve, loyalty program and the mailing of new terms and condition of contracts to subscribers). Marketing expenses increased by PLN 9.0m.
The PLN 8.0m increase in depreciation was caused by the increase in the number of set-top-boxes subject to depreciation.
Signal transmission costs increased by 3.5% y/y. Cost expansion in this category, which was a natural consequence of the higher number of subscribers and the additional transponder, was contained thanks to the stronger zloty and the renegotiation of the contract with Nagravision (with respect to conditional access fees).
A considerable part of other operating expenses were the significant write-offs on receivables (PLN 10.8m, +PLN 6.0m y/y).

All in all, Cyfrowy Polsat generated an EBIT of PLN 106.9m vs. PLN 104.2m forecasted by us. Both earnings from financial operations and the effective tax rate were close to our estimates; as a result, the discrepancy vis-à-vis our forecast was PLN 0.9m (PLN 96.1m vs. PL 85.2m).

To sum up, we have a positive view of these earnings. Our forecasts for this year already factor in slower expansion in the number of subscribers, and it should not be seen as surprising, especially in the first quarter (cf. the adjustment mechanism and contract termination, as discussed above). The significant increase in the ARPU, in turn, is a positive development.

Future Outlook: Broadband Access

At the end of Q1'10, Cyfrowy Polsat had 5,000 broadband users, and 8,000 as of 17 May. We are pleased with the growth in the number of users of this service. Despite the fact that it is only available to ca. 30% of CP's subscribers at the moment, the growth rate is much faster than for the MVNO service (which has 29k subscribers after 2.5 years in business). The Management believes there will be few additional costs stemming from the introduction of new services, as a considerable part of these expenses was already incurred when the MVNO service was introduced. Additional marketing expenses should not exceed 10% of the current level. We reiterate the view that the broadband service will be a big success, but as there is no permanent contract between Cyfrowy Polsat, Sferis and Aero2, it is hard to estimate how the gains will be divided among them.

Future Outlook: Depreciation of the Zloty and Its Impact on Earnings for Q2 2010

In the second quarter, we have seen the Polish currency weaken considerably, especially vs. the USD. Should the current EUR/PLN and USD/PLN exchange rates persist through the end of the quarter, content licensing costs will, all other things being equal, increase by PLN 9.0m q/q, and signal transmission costs by PLN 0.3m. We believe this increase in costs may be largely offset by a seasonal decline in write-offs on trade receivables.

Changes in Contract Terms and Conditions: the Final Stage

The last batch of notices informing subscribers of changes to general terms and conditions of service provision was sent out in March. At this stage, notices were mailed to the most valuable subscribers. The full impact of changes to terms and conditions on the size of the subscriber base should be fully visible at the end of Q2. In Q1'10, churn increased from 8.0% in the preceding quarter to 10.7%, and we believe the situation could be similar in the second quarter as well. In the second half of the year, churn is likely to go down as the changes in terms and conditions of agreements should be completed by then; moreover, these new contract terms should help stabilize subscriber base (by reducing churn) and/or help increase the ARPU (with the subscription fees increasing by PLN 2 per package).

Sales Through Punkt; No Deal with Polkomtel

In the first quarter, Cyfrowy Punkt started to distribute its products through the Punkt network. Unfortunately, it was unable to reach a deal with Polkomtel, which means that at the moment Punkt outlets offer either CP's or Polkomtel's products (or, in some cases, both with the exception of CP's broadband services). We expect that in the end Polkomtel will stop cooperating with Punkt. CP's Management believe that even when this happens, Punkt should remain profitable in the medium term (CP's current distribution network is commercially viable). In 2010, however, a PLN 6-9m loss can be expected.

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List of abbreviations and ratios contained in the report.
EV *– net debt + market value (EV – economic value)*
EBIT *– Earnings Before Interest and Taxes*
EBITDA *– EBIT + Depreciation and Amortisation*
PBA *– Profit on Banking Activity*
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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HOLD – we expect that the rate of return from an investment will range from –5% to +5%
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