Citi Research

Equities

05 Jun 2018 10:50:48 ET | 9 pages

Telecommunications Operators
Western Europe | Germany

1&1 Drillisch AG (DRIG.DE)

Model Update

- We update our numbers following 1Q18 results and the release of full year guidance. Under the new 1&1 Drillisch structure, reporting is less granular and comes with fewer KPIs which blurs trends and forecast drivers.

- 1Q18 results were in line in terms of revenue but margins came down significantly as the company changed its commercial strategy towards heavy handset sales, along with an accounting change following IFRS15 implementation.

- We therefore increase handset revenue forecasts in our model, in line with the company's new strategy and incorporate the IFRS15 impact on revenue, EBITDA and NWC. Our revenue and EBITDA forecasts increase in 2018E, in line with the new guidance, which drives c10% increase in our 2018E EPS vs previously. Our 2019E EPS is broadly unchanged, while 2020E EPS falls by c9% as we lower our service revenue growth assumption implying a higher proportion of low margin handset revenue in the mix, which drives a cut in our EBITDA forecasts vs before. We still have 2020E EBITDA margins increasing yoy due to the positive impact of synergies.

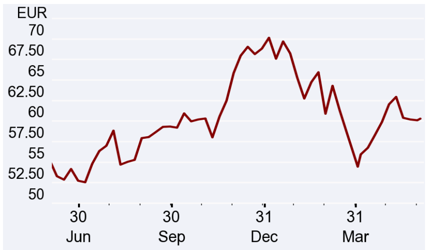
- We reiterate our Sell recommendation as we remain cautious about the growth prospects under the MBA MVNO agreement beyond 2020 when the terms need renewal (potentially at higher costs) and capacity may approach its upper limit.

- We slightly lower our WACC (from 7.4% to 7%) to be in line with German peers as we believe Drillisch's balance sheet could become more efficient over time. However, we leave our target price unchanged due to lower EBITDA and FCF forecasts.

- **Estimate Change**

Sell	**3**
Price (05 Jun 18 09:39)	€60.40
Target price	€49.00
Expected share price return	-18.9%
Expected dividend yield	3.1%
Expected total return	**-15.7%**
Market Cap	€10,677M
	US$12,490M

Price Performance
(RIC: DRIG.DE, BB: DRI GR)



1&1 Drillisch AG (EUR)

Year to 31 Dec	2016A	2017A	2018E	2019E	2020E
Sales (€M)	710.0	2,812.3	3,728.5	3,923.1	4,056.9
Net Income (€M)	26.5	464.7	396.5	450.3	498.9
Diluted EPS (€)	0.44	2.63	2.24	2.55	2.82
Diluted EPS (Old) (€)	0.44	3.13	2.04	2.53	3.09
PE (x)	135.9	23.0	26.9	23.7	21.4
EV/EBITDA (x)	88.9	21.3	13.8	12.1	10.6
DPS (€)	1.80	1.60	1.92	2.21	2.54
Net Div Yield (%)	3.0	2.6	3.2	3.7	4.2

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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

DRIG.DE: Fiscal year end 31-Dec — Price: €60.40; TP: €49.00; Market Cap: €10,677m; Recomm: Sell

Profit & Loss (€m)	2016	2017	2018E	2019E	2020E
Sales revenue	710	2,812	3,728	3,923	4,057
Cost of sales	-431	-1,888	-2,515	-2,636	-2,686
Gross profit	279	925	1,213	1,287	1,371
Gross Margin (%)	39.3	32.9	32.5	32.8	33.8
EBITDA (Adj)	**120**	**504**	**756**	**824**	**922**
EBITDA Margin (Adj) (%)	16.9	17.9	20.3	21.0	22.7
Depreciation	-61	-64	-155	-159	-166
Amortisation	0	0	0	0	0
EBIT (Adj)	**79**	**455**	**586**	**670**	**761**
EBIT Margin (Adj) (%)	11.2	16.2	15.7	17.1	18.8
Net interest	-3	-9	0	0	0
Associates	0	0	0	0	0
Non-Op/Except/Other Adj	-21	-15	-5	-5	-5
Pre-tax profit	**56**	**431**	**581**	**665**	**757**
Tax	-29	-121	-185	-215	-258
Extraord./Min.Int./Pref.div.	0	154	0	0	0
Reported net profit	**26**	**465**	**397**	**450**	**499**
Net Margin (%)	3.7	16.5	10.6	11.5	12.3
Core NPAT	26	465	397	450	499
Per share data	**2016**	**2017**	**2018E**	**2019E**	**2020E**
Reported EPS (€)	0.44	2.63	2.24	2.55	2.82
Core EPS (€)	0.44	2.63	2.24	2.55	2.82
DPS (€)	1.80	1.60	1.92	2.21	2.54
CFPS (€)	1.35	1.35	2.36	3.36	3.70
FCFPS (€)	1.25	1.25	2.19	3.19	2.93
BVPS (€)	5.17	21.53	24.27	24.90	25.51
Wtd avg ord shares (m)	55	177	177	177	177
Wtd avg diluted shares (m)	60	177	177	177	177
Growth rates	**2016**	**2017**	**2018E**	**2019E**	**2020E**
Sales revenue (%)	12.8	296.1	32.6	5.2	3.4
EBIT (Adj) (%)	-6.5	472.8	28.8	14.3	13.6
Core NPAT (%)	-42.2	na	-14.7	13.6	10.8
Core EPS (%)	-43.1	491.4	-14.7	13.6	10.8
Balance Sheet (€m)	**2016**	**2017**	**2018E**	**2019E**	**2020E**
Cash & cash equiv.	93	150	159	383	511
Accounts receivables	110	183	555	570	581
Inventory	10	46	94	94	94
Net fixed & other tangibles	23	239	179	171	174
Goodwill & intangibles	354	3,834	3,694	3,572	3,540
Financial & other assets	6	284	691	691	691
Total assets	**595**	**4,736**	**5,372**	**5,482**	**5,591**
Accounts payable	45	230	282	282	282
Short-term debt	51	222	44	44	44
Long-term debt	95	6	6	6	6
Provisions & other liab	121	473	749	749	749
Total liabilities	**312**	**931**	**1,081**	**1,081**	**1,081**
Shareholders' equity	283	3,805	4,290	4,401	4,510
Minority interests	0	0	0	0	0
Total equity	**283**	**3,805**	**4,290**	**4,401**	**4,510**
Net debt (Adj)	**-35**	**-98**	**-100**	**-324**	**-452**
Net debt to equity (Adj) (%)	-12.4	-2.6	-2.3	-7.4	-10.0

Valuation ratios	2016	2017	2018E	2019E	2020E
PE (x)	na	23.0	26.9	23.7	21.4
PB (x)	11.7	2.8	2.5	2.4	2.4
EV/EBITDA (x)	88.9	21.3	13.8	12.1	10.6
FCF yield (%)	2.1	2.1	3.6	5.3	4.8
Dividend yield (%)	3.0	2.6	3.2	3.7	4.2
Payout ratio (%)	405	61	86	87	90
ROE (%)	8.3	22.7	9.8	10.4	11.2
Cashflow (€m)	**2016**	**2017**	**2018E**	**2019E**	**2020E**
EBITDA	120	504	736	824	922
Working capital	-20	-147	-135	-16	-10
Other	-20	-118	-185	-215	-257
Operating cashflow	**80**	**238**	**417**	**594**	**654**
Capex	-6	-17	-29	-30	-136
Net acq/disposals	-20	-9	1	0	0
Other	1	0	0	0	0
Investing cashflow	**-25**	**-25**	**-28**	**-30**	**-136**
Dividends paid	-96	0	-283	-339	-390
Financing cashflow	**-87**	**-146**	**-359**	**-339**	**-390**
Net change in cash	**-31**	**67**	**29**	**224**	**128**
Free cashflow to s/holders	**75**	**222**	**387**	**564**	**518**

For definitions of the items in this table, please click here.

1&1 Drillisch AG

Company description

Drillisch is a Mobile Virtual Network Operator (MVNO) concentrated on the lower end of the consumer segment. The company has a record of innovation in the rate plans it offers to end-customers since becoming an MVNO (cheap EU roaming, student rates and connected SIMs).

In 2014, Drillisch signed a transformational agreement with O2 Germany to acquire 20% of the capacity of its network post integration of E-Plus. Drillisch has stated that it will focus its subscriber acquisition efforts in the LTE market.

Investment strategy

We rate Drillisch Sell. Drillisch share price has increased to a level that appears to price in all future benefits from the Drillisch / 1&1 merger. Though we see the deal as positive and value accretive we do not see room for further upside from current market value. We also see risks around sustainable growth in the long term given the cap in capacity under the MBA MVNO agreement.

Valuation

We have a target price of €49 for Drillisch. We arrive at this target price using a DCF with a WACC of 7%, beta of 1 and terminal growth of 0.5%. We use a DCF methodology to appropriately capture the upside from significant growth in coming years driven by the recent merger with 1&1.

Risks

The valuation depends on Drillisch's success in crystallising the synergies from the merger with 1&1 and in executing its capacity MVNO contract achieving significant growth on its customer base. The main risk for Drillisch is that the benefits from the merger could be lower than those priced in by the market. Also, if data growth continues to accelerate, Drillisch may risk reaching its 30% capacity ceiling which would stall growth and squeeze margins.

Drillisch may benefit from further synergies and a more benign pricing environment than we anticipate. It may also fill the capacity at a better yield than we forecast, which would increase its cash-flow generating capability. It may also grow at a slower pace than the rest of the traffic on the TEF De network and never reach its capacity ceiling. If either of these outcomes prevails the shares may outperform our Target Price.

Appendix A-1

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1&1 Drillisch AG (DRIG.DE)

Ratings and Target Price History
Fundamental Research

Analyst: Georgios Ierodiaconou
Covered since March 29 2017

	Date	Rating	Target Price	Closing Price
1	17-Jun-16 01:27:27	1	*42.00	34.17
2	04-Oct-16 00:00:00	*2	*44.00	42.40
3	01-Jun-17 01:17:08	*3	*51.00	55.88
4	14-Aug-17 01:40:17	3	*49.00	56.00

*Indicates Change

Rating/target price changes above reflect Eastern Time

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Data current as of 31 Mar 2018	**Buy**	**Hold**	**Sell**	**Buy**	**Hold**	**Sell**
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% of companies in each rating category that are investment banking clients	64%	63%	55%	62%	64%	58%

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