BRYAN, GARNIER & CO

INDEPENDENT RESEARCH

19th January 2016

TMT

Iliad

The wild child comes of age: thank you Orange!

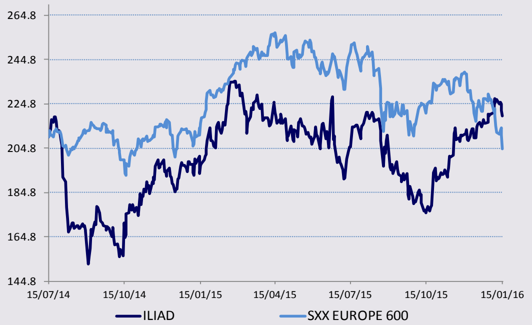
Fair Value EUR270 (price EUR219.40)

BUY
Coverage initiated

Bloomberg	ILD FP
Reuters	ILD.PA
12-month High / Low (EUR)	235.1 / 175.5
Market capitalisation (EURm)	12,856
Enterprise Value (BG estimates EURm)	13,979
Avg. 6m daily volume ('000 shares)	95.10
Free Float	42.0%
3y EPS CAGR	27.2%
Gearing (12/14)	47%
Dividend yields (12/15e)	0.17%

YE December	12/14	12/15e	12/16e	12/17e
Revenue (EURm)	4,168	4,428	4,782	5,149
EBITA EURm)	565.9	685.9	809.9	1,073
Op.Margin (%)	13.7	15.6	17.0	20.9
Diluted EPS (EUR)	4.73	5.85	7.13	9.73
EV/Sales	3.34x	3.16x	2.98x	2.73x
EV/EBITDA	10.9x	9.3x	8.1x	6.8x
EV/EBITA	24.6x	20.4x	17.6x	13.1x
P/E	46.4x	37.5x	30.8x	22.6x
ROCE	9.7	10.5	10.3	12.1

Price and data as at close of 15th January



We are initiating coverage of Iliad with a Buy recommendation and a fair value of €270, assuming the materialisation of the merger between Orange and Bouygues Telecom. In this consolidation, we essentially see value in the effects of a 'market repair' leading to reduced promotional intensity in the market. This merger also enables Free's prospects to be secured on the issue of the roaming contract with Orange and the deployment of its mobile network.

- Free is at a pivotal point in its history. It needs to negotiate the **exit from the roaming contract** with Orange, **accelerate the deployment of its mobile network**, make up for its **lag in optical fibre infrastructure** and **identify a value growth relay** as its volume growth starts to decelerate. Within this context, while we believe that Free is capable of going it alone, it looks to have the most to gain from market consolidation driven by the Orange/Bouygues Telecom merger. After the roaming contract, the acquisition of Bouygues Telecom: thank you Orange!

- We see Free as capable of maintaining strong revenue growth without market consolidation, **averaging some 6% over the next three years,** driven mostly by volumes. We estimate the additional revenue effects of a landline and mobile **market repair at + €259m by 2018**.

- The share price has already reacted to the announcement of discussions between Bouygues Telecom and Orange but has yet to price in all the opportunities linked to market repair. Having moved up from €208 to €219 since the announcement of discussions, **our scenario based on the realisation of the deal derives a fair value of €270.** All other things being equal, **in the absence of consolidation, our fair value is €212.**

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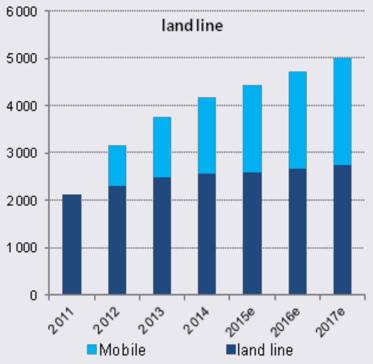

Company description

Iliad SA is a France-based holding company active in the integrated telecommunications sector. The Company provides Internet access and telephony services and hosting services.

Simplified Profit & Loss Account (EURm)	**2012**	**2013**	**2014**	**2015e**	**2016e**	**2017e**
Revenues	3,153	3,748	4,168	4,428	4,782	5,149
Change (%)	*48.6%*	*18.9%*	*11.2%*	*6.2%*	*8.0%*	*7.7%*
Adjusted EBITDA	921	1,204	1,284	1,507	1,761	2,062
EBIT	405	537	566	686	810	1,073
Change (%)	*-17.9%*	*32.5%*	*5.4%*	*21.2%*	*18.1%*	*32.4%*
Financial results	(91.1)	(83.7)	(85.5)	(88.5)	(87.1)	(97.9)
Pre-Tax profits	314	453	480	597	723	975
Tax	(128)	(188)	(202)	(247)	(296)	(392)
Minority interests	(2.8)	(3.8)	(4.4)	(0.56)	(1.2)	(1.2)
Net profit	187	265	278	350	427	583
Restated net profit	187	265	278	350	427	583
Change (%)	*-25.9%*	*42.3%*	*4.9%*	*25.8%*	*21.9%*	*36.5%*
Cash Flow Statement (EURm)						
Operating cash flows	922	1,021	961	1,293	1,520	1,667
Change in working capital	131	(23.2)	(72.1)	(37.6)	(20.3)	(83.2)
Capex, net	(945)	(905)	(968)	(1,236)	(1,692)	(1,319)
Dividends	(21.2)	(21.5)	(21.7)	(23.0)	(23.0)	(23.0)
Net debt	1,064	1,023	1,084	1,123	1,405	1,178
Free Cash flow	(23.7)	116	(7.3)	57.1	(172)	348
Balance Sheet (EURm)						
Tangible fixed assets	2,326	2,501	2,788	3,200	3,445	3,508
Intangibles assets	1,544	1,396	1,450	2,271	2,225	2,178
Cash & equivalents	384	318	137	852	570	797
current assets	388	462	607	742	789	832
Other assets	105	99.1	66.1	56.8	56.8	56.8
Total assets	4,747	4,776	5,048	7,121	7,086	7,372
L & ST Debt	1,448	1,341	1,221	1,974	1,974	1,974
Others liabilities	1,572	1,422	1,516	2,505	2,066	1,793
Shareholders' funds	1,727	2,014	2,310	2,641	3,045	3,605
Total Liabilities	4,747	4,776	5,048	7,121	7,086	7,372
Capital employed	2,842	3,149	3,443	3,856	4,542	4,875
Ratios						
Operating margin	13.06	14.43	13.66	15.58	17.02	20.91
Tax rate	(40.64)	(41.45)	(42.05)	(41.38)	(38.50)	(38.50)
Net margin	5.91	7.08	6.68	7.91	8.92	11.32
ROE (after tax)	11.03	13.42	12.26	13.29	14.07	16.21
ROCE (after tax)	8.39	10.03	9.66	10.46	10.35	12.11
Gearing	61.63	50.80	46.92	42.50	46.12	32.67
Pay out ratio	11.37	8.10	7.79	6.57	5.39	3.95
Number of shares, diluted	58,523	59,443	59,808	59,984	60,027	60,027
Data per Share (EUR)						
EPS	3.24	4.53	4.73	5.85	7.13	9.73
Restated EPS	3.24	4.53	4.73	5.85	7.13	9.73
% change	*-24.3%*	*40.0%*	*4.4%*	*23.7%*	*21.9%*	*36.4%*
BVPS	29.33	33.76	38.58	43.99	50.69	60.01
Operating cash flows	15.75	17.18	16.07	21.56	25.33	27.77
FCF	(0.41)	1.95	(0.12)	0.95	(2.87)	5.79
Net dividend	0.36	0.36	0.36	0.38	0.38	0.38

Source: Company Data; Bryan, Garnier & Co ests.

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1. Investment Case

Why the interest now?

The reason for writing now

Iliad is at a pivotal point in its history in that, after the launch of the 3P box in 2002 and mobile in 2012, it is facing a third major change in business model. While its growth is slowing, the company needs to move to another level to rank alongside the major infrastructure operators, and reinvent itself so as to identify new medium-term growth relays. **In our view, the company is ready to make this transition to adulthood, while market consolidation should open up new opportunities.**

Cheap or Expensive?

Valuation

The market has not exaggerated the opportunities linked to the possible merger beween Orange and Bouygues Telecom. At current levels, the share price is only partially pricing in the effects of the ensuing market repair. **Our FV of €270 factors in the materialisation of the deal, which represents a +€58 premium vs a scenario with no consolidation**, and **+23% vs the current share price**. Excluding the effects of consolidation, we are modelling strong sales in a market whose growth is slowing, stable ARPUs in landline and very modest growth in mobile. We are factoring in a significant improvement in the EBITDA margin given the optical fibre growth, the exit from the Orange roaming contract and opex scale effects. Capex should remain very high through to 2018.

When will I start making money?

Catalysts

The share price performance will be linked to: **1/** the materialisation (or not) of a consolidation in the French market, **2/** the management of the exit from the Orange roaming contract, **3/** Free's ability to play a more significant role in optical fibre, **4/** the company's ability to generate more value from mobile customers, **5/** the M&A prospects internationally.

What's the value added?

Difference from consensus

In our view the market is only partially pricing in the consolidation opportunity in the French market, revenues are underestimated by 5% in 2018, and EBITDA margin forecasts remain conservative at 39.6% vs 43% in our scenario.

Could I lose money?

Risks to our investment case

The main risks to our scenario are the following: **1/** no market consolidation, **2/** a difficult exit from the Orange roaming contract, **3/** increased competitive intensity on mobile ARPU, **4/** loss of product competitiveness (optical fibre, box and contents).

2. Context: the wild child comes of age

Free's life has largely been lived within Orange. With punchy phrases, pricing and technological ingenuity, regulatory support, opinion multipliers and viral marketing, **the wild child has, however, been able to establish itself as a major player** and a key market maker in the French telephony landscape. The real birth of Iliad, its founding act, was the launch of the first Triple Play box in 2002. Then, in 2012, came the Free mobile madness and its audacious growth, shaking up the French telecoms industry. **In our view, Iliad is now ready to take a new decisive step. Out with provocation and guardians of one sort or another and in with self affirmation. Ilia is about to realise its full potential as a fully-fledged, independent, convergent, qualitative and 'smart cost' infrastructure operator. In other words, to come of age. Without renouncing its childlike spirit as a challenger and an innovative start-up.**

Negotiating this impending maturity will not be easy. It requires significant financial and operational capability to achieve the critical transition in optical fibre and deploy a proprietary mobile network. In mobile, this will also mean moving from a 'volume' to a 'value'-oriented rationale and contending, particularly in landline, with a price war in which the injured beasts are selling their hides at high prices. All this while leveraging its assets of a strong brand and powerful viral marketing without giving up on the qualities constituting its strength: an ability to innovate, focus and simplicity.

One event could, however, greatly facilitate Free's task and accelerate this transition: market consolidation via a merger between Bouygues Telecom and Orange, which looks set to open up opportunities for Free. Amongst other things, it addresses two major challenges which Free is facing: the exit from the roaming contract with Orange, and the enduring price war in landline. **After the roaming contract, the acquisition of Bouygues Telecom: thank you Orange!**

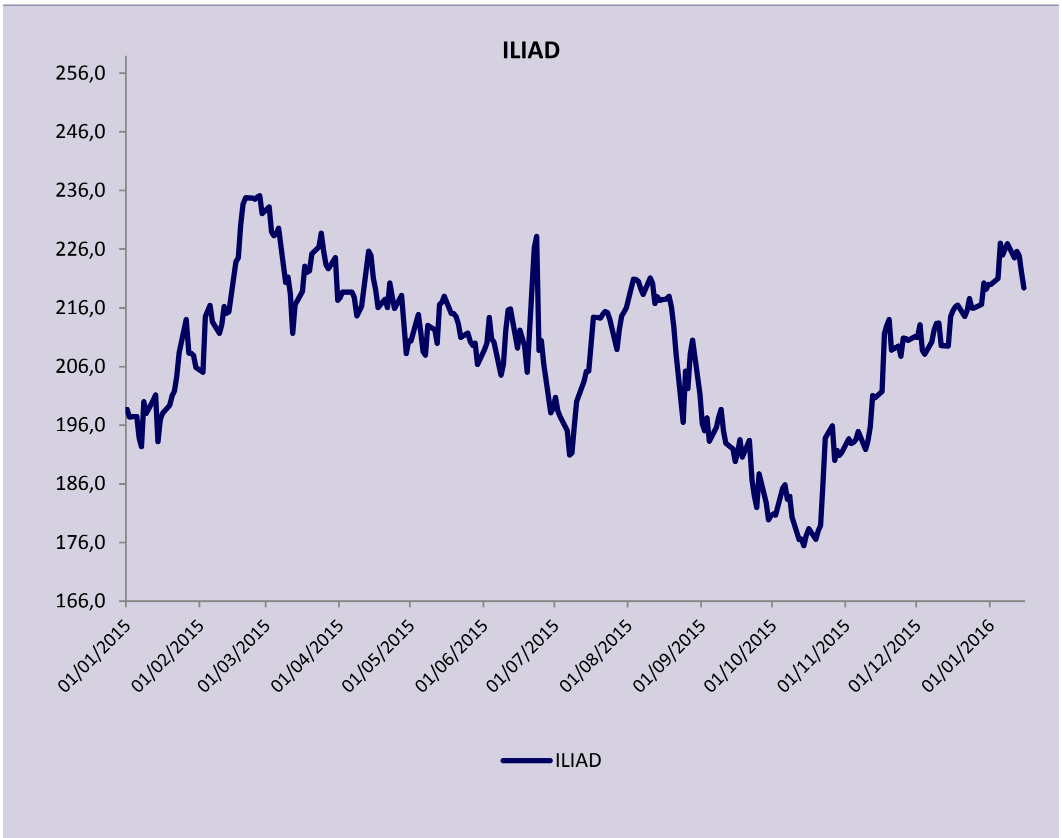
Lastly, in our view, Iliad is likely to gain a second wind by flying the national nest and running a slide rule over potential M&A targets while its competitors, headed by Orange and Altice, are wasting no time in conquering new horizons and cross-border consolidation moves begin to take shape: external growth to take over organic growth.

3. Valuation

3.1. Trend in the Iliad share price

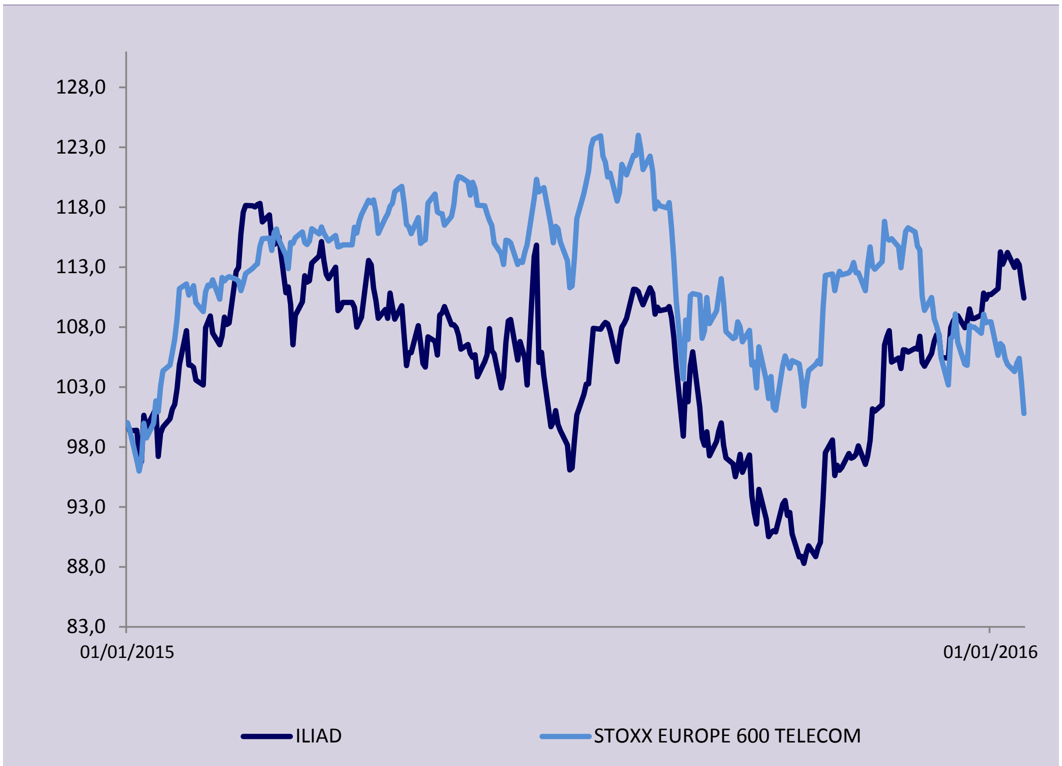
The stock is currently trading **at levels below its early-2015 high.** Iliad posted a positive performance in early 2015: **the uncertainties which might have been those of 2014 failed to materialise**, with SFR's commercial difficulties giving the whole market some room for manœuvre and Bouygues Telecom' mobile tariff repositioning having no real impact on Free's performance. After volatile trading in the early summer linked to the Altice/Bouygues Telecom discussions, and having lost ground at the end of the summer on the back of **uncertainties linked to an upwards revision in capex**, Iliad subsequently witnessed renewed strength thanks to a **good set of Q3 commercial and financial results**. Lastly, **the stock reacted favourably to confirmation of discussions between Orange and Bouygues Telecom** on a potential merger, closing the performance gap with the STOXX Europe 600 Telecoms index. Since the first merger rumours on 8 December, the share price has moved from €208 to €219, **gaining some 5%, when CAC40 has lost 10% over the same period.**

Fig. 1: Iliad share price performance since 2015



Source: Thomson Reuters.

Fig. 2: Iliad share price versus the STOXX Europe 600 Telecom index (base 100)



Source: Thomson Reuters.

3.2. DCF

We first derive a DCF excluding a Bouygues Telecom/Orange merger (stand-alone scenario), then detail the impacts of such a merger.

Our DCF valuation, excluding market repair, is based on the following assumptions:

- **Revenues and ARPU**: Our forecasts show revenue growth remaining strong, largely driven by volumes, with **+6.2% in 2015, +6.8% in 2016, +5.9% in 2017 and +5.0% in 2018**. In 2015, landline growth is limited to 1.0% given the ARPU pressure but picks up to +3% in 2016 as ARPU stabilises. In mobile, while volumes are decelerating, ARPU is slowly starting to take over and revenue is expected to grow again by 15% in 2015 and 12% in 2016, then falling below the 10% threshold as of 2017 with volumes experiencing a more significant deceleration.

- **EBITDA margin:** we expect a steady improvement in the EBITDA margin, **from 34.0% at the end of 2015 to 41.3% in 2018**, largely due to the optimisation of the margin on the cost of landline and mobile purchases used in production. In landline, optical fibre volume growth enables a saving on the payments to Orange, the margin on landline purchases moving from 56% in 2015 to 58% by 2018. In mobile, the gradual exit from the roaming contract with Orange enables an improvement in the margin on mobile purchases used in production from 40% in 2015 to 53% by the end of 2018.

- **Capex (excluding licenses):** these EBITDA targets cannot be reached without significant capex enabling, firstly, the deployment of optical fibre infrastructure and, secondly, the 3G mobile network to be able to migrate a growing number of customers. We model a **high level of capex at around €1.2bn in 2016 and 2017**, or more than 20% of revenues, then reduce this level progressively towards a targeted 16% of revenues.

- **WCR:** we assume that the sale of terminals with financing has now stabilised and estimate that the impact of this offer is no longer significant on WCR as of 2016. Furthermore, we factor the payment for the 4G 700MHz mobile licence into cash flow, booked at €933m in 2015, but disbursed over 2016-18 in four payments of €233m (of which two in 2016).
- We use a normalised tax rate of 38.5% including corporation tax and the value-added contribution for businesses (*cotisation sur la valeur ajoutée des entreprises* - CVAE), and a pre-tax cost of net debt of 4.5%.
- We retain a discount rate of 6.8%, with a Beta of 0.8, in line with Iliad's two-year historic Beta vs CAC40, a risk premium of 6.4% and a risk-free rate of 2%.
- Our growth rate to perpetuity is 1.0%.

Fig. 3: Calculation of the discount rate

Inputs	
Risk Free rate	2.00%
Market risk premium	6.40%
B	0.80
Cost of Equity	**7.12%**
Cost of Debt after taxes	3.5%
Gearing	8.7%
WACC	**6.8%**

Source: Thomson Reuters; Bryan, Garnier & Co ests.

Fig. 4: Discounted cash flow model, stand-alone scenario

EURm	2015e	2016e	2017e	2018e	2019e	2020e	2021e	2022e	2023e	2024e	2025e	2026e
Sale	4 428	4 727	5 005	5 253	5 456	5 615	5 737	5 831	5 902	5 960	6 018	6 077
Change in sales	6,2%	6,8%	5,9%	5,0%	3,9%	2,9%	2,2%	1,6%	1,2%	1,0%	1,0%	1,0%
EBIT	686	764	960	1 159	1 225	1 292	1 362	1 414	1 452	1 480	1 506	1 530
As % of sales	15,5%	16,2%	19,2%	22,1%	22,4%	23,0%	23,7%	24,3%	24,6%	24,8%	25,0%	25,2%
Tax rate	41,2%	38,5%	38,5%	38,5%	38,5%	38,5%	38,5%	38,5%	38,5%	38,5%	38,5%	38,5%
Net Op. Profit after Tax	403	470	590	713	753	794	838	870	893	910	926	941
+ D&A and prov.	887	1021	1064	1092	1113	1114	1095	1084	1077	1073	1072	1074
Cash flow from op.	1 290	1 491	1 655	1 804	1 866	1 908	1 933	1 953	1 970	1 983	1 998	2 014
- Net investments (incl. Frequencies)	-1 236	-1 692	-1 319	-1 284	-1 091	-1 011	-918	-933	-944	-954	-963	-972
- change in WCR	-38	-20	-83	-34	-28	-22	-17	-13	-10	-8	-8	-8
Free cash Flow	16	-222	252	486	747	876	998	1 008	1 015	1 022	1 027	1 034
Discounted FCF		-207	221	400	575	631	674	637	601	567	534	503
Sum of disc. FCF		5 134										
+ disc. terminal value		8 714										
- net debt, 2015		-1 123										
- minority interests		-3										
+ financial fixed assets		9										
Valuation		12 732										
Nbre of shares (fully diluted)		60										
Value per share		212										

Source: Company Data; Bryan, Garnier & Co ests.

Within the framework of our base case scenario with market consolidation, we then need to factor the positive elements induced by market repair into the DCF:

- Landline revenue growth revised up by **€162m in 2018**, given the value effect linked to reduced promotional activity and a transfer of Bouygues Telecom volumes to all the market players, including Free.

- Growth in mobile revenues revised up by **€97m in 2018**, mainly due to a value effect linked to the recruitment of higher-quality customers and less promotional activity (acceleration of proprietary network coverage and disappearance of one player).

- Increase in **CAPEX by 3% from 2018**, because of better economic conditions for investing.

- We reduce the Beta by 0.05, from 0.8 to 0.75, to take into account the securing of Free's business activity via the acquisition of assets coming from the merger (mobile network, exit from the roaming contract).

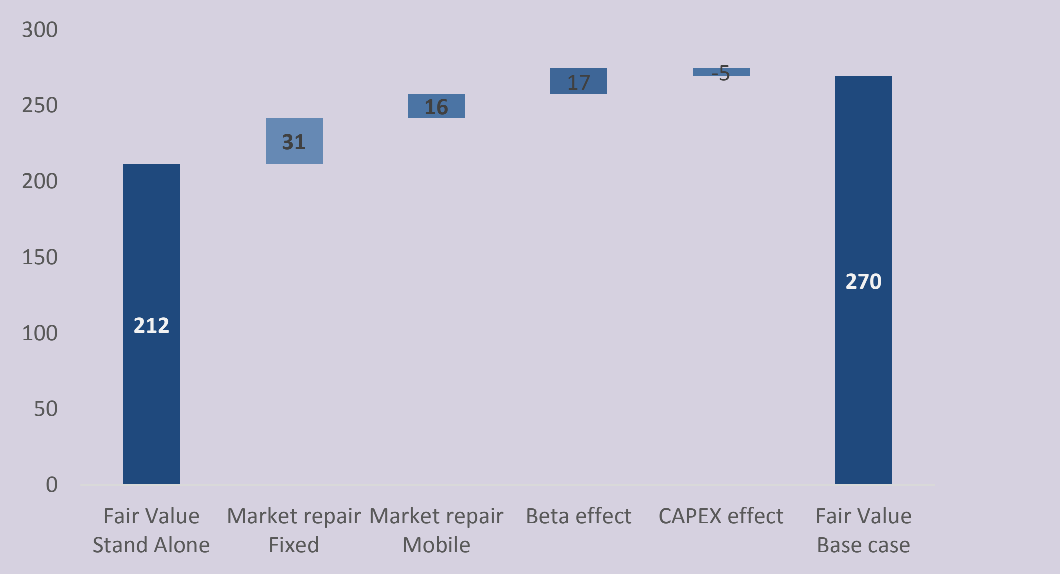
Fig. 5: Revenues and EBIT with market consolidation

EURm	2015e	2016e	2017e	2018e	2019e	2020e	2021e	2022e	2023e	2024e	2025e	2026e
Sale	4 428	4 782	5 149	5 512	5 823	6 069	6 201	6 302	6 380	6 442	6 505	6 569
Change in sales	6,2%	8,0%	7,7%	7,1%	5,6%	4,2%	2,2%	1,6%	1,2%	1,0%	1,0%	1,0%
EBIT	686	810	1 073	1 357	1 458	1 562	1 637	1 692	1 732	1 762	1 790	1 816

Source: Company Data; Bryan, Garnier & Co ests.

In our view, the market is far from pricing in all of the opportunity linked to market consolidation since December. We are initiating coverage of **Iliad** with a **Buy recommendation** and a **Fair Value of €270,** i.e. **upside of 23%** relative to the current share price, **assuming a market consolidation effective in early 2017.** In the event of no consolidation we deem the stock to be **3.5%** overvalued currently, based on an estimated stand-alone Fair Value of **€212.**

Fig. 6: Iliad Fair Value with and without sector consolidation



Source: Bryan, Garnier & Co ests.

3.3. Peer group multiples

Iliad is currently trading on multiples of 8.42x 2016e EBITDA, whereas our Fair Value derives a multiple of **9.81x 2016e EBITDA,** based on above-consensus EBITDA forecasts.

Fig. 7: Iliad multiples (share price at 15/01/2016)

	2015e	2016e	2017e
VE/EBITDA (x) - consensus	9,74	8,42	7,39
VE/EBITDA (x) – Stand-alone case	9,19	8,07	7,10
VE/EBITDA (x) - Base case	11,47	9,81	8,38

Source: Thomson Reuters; Bryan, Garnier & Co ests.

Iliad's multiples are higher than those of its French peers although the company does have much higher EBITDA growth prospects. If, as in the chart below, we look at the 'EV/EBITDA to growth multiple', we can see that Iliad's EBITDA growth is valued more cheaply than that of Orange or Numericable-SFR (the case of Altice is different with a change of scope in 2016 and a very significant level of debt).

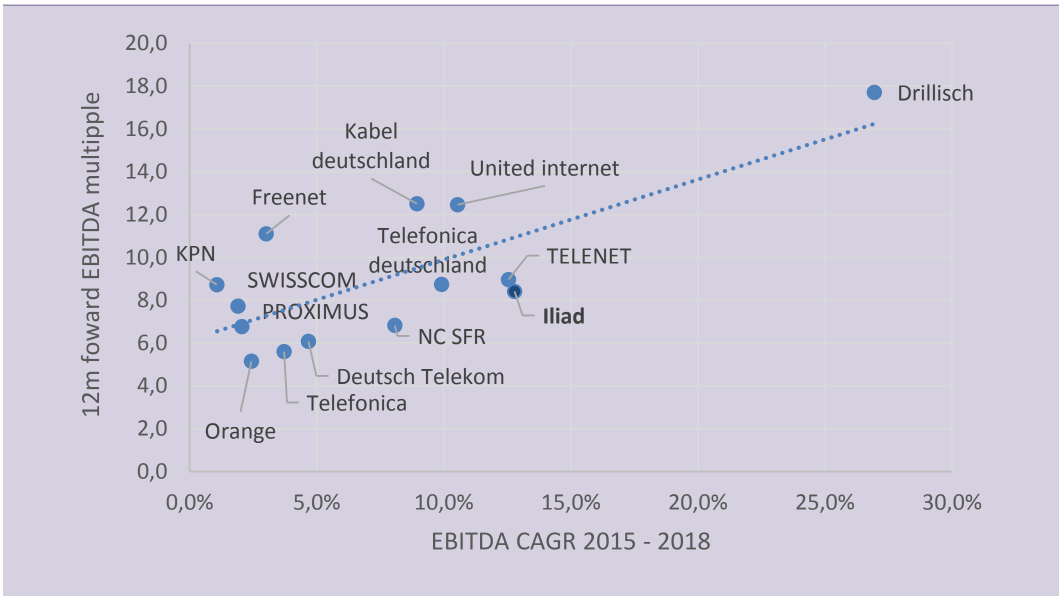
Fig. 8: 'EV/EBITDA to growth' multiple (share price of 15/01/2016)

	VE/EBITDA 2016e	EBITDA CAGR 2015e-2018e	VE/EBITDA/Growth
Orange	5,2	2,4%	2,13
NC SFR	7,1	8%	0,87
Altice	6,9	22,2%	0,31
Iliad consensus	8,4	12,8%	0,66
Iliad standalone BG	8,1	13,0%	0,62
Iliad base case BG	9,8	16,3%	0,60

Source: Thomson Reuters; Bryan, Garnier & Co ests.

For a sample of Western European stocks, the following chart presents the correlation between consensus 2015-18 EBITDA CAGR with the current 12-month forward EBITDA multiples.

Fig. 9: Correlation between EBITDA growth and EV/EBITDA multiples (share price at 15/01/2016)



Source: Thomson Reuters; Bryan, Garnier & Co ests.

There are some marked variances, but note the high valuations of the German challengers in a market which has seen consolidation in recent years, moving from four to three mobile network operators (over 2013 and 2014, O2/e-plus and VF-Kabel Deutschland mergers).

In our view, the Iliad share price already prices in some, but by no means all, of the market consolidation opportunity.

4. The French market: remodelling the industry

4.1. Player prospection continues

The recent months have witnessed a shake-up in the market driven by two main players:

- **Under pressure to ensure its survival, Bouygues Telecom has opted for a strategy based on volume and market share gains.** Firstly, by reducing its landline range entry point to €19.99 including taxes, i.e. a discount of around €10 including taxes relative to the market. Secondly, by aligning its low cost mobile B&You range with its historic Sensation premium range and proposing premium services at low cost tariffs: stores and telephone-based customer service.

- **SFR, purchased by Altice/Numericable, backed by a landline ultra-fast broadband asset base which is unique in the market,** opted for the opposite strategy to Bouygues Telecom, i.e. **a value focus.** With an approach very much centred on optical fibre, Numericable-SFR increased its landline and subsequently its mobile (Red) prices and followed this with another increase in early 2016.

Fig. 10: Simplified tariff structure, mobile offers

EUR (Taxes incl.)	Price Plans without handset (non exhaustive)								
Voice	**2h**	**2h**	**2h**	**24/24**	**24/24**	**24/24**	**24/24**	**24/24**	**24/24**
Data	**0-50Mb**	**100Mb**	**1Gb**	**0-50Mb**	**200Mb**	**1Gb**	**2-3Gb**	**5Gb**	**8-10Gb**
Red	-	5.99 €	-	-	12.99 €	-	19.99 €	25.99 €	-
Sosh	4.99 €	-	-	9.99 €	-	-	19.99 €	24.99 €	-
B&You	3.99 €	-	14.99 €	10.99 €	-	-	19.99 €	29.99 €	39.99 €
Free (1)	2.00 €	-	-	-	-	-	19.99 €	-	-
Bouygues Telecom	-	-	-	-	-	-	-	-	-
SFR (2)	-	9.99 €	14.99 €	-	-	24.99 €	-	33.99 €	41.99 €
Orange	9.99 €	-	14.99 €	-	-	24.99 €	-	32.99 €	39.99 €

EUR (Taxes incl.)	Price Plans with subsidised handset (non exhaustive)								
Voice	**2h**	**2h**	**2h**	**24/24**	**24/24**	**24/24**	**24/24**	**24/24**	**24/24**
Data	**0-50Mb**	**100Mb**	**1Gb**	**0-50Mb**	**200Mb**	**1Gb**	**3Gb**	**4-5Gb**	**8-10Gb**
Bouygues Telecom (*)	10.99 €		19.99 €	17.99 €	-		32.99 €	39.99 €	49.99 €
SFR (*)	-	14.99 €	19.99 €	-	-	29.99 €	-	43.99 €	53.99 €
Orange	-	-	-	-	-	-	-	42.99 €	54.99 €

Source: Company Data

(1) Includes 50Gb at 19.99€ price point

(2) Includes free multimedia content based on the 24/24 2-3Gb ranges and above

Fig. 11: Simplified tariff structure, landline offers

EUR (Taxes incl.)	Price Plans (non exhaustive)							
Nbre of TV channels	**0**	**0**	**25**	**150-160**	**150-160**	**190-200**	**190-200**	**> 200**
Unlimited calls to mobile	**no**	**yes**	**no**	**no**	**yes**	**no**	**yes**	**yes**
Red Fibre	29.99 €	-	31.99 €	-	-	-	-	-
SFR DSL (1)	-	-	-	-	39.99 €	-	51.99 €	60.99 €
SFR Fibre (1)	-	-	-	-	39.99 €	-	51.99 €	60.99 €
Bouygues Telecoms DSL (2)	-	-	-	19.99 €	25.99 €	-	-	-
Bouygues Telecoms Fibre (2)	-	-	-	-	25.99 €	-	-	-
Free DSL (3)	29.99 €	35.98 €	-	-	-	31.98 €	37.97 €	-
Free Fibre (3)	29.99 €	35.98 €	-	-	-	31.98 €	37.97 €	-
Sosh DSL (4)	-	25.00 €	-	-	30.00 €	-	-	-
Sosh Fibre (4)	-	30.00 €	-	-	35.00 €	-	-	-
Orange DSL (5)	-	-	-	36.99 €	40.99 €	-	-	-
Orange Fibre (5)	-	-	-	36.99 €	40.99 €	-	-	-

Source: Company Data; Bryan, Garnier & Co ests.

(1) Includes the Zive service (unlimited SVoD) starting from €51.99

(2) BBox Miami at €19.99. BBox Sensation at €25.99

(3) Freebox Mini 4k on the unlimited offers to mobile. Freebox Révolution on the others

(4) Offers available only with a mobile – thus tariffs are not really comparable

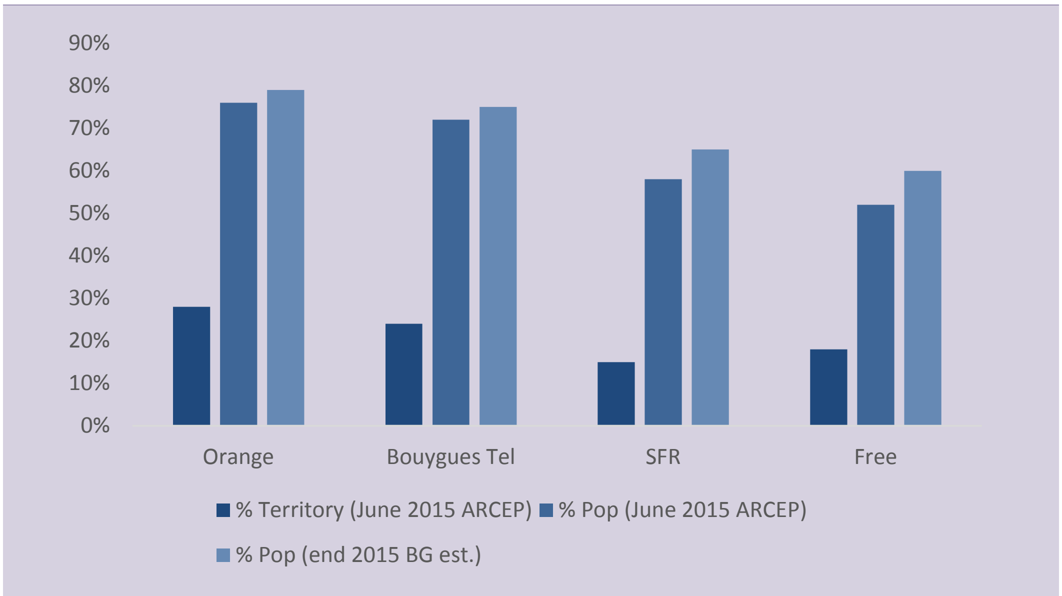
(5) Livebox Play decoder on offer at €40.99

Another key disruptive element structuring the market: the **heterogeneous development of fourth generation mobile telephony,** the 4G ultra-fast technology enabling mobile speeds very comparable to those of ADSL. Here too Bouygues Telecom and Numericable-SFR have contributed to destabilising the market:

- **Bouygues Telecom has been able to rapidly deploy 4G infrastructures,** on the heels of Orange, and benefiting, notably, from regulatory authorisation for the refarming of its 1800MHz frequencies.

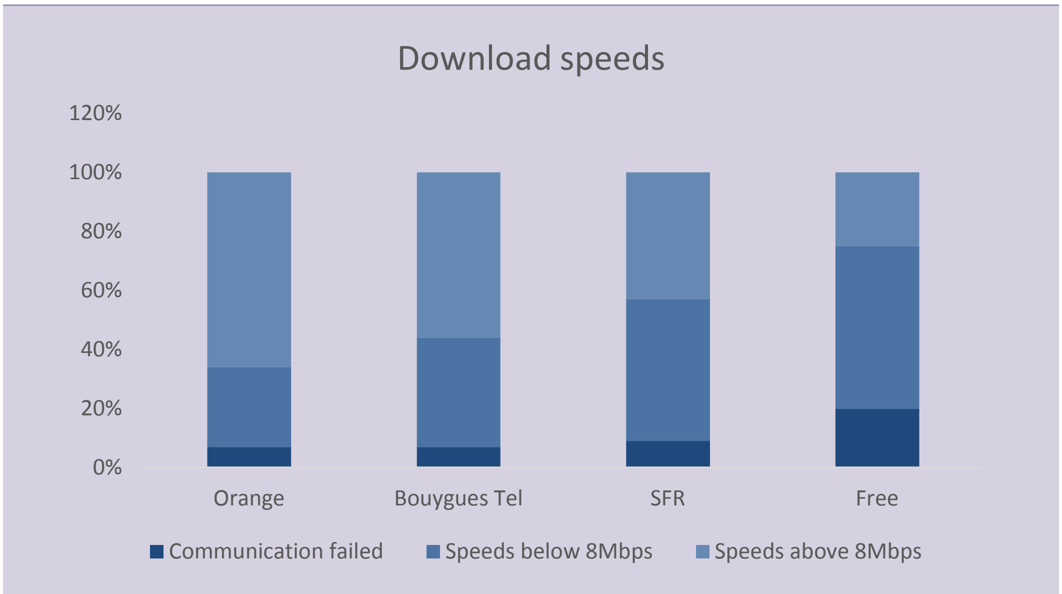
- **Inversely, SFR finds itself at the rear of the pack with Free,** suffering from the inadequate investment during the Vivendi era in 2014 but also a tardy pick-up in investment during the Altice/Numericable era as of the beginning of 2015.

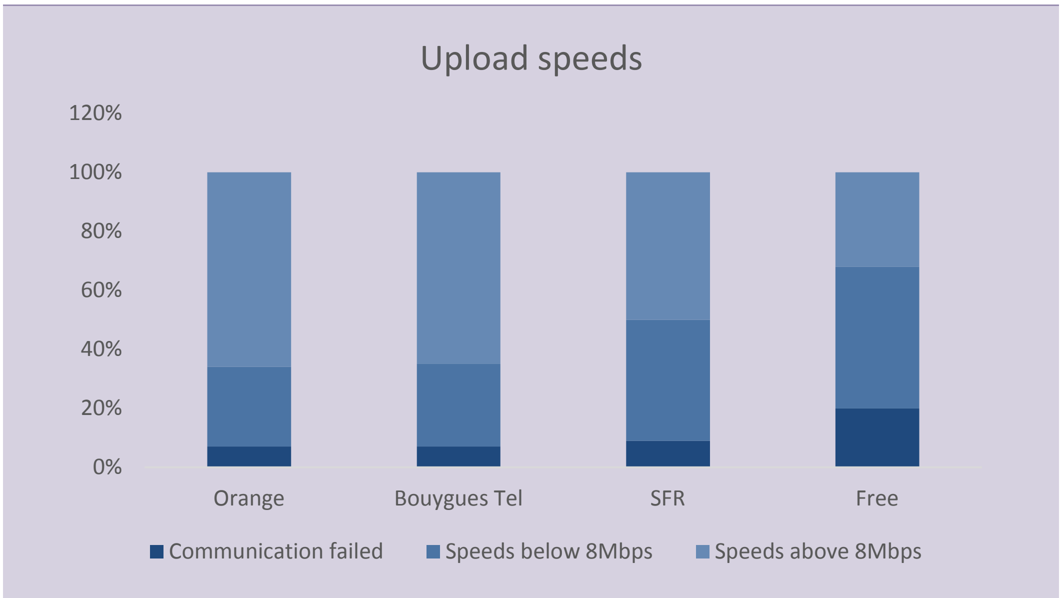
Fig. 12: 4G coverage of the population and territory by operator



Source: ARCEP, Garnier & Co ests.

Fig. 13: 4G upload and download speeds by operator (data traffic, July 2015)





Source: ARCEP.

In the meantime, Free and Orange settled for plotting their routemaps, remaining true to their respective positioning with no radical changes to either their pricing strategies or philosophies, while being forced to step up their promotional activities, particularly in landline, to be able to stay in the race.

The various strategies and positionings have been reflected in the commercial trajectories and performances in recent quarters.

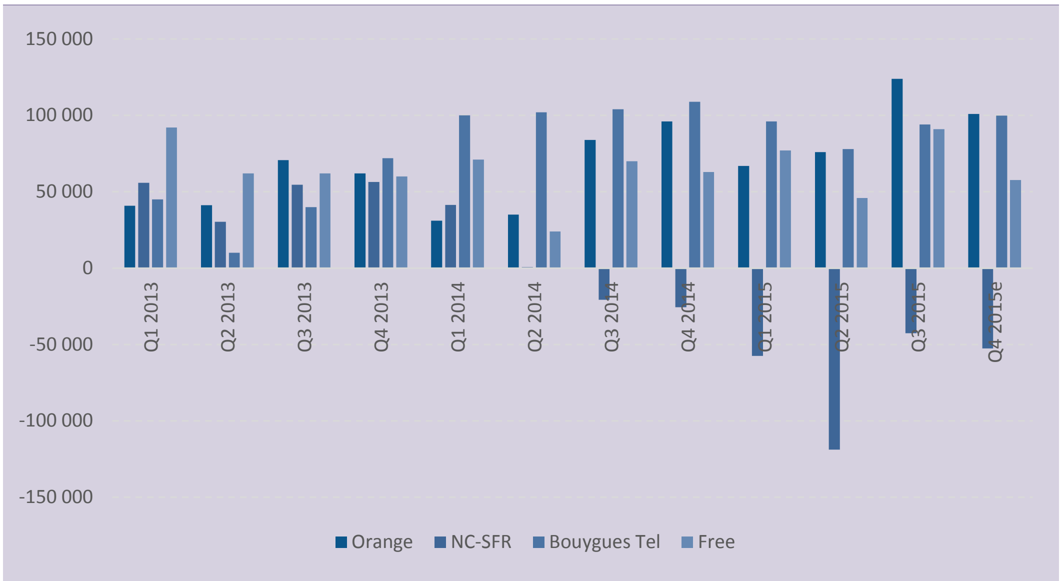
In mobile, Free remains at very high recruitment levels: 1.2m new customers over the first three quarters of 2015, vs 2m in 2014 and 2.8m in 2013. Bouygues Telecom, which continued to suffer in 2013 mostly from the arrival of Free with a loss of -130k subscribers, staged a recovery in 2014 largely due to its price repositioning move in Q4, capturing 116k new subscribers over the year followed by a total of 460k new subscribers over the three first quarters of 2015. SFR, which had enjoyed a good year in 2013 following its repricing with +280k new subscribers, began to suffer from network quality problems in 2014 losing -252k subscribers over the year before losing -540k subscribers over the three first months of 2015 given, in particular, a lack of competitiveness in 4G, an increase in Red prices and other terminal pricing decisions at the beginning of the year. For its part, Orange maintained a high level of net sales at 473k new subscribers over the three first quarters of 2015.

Fig. 14: Fig. 14: History of mobile subscriber net sales (excluding M2M)

Source: Company Data; Bryan, Garnier & Co ests.

In landline, Numericable-SFR has been losing customers since the Bouygues Telecom tariff repositioning move in 2014. Having lost 46k customers in H2 2014, SFR subsequently lost 220k customers in the first three months of 2015 given, notably, price hikes and despite a significant level of promotional activity. The Bouygues Telecom volume strategy paid off, moving from net sales of +167k in 2013 to +415 k in 2014 and +270k in the first three quarters of 2015. Iliad, which suffered somewhat in 2014, with +230k net sales, posted a performance comparable to that of 2013 in 2015 with net sales of 215k over the three first quarters of the year, a remarkable performance in a slowing market but admittedly achieved at the price of a proliferation in promotional periods. Orange was less affected, moving from net sales of 214k in 2013 to 246k in 2014 and a total of 267k net sales in the first three quarters, benefiting to the full from SFR's underperformance and driven, notably, by the good performances in optical fibre.

Fig. 15: History of landline net sales (broadband and ultra-fast broadband)



Source: Company Data; Bryan, Garnier & Co ests.

In our view, this situation, in landline but even more so in mobile, is highly unstable and will not last. It raises two important questions: **1/** how is Numericable-SFR going to correct its trajetory, and **2/** is the market viable with four operators? The two questions are naturally interrelated and lead us to ask ourselves about the credibility to be given to a merger scenario between Orange and Bouygues Telecom.

4.2. The opportunity of a merger between Orange and Bouygues Telecom

Why is this merger credible?

In a market with fixed costs in which scale is key to absorbing operating and capital expenditure, the smallest player often tends to be the weakest. Bouygues Telecom understands this very well which is why it has been betting on volumes for more than a year. It has also understood that the resale value of its business primarily depends on the volume of its customer base, the synergies with another national player potentially easily remedying its profitability issues (which explains why, within such a context, it is preferable to use multiples of customers or revenues rather than EBITDA for valuation purposes).

In June 2015, Martin Bouygues refused a cash offer from Altice group valued at €10bn, citing risks to employment and competition concerns. Since December, new discussions have taken place between Bouygues Telecom and Orange, this time concerning a potential merger. Let's take a look at the reasons why the assumption of a disposal of Bouygues Group's Telecoms activities appears credible currently despite the refusal of the offer last June:

A seller more motivated than last summer…

- **The envisaged structure of the deal is attractive for Bouygues.** The refutal published by Bouygues on the emergence of merger rumours in early December stated that the Bouygues group 'has no plans to withdraw from the telecoms and television sectors and reaffirms its long-term presence in these two industries'. The envisaged transaction with Orange does not contradict this position since it involves the transfer of its telecoms assets in return for the entry by Bouygues into the Orange share capital, which would make Bouygues the largest private shareholder in Orange. In our view, this is the main reason for Martin Bouygyes' change of stance between June and December 2015: a proposition which enables him to remain in telecoms and secure the long-term future of the business he himself created.

- **The survival of Bouygues Telecom is still not assured** despite the recovery plan presented at the 6 October Investor Day. The plan is based on two major premises. 1/ The ability to continue to acquire landline and mobile customers at the current rate over the long term. Given, in particular, the performance of Numericable-SFR to date, this assumption seems to us credible in 2016 but nonetheless runs the risk of a renewed tariff war at SFR's initiative. 2/ The maintenance of capex below the €800m threshold to ensure that the business generates a minimum ROCE. This target is incompatible with massive growth in the optical fibre customer base and supposes that the DSL technology remains 'adequate' in a context where Free is rolling out aggressive deployment plans and Orange and Numericable-SFR are already very present.

- **The identity of the buyer may loom large.** In this competitive telecoms battle in France, which is also a battle of egos between the three telecoms musketeers, Martin Bouygues. Xavier Niel and Patrick Drahi, 'emotional' motivations cannot be ruled out, particularly for a business which is something of a 'baby' for Martin Bouygues (at least one of his major entrepreneurial achievements). In this regard, it is not unreasonable to believe that a disposal to Xavier Niel or

Patrick Drahi would be felt as a failure. Inversely, an agreement with Orange could constitute a win-win exit strategy.

- **In our view, a cross-shareholding agreement with TF1 would not be a decisive factor.** The initial rumours pointed to Orange taking a 10% stake in TF1. Stéphane Richard has since stated that this was not on the agenda for the ongoing discussions but has not ruled out a brainstorming on media/telecoms convergence. We do not see significant synergies in Orange taking a minority shareholding in TFI. In our view this point is thus not decisive from a financial perspective within the framework of the current discussions. It may, however, be key for political or strategic reasons over the longer term. Were such an agreement to one day be confirmed, it would need to be approved by the CSA and likely incur the fury of the journalist profession which would be very opposed to the French State becoming a shareholder in the leading private French media company.

For Orange, such a deal would offer two major advantages:

… a buyer who must seize the opportunity.

- **Market repair.** Clearly, such a merger would be beneficial for all the market players: certainly from a volume perspective since the remaining players would share the sales but especially from a value perspective since the competitive and promotional intensity would be ratcheted down (particularly in the case of the disappearance of a very aggressive player commercially). Given its premium positioning and highly qualitative brand image, Orange is not the most affected by Bouygues Telecom' aggressive price strategy. We see this in the net sales figures, and Orange is not the most aggressive on promotions even if it is enjoying significant temporary benefits from the customer losses at Numericable-SFR. In our view, a market repair could be proportionally more to the advantage of Orange's competitors than to Orange itself. Remember that Patrick Drahi was initially in the biggest rush to purchase Bouygues Telecom, and already prepared to put €10bn on the table a few months ago for a business which is targeting €750m of EBITDA for the year end. The leverage effect for the legacy operator which benefits from a very large customer base is, however, enormous. ARPU upside of €1 across the existing landline and mobile customer base represents a revenue gain of approaching €400m over a full year and almost as much at earnings level, i.e. upside of 4% for the group's EBITDA in France. Similarly, a slowdown in the 'market churn' effect in which customers switch from one operator to another could have a very significant impact on Orange in terms of savings on acquisition and loyalty costs.

- **Reinforcement of its share capital**. Within a context where pan-European mergers are set to accelerate and Orange looks to be both a predator and a potential target, the entry into the share capital of a large private shareholder, and French to boot, is an attractive opportunity, particularly for Orange's main shareholder, the French State. This move would reinforce Orange's acquisition capability, with debt virtually unchanged and cash safeguarded, and offer better protection from hostile moves.

There are a few points which could still scupper such a merger:

Some obstacles to overcome, but it is in the interest of all stakeholders to cooperate.

- **The position of the competition authorities**. The first question concerns the level at which the merger would be reviewed: at European level by the Competition Bureau or French level by the Competition Authority. Any remedial measures required by the authorities would no doubt be very significant. In both landline and mobile internet access (excluding M2M), the new group's market share could exceed 50%. In the 4P market, which is analysed by the authorities as a market in its own right, we put the new group's market share at 66%. This situation is naturally not acceptable but the authorities will also want to be sure that, even with rebalanced market shares, a market with three operators does not prove to be unfavourable to consumers and investment. On this subject, note that the few statements from the French representatives seem to be fairly conciliatory and constructive. Emmanuel Macron, Minister of the Economy, has said that he is relatively relaxed about the number of operators (a change in stance relative to his previous statements back in June) with Bruno Lasserre, President of the Competition Authority, stating 'do we need to be wedded to four operators and say that competition is only a matter of numbers? Certainly not'. The attitude of the European authorities and Margrethe Vestager, the European Competition Commissioner, seems more hard line as shown by her role in the failed merger between Telia and Telenor in Denmark. According to Stéphane Richard's latest declarations, the balance seems to be more on the French side.

- **Valuation and the portion paid in cash**. Naturally, it will be the latter that determines the Bouygues shareholding in Orange and the dilution for the existing shareholders including the main shareholder the French State, and thus the future power balance. It is not obvious that the €10m offered by Patrick Drahi will continue to hold good for Orange. Especially since this valuation depends on the price at which the assets needing to be sold will be purchased by the competition. And here, time is rather against Bouygues Telecom, particularly in terms of the network: the more time passes, the more Free deploys its proprietary mobile infrastructure and the more this asset loses value. On the other hand, Free demand remains strong on optical fibre.

- **Negotiation of the asset disposals**. Stores, mobile networks, frequencies and the low cost and BtoB customer bases all figure amongst the assets likely to be put up for sale to satisfy the competition authorities. Concerning the first three, note that Orange has little to lose from selling them since they are mainly overlapping assets. As already mentioned, the mobile network has an obvious attraction for Free, but one which dwindles over time. The stores could act as a growth accelerator for Free and strengthen its presence in areas where it is underperforming, Free itself having already deployed some fifty Free centres. The stores hold fewer attractions for Numericable-SFR which is in the process of rationalising its network, overlaps with the Bouygues Telecom network also being very high. We don't see Free positioned in BtoB which constitutes a very separate business but there may be some real advantages for Numericable-SFR which has been struggling in recent years, via successive restructuring moves, to relaunch its BtoB division. Lastly, concerning the resale of a low cost customer base, B&You or Sosh, the two players Iliad and SFR could stand to benefit. In this war for customers, Numericable-SFR probably has the most need: to offset substantial losses and continue to improve its EBITDA margin. But watch out for customer losses during the migration to the acquirer operator: we don't see Free or Numericable-SFR adding a new brand to their businesses as long as the existing brand remains strong for the former and given the already plentiful brand portfolio of the latter. And, in any event, customers will need to be migrated to the host operator's information system.

- **Governance of the new group**. While the valuation of Bouygues Telecom and the Bouygues shareholding in Orange is a major issue, so is the related governance. How many Board directors and how will the balance of power with the French State play out? An agreement on these discussions is vital even if it does not seem the most difficult thing to obtain.

Given **1/** the presence of a buyer and a seller determined to get on, **2/** the interest for all the stakeholder operators in the successful completion of the deal, and **3/** the very early preparation of the response to the potential remedial measures required by the authorities, we put a very high probability on the deal going ahead. We have thus decided to **retain an Iliad Fair Value including the Orange/Bouygues Telecom merger.** We therefore assume a merger effective at the end of the 2016 Q4 with the first effects as of the end of 2016.

5. Mobile: standing on its own two feet

5.1. Solid foundations from which to grow

In recent years, the growth in the mobile subscriptions market has been driven by **1/** increased penetration of mobile telephony in France, **2/** the development of very low price subscriptions (particularly the Free proposition at €2) favouring notably multi equipment, and **3/** the migration of pre-paid customers to entry level subscriptions. These three factors are now a thing of the past and we forecast **mobile subscription market CAGR of 2.6% for 2015-18 vs 6.7% CAGR for 2011-15**.

Within this context, Free enjoys a unique position, with a value proposition completely consistent with the brand image that it has been able to build. Free has effectively developed a strong brand identity, based on a real technical and tariff innovation capability, backed by impactful communication and powerful opinion multipliers, Xavier Niel's personality and drive being at the heart of the machine. In particular, Free's know-how in terms of viral and digital community marketing enable it to maintain a high level of recruitment with a very limited physical distribution network (50 stores vs. several hundreds for its competitors). The strength of its brand and image together with the quality of the landline customer base enables the company to sustain mobile network quality levels broadly below those of the competition without harming its commercial performance. B&You needs to be a joint-leader in 4G coverage to generate commercial growth but Free can be towards the back of the pack and still continue to recruit new customers.

With its value-for-money proposition very well perceived by customers, Free has preempted a territory for which it is unrivaled in the French market. And, given a very lean cost structure, a focus on a few simple offers and no costly legacy information systems in mobile in particular, Free's model is very difficult for the competition to replicate, despite the attempts of B&You for example, which struggles to propose offers at equivalent tariffs in a network of more than 500 stores.

Fig. 16: Free's main competitive strengths and weaknesses

Free's main competitive strengths	Free's main competitive weaknesses
Brand image	Range of services and segmentation
Viral marketing	Mobile network: 3G quality and 4G coverage
Direct distribution	Lack of Fibre infrastructures
Efficient cost vs quality trade-off	Dependence on Orange for Mobile
Focus and simplicity	Size
Lean cost base	Network of outlets
Innovation capacity	
Management leadership	

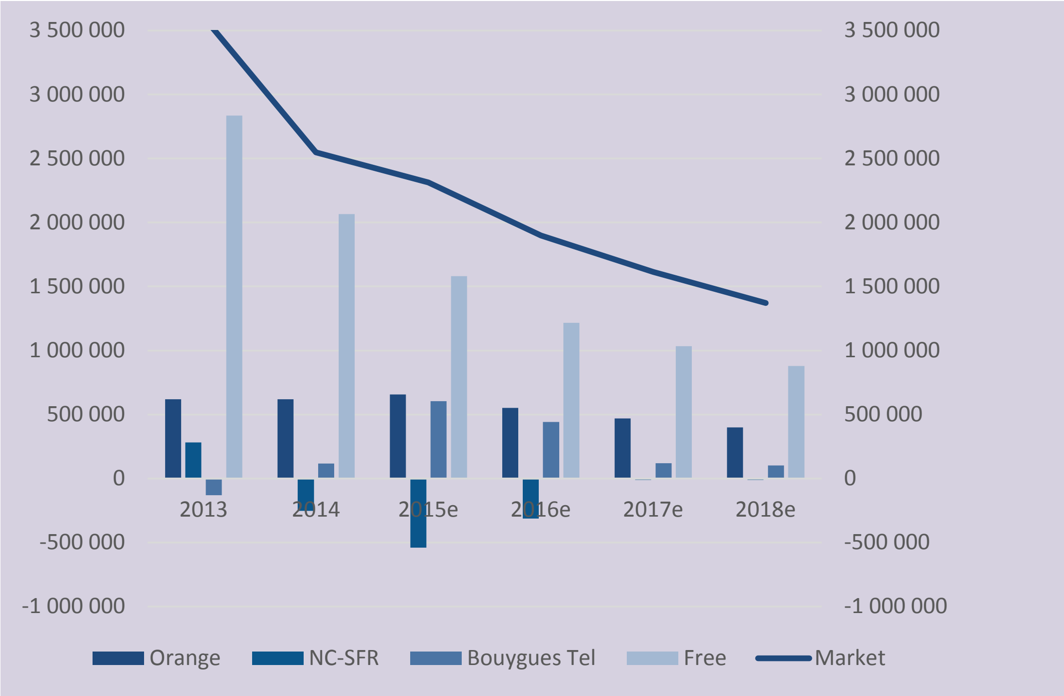
Source: Bryan, Garnier & Co

We see no reason for a reversal in Free's positive dynamic, and thus see the company continuing to grow its mobile customer base, with a progressive slowdown in line with that of the market. **Free is, however, facing two challenges; namely the successful management of the exit from the roaming contract with Orange and its ability to capture high-value customers more effectively,** as discussed in the next two chapters.

For its part, Numericable-SFR will again suffer from a difficult 2016, with a still-sub-par network and the integration of SFR and Numericable not yet complete (synergy and restructuring projects still ongoing in customer service, the retail operations and the brand portfolio, the coexistence of Red and Virgin hardly optimal in our view) before stabilising its customer bases by 2017/2018. **Benefiting from SFR customer losses and their network leadership, Bouygues Telecom and Orange will continue to post strong performances in 2016,** before seeing a stabilisation in 2017/2018 marking a return towards the breakeven of 2014.

With no market consolidation, we are forecasting Free volume growth of 10% in 2016, 8% in 2017 and 6.3% in 2018 vs. 26% in 2014 and 16% in 2015. Numericable SFR will see negative growth of -3% in 2016 followed by a broadly stable performance in 2017 and 2018, after having lost 5% of its volumes in 2015. Bouygues Telecom will enjoy renewed growth of 4% in its existing subscriber base during 2016 vs. 8% in 2015, prior to a return to 0.5% for 2017 and 2018, or levels of performance comparable to Q2/Q3, 2014. Orange will still benefit from reasonable growth of 2.7%/2.3%/1.9% over 2016/2017/2018, having posted +3.4% in 2015 and 2014.

Fig. 17: Trend in net mobile subscription sales (excluding M2M)



Source: Company Data; Bryan, Garnier & Co ests.

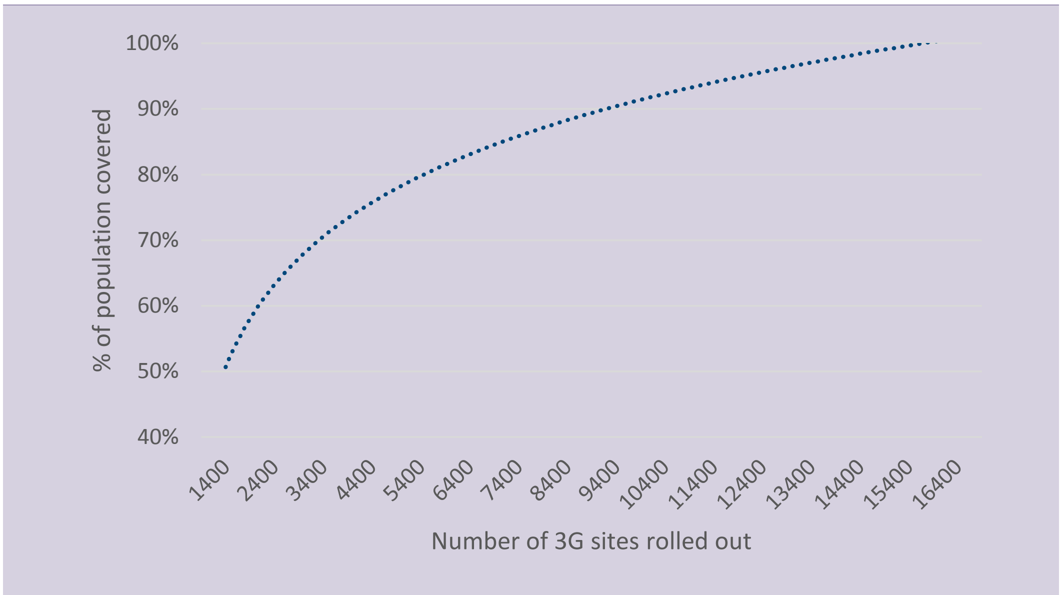
We expect only a modest impact from market consolidation on Free mobile volumes (excluding possible customer base acquisition) with the Orange/Bouygues Telecom merger becoming effective in 2017. As explained above, however, we expect the net subscriber sales realised by Bouygues Telecom in 2017 to be around 80k, hence a transfer limited to net sales of ~20k, assuming 25% appropriated by Free.

5.2. Cutting the umbilical cord of the roaming contract

While the 2G/3G roaming contract used to be Iliad's Trojan horse in mobile, it now constitutes its Achilles heel. The contract, which expires in January 2018, must be the subject of a renegotiation between the two partners, Free not being in a position to deploy sufficient proprietary infrastructure to absorb 100% of the traffic within this time frame.

While, at the end of 2015, Free had 6,000 3G sites in service, on our estimates it needs to target 10,000 to 12,000 3G sites in operation by the end of 2018 to be able to offer a population coverage rate of around 95%, a level which remains slightly short of that of the competitor with the lowest coverage to date, Bouygues Telecom, with 97% at the end of 2015. And each coverage percentage point is more costly to obtain than the last, the deployments taking place in the regions with the lowest population densities.

Fig. 18: 3G overage rates and deployment



Source: Company Data; Bryan Garnier & Co ests.

We estimate the amount of the Orange roaming contract (opex + capex) at more than €700m in 2015, with the increase in Free's proprietary network being partially offset by the increase in data traffic per customer. Our forecasts show a mobile gross margin of around 45% (margin on purchases used in production excluding terminal revenues and purchases) for 2015 and a structural target excluding the roaming contract of 70%. **On our stand-alone scenario, we expect the margin rate of 60% on purchases used in mobile production to be progressively reached by H2 2018,** with a portion of traffic remaining on the Orange network (2G voice notably, together with a modest proportion of 3G traffic data which could also be absorbed by the 4G infrastructures). **This scenario is consistent with the maintenance of a high level of capex at ~€1bn over the next three years** (excluding licences and the capex share of the roaming contract with Orange) which we see as necessary to supporting the deployment of the mobile network in particular, as well as the backhaul infrastructures required to support fibre-to-BTS to absorb the increase in bandwidth.

The regulator is also watching. On January 12th, The French industry regulator (ARCEP) submitted a working document to public consultation which includes draft guidelines on mobile network sharing, and on the contract between Free and Orange in particular. For (3G equivalent) high-speed mobile services, ARCEP believes that the agreement should be terminated at a date to be set between the end of 2018 and the end of 2020. For voice, SMS and low-speed (2G equivalent) services, the termination could come into effect on a date to be set between the beginning of 2020 and the end of 2022. ARCEP also recomands the organization of a progressive region-by-region termination process, allowing to control the trajectory towards a full extinction. **In effect, the law for growth, activity and equal economic opportunities granted ARCEP a new power: the ability to ask operators to amend their mobile network sharing contracts when required to achieve its regulatory objectives.** Awaiting this, in May 2014, ARCEP had already opened an administrative inquiry to ensure that the operator was embarked on an investment path compatible with its coverage obligations. In our view, the targets of ARCEP are reachable at the current rate of deployment and the capex budget in our model. Nevertheless, these new constraints reinforce Free's interest in buying out Bouygues Telecom's mobile network assets.

Iliad must not miss the opportunity of buying out Bouygues' network assets

We see four major advantages for Iliad in purchasing the Bouygues Telecom network infrastructures on a potential merger between the latter and Orange:

- Within a short time frame, the ability to offer a **higher level of service quality** thanks to end-to-end control of an extended network and to compete on an equal footing with the other network operators.
- **Accelerate the exit from the Orange roaming contract** and thus achieve an optimal level of gross margin more rapidly.
- **De-risk the** tricky and costly massive network roll-out operations.
- **Offload some regulatory pressure.**

Assuming an agreement effective at the end of 2016 and a one-year integration/infrastructure migration period, we would expect the new network to become **operational in early 2018.**

Within this time frame, we expect the higher-quality service offer to be reflected in the **recruitment/retention of higher-quality customers, with ARPU upside** as outlined in the next chapter. In parallel, we expect such an asset purchase to favour some de-risking of Iliad's company profile, something we reflect by **reducing the Beta in the stand-alone scenario from 0.8 to 0.75**. **On the other hand, we do not value the acquisition of the network per se**, the capex avoided and the acceleration in the achievement of an optimal mobile gross margin. We effectively assume here that the price paid by Iliad for the network will result in a balanced negotiation and will be equivalent to the discounted value of the capex avoided plus a premium corresponding to the resulting gross margin benefit.

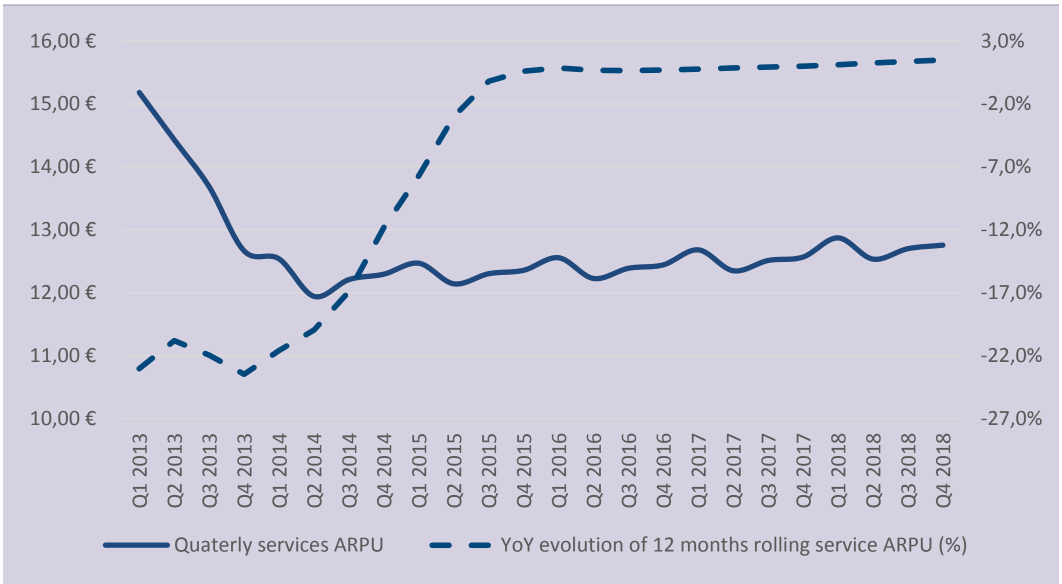
5.3. Developing value

While the Free volume dynamic outlined above is real, it should not obscure that fact that, until the end of 2015, it was supported by ever-higher volumes of entry-level offers priced at €0 or €2. After years of double-digit growth in the customer bases, **activating a value growth relay is becoming key for Free.**

In our view, the main ARPU growth opportunity lies in Free's ability to adjust its €2/€20 mix. While the other operators have more to lose when it comes to repositioning their high-end customers lower down the value curve at the mercy of market trends (alternative subsidy models, growth of SIM only, lowering of abundance thresholds in roaming and data), Free has a great deal to gain in supporting the data uses of its customers.

The challenge for Free is thus to attract and retain customers who use large quantities of data and maximise the mix at €20. Free is currently achieving this thanks to the most comprehensive data proposition in the market at €20 (50 Go in 4G), thanks to the quality/coverage mix of its network. In particular, it needs to maximise the number of customers at €2 by developing their data usage. Over the past two quarters, a recruitment mix at €20 exceeding a 50% share and migrations from the existing customer base at €2 to the €20 offer have enabled **a services ARPU increase for the first time since the launch of Free mobile**: +1.7% in Q2 2015 and +0.8% for Q3 2015 based on our estimates. **We expect this trend to continue**, by maintaining a modest trend of around 0.7% in 2016, **still subject to pressure from aggressive promotional offers** on data from the competition, and particularly SFR (c.f. data abundance offers at very low prices from Red at Christmas, and life-time promotions), then 1% and 1.5% respectively in 2017 and 2018, continuing to **benefit from migrations from existing customers and an acquisition mix driven by data usages.**

Fig. 19: Trend in mobile services ARPU



Source: Company Data; Bryan, Garnier & Co ests.

Our forecasts do not include other sources of upside for Free tariffs. The introduction of a new intermediary entry point between €2 and €20 would present a real cannibilisation risk, without necessarily offering the equivalent volume benefits. The competition already offers such price points, something which has manifestly failed to hamper Free's growth, and this would also prejudice the strategy of generating value from data usages. Concerning the subsidy, which has frequently been envisaged but never launched, this is now less in the natural course of events in a market where SIM only and alternative financing models are seeing rapid growth.

The value impact of the market repair can be very significant.

The value opportunities linked to a merger between Bouygues Telecom and Orange are two-fold: impact on **Free's network quality and pricing power** on one hand and a **market repair effect** on the other.

As outlined in the previous chapter, increased network quality must enable the **more effective acquisition of data-hungry customers**, i.e. a recruitment flow more oriented towards the €20 entry point, better retention of customers using a large amount of data and an increased incentive to migrate from the €2 to the €20 offer. We estimate the potential incremental ARPU upside at €0.25 from this effect, or the equivalent of a 2-percentage point increase in 'up' migrations (€2 to €20) within the existing customer base. Secondly, the market repair effects should be felt in a **reduction in promotional intensity on the market**. We would expect 2018 ARPU upside limited to €0.25 relative to our stand-alone scenario since promotional activity was already present prior to the Bouygues Telecom tariff repositioning at the end of 2014, and we expect **Free to continue to need 'Exclusive Sale' type initiatives to achieve its sales targets.** On the other hand, we see no outright tariff increases at Free timed to coincide with market repair, Free maintaining a highly aggressive tariff strategy consistent with its positioning and, again, relying more on existing customer migration effects than on its tariff structure when it comes to increasing customer value.

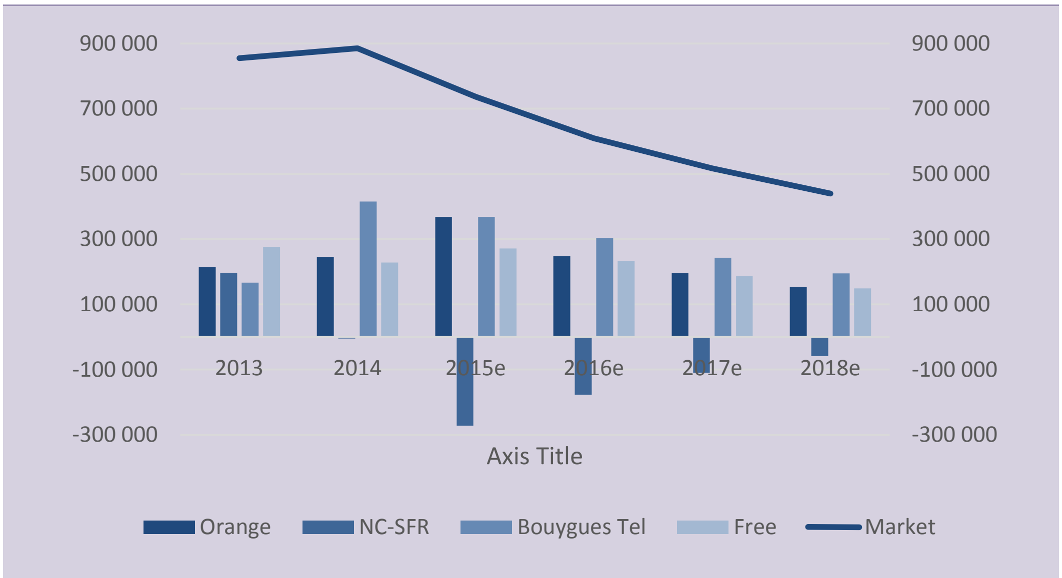
6. Landline: planning for the future

6.1. Fibre: from reaction to affirmation

The growth in the landline internet access market continues to slow, moving from a **2012-15 CAGR of 4.2% to an estimated 2015-18 CAGR of 2.4%,** the penetration rate progressively tending towards an asymptote-type curve.

In a slower-growth market in 2016-18, we see a **modest decleration in the trends noted in 2015**. SFR should progressively reduce its customer losses but continue to post **slightly negative net sales given its reaffirmed premium positioning and a focus on optical fibre**, as witnessed by the €3 increase in prices expected for early 2016 on the Fibre Power boxes as well as investment in Altice content (Zive, premier league football rights, particularly in the United Kingdom). **Bouygues Telecom should maintain a high level of recruitment, benefiting from its attractive price positioning. Orange could suffer somewhat from SFR's progressive recovery, Iliad's net sales decelerating in line with the market slow-down.**

Fig. 20: Trend in landline (broadband and ultra-fast broadband) net sales

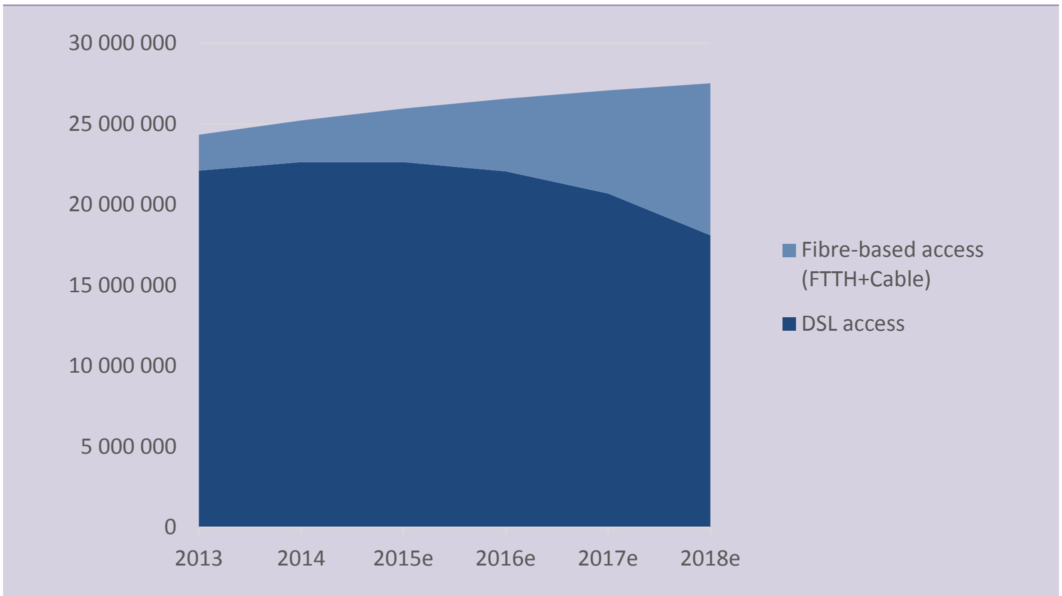


Source: Company Data; Bryan, Garnier & Co ests.

Hidden behind these figures is the progressive switch from DSL to optical fibre. This switch is currently mainly more due to existing customer migration phenomena than to the recruitment of new customers. In particular, during 2015, Numericable-SFR launched massive (non-mandatory) migration operations involving the DSL customers inherited from SFR to Numericable's ultra-fast broadband infrastructures.

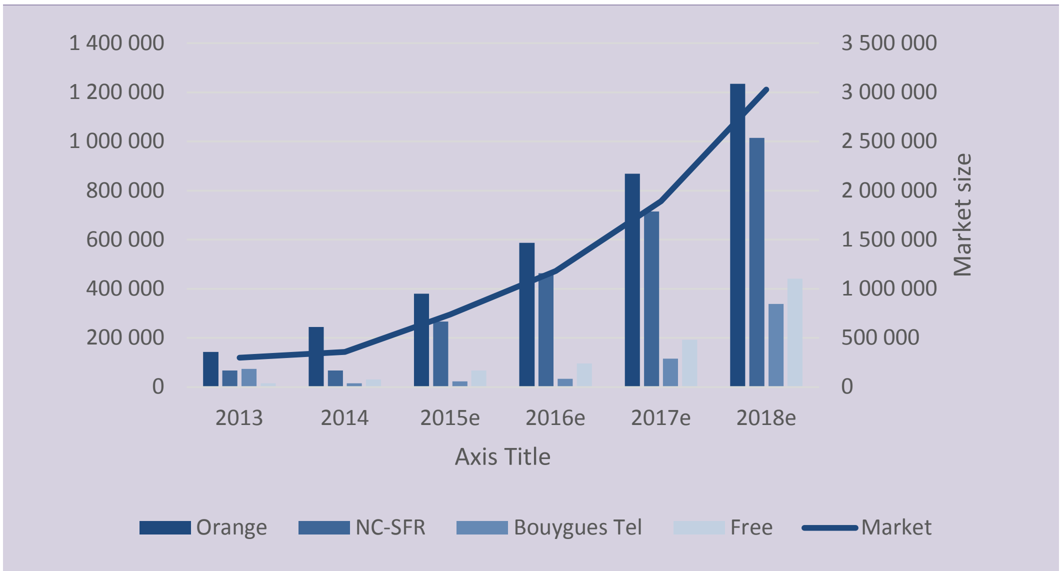
We see this **phenomenon continuing and gaining momentum in the next few years,** encouraged by **1/** the growth in usages requiring significant bandwidth (multiplication of 4k audiovisual content, development of multi screen and simultaneous household uses, increased streaming), and **2/** the strategies of the players who are progressively ceasing to sell ADSL in zones where there is optical fibre access to increase the return on their investment. We are thus forecasting a **virtual tripling in the volume of optical fibre subscriptions in the market** between the end of 2015 and the end of 2018.

Fig. 21: Trend in broadband and ultra-fast broadband infrastructure (four operators)



Source: Company Data; Bryan, Garnier & Co ests.

Fig. 22: Trend in ultra-fast broadband net sales (FTTH + Cable)



Source: Company Data; Bryan, Garnier & Co ests.

In the short term, however, we don't expect the Fibre proposition to be a key element in the recruitment of customers as it is likely to be a longer-term phenomenon. Fibre subscriptions (FTTH) mostly require the installation of an optical fibre socket, which means a visit from a technician and the completion of some work in the home (drilling of holes in the walls, positioning of cables). This thus involves some **inconvenience** for the customer (note: this point holds less true for the cable technology which more frequently has a socket already installed in the home). Additionally, customers who find fibre the most advantageous are those with a poor-quality DSL service (and thus not TV on DSL, or poor quality), i.e. customers present in regions that generally have average population densities which currently have a lower level of optical fibre coverage and will only progressively receive a fibre connection. We estimate that it is in these **lower density areas, more than in high-population-density regions, that fibre coverage will be a key element in competitiveness**. For Free, which we understand from contact with the company has a stronger presence in urban/high-population-density zones, optical fibre in high density areas will primarily be a migration/retention tool, whereas it constitutes more of a recruitment adventage in average-density zones. Final point: **while fibre helps to sell content, inversely content helps to sell fibre.** This is one of the reasons why, in particular, SFR-Numericable is investing heavily in content.

Fiber will be key on a medium term, but investments are high and return is uncertain.

In our view, it is thus crucial for Free to anticipate the future by strengthening its positioning in optical fibre deployments, Orange and Numericable are forging ahead. We estimate that Free currently has 4.5m HSPs (horizontal links) deployed in very high-density zones, 700k sockets available in average-density zones and 4.5m of additional potential via a partnership with Orange. Note that the **regulatory context in average density regions is very favourable** and enables co-investors to follow the network operator who deploys by tranches of 5% market share. We then expect one million new Free sockets to be deployed on an annual basis for a targeted c.5 million HP sockets (vertical) available at the end of 2018 and a budget equivalent to €200m of annual capex (excluding customer connections). Underpinned by this deployment, we expect a CAGR of 70% in Free's optical fibre subscriptions between the end of 2015 and the end of 2018, with 800k fibre customers within this time horizon, i.e. 12% penetration of the existing customer base vs. 3% to date.

The issue of generating more value from Fibre customers remains, however, a tricky one. At this stage, we have no clear demonstration (despite the communication of some operators) that a Fibre customer brings in significantly more than a DSL customer. Put more precisely, **we have no certainty that a customer switching from ADSL to optical fibre will start to spend more.** Firstly, there is often an observation bias in some figures reported by the operators which means that the customers already present on these technologies are early adopters with misrepresentative profiles, and who are naturally bigger users of services. Especially, however, **Fibre offer pricing is currently very close to the price points on the DSL offers**, as seen in figure 11. There are sometimes even promotional offers for optical fibre at **prices below those practiced for DSL**.

Herewith a simplified business case: we estimate the cost of deploying an optical fibre socket at €600 in average population-density zones (both horizontal and vertical) and the average cost of building a customer connection at €400 in these zones. Without ARPU impact, the ROCE of such an investment is 7.2% (estimating the monthly post-tax savings on payments to Orange and a target 15% 'no-fill' rate on the sockets), showing **very limited value creation** based on a WACC at 6.8%.

We understand very well that the players are currently in a **sunk cost rationale for optical fibre investments which have already been made**: better to fill the capacity at any price and save on payments to Orange rather than leave the network empty, even it means launching special promotions. On the other hand, **new deployments cannot be justified in this way**. Except on a very long-term patrimony-based rationale, the relentless pursuit of optical fibre deployment is thus motivated firstly by the competitive game (namely that, over the medium/long term, not being present in optical fibre is worst than being present) and, secondly, by the **players' shared hope that some incremental value will one day effectively appear**.

The impact of a market repair is very significant.

The contribution from market repair is thus key to optical fibre profitability: freed from excessive competitive pressure, this is the opportunity for operators to at last practice prices more in phase with the underlying investments. Or inversely, dispose of a competitive and price environment favourable to investment and regional development. No doubt the operators will make this type of conversation an integral part of their discussions with the competition authorities and the regulator. We detail the pricing and ARPU issues in the following section.

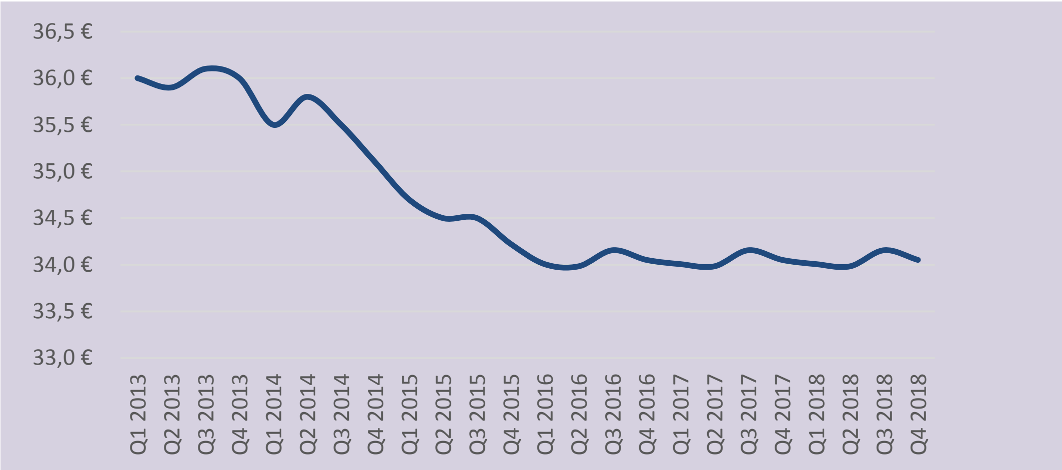
A merger between Orange and Bouygues Telecom will also have repercussions in terms of volumes. Firstly, by 2017 (resp 2018), our forecasts put Bouygues Telecom' landline net sales at 243k (resp 195k) and thus a transfer to Free of around 83k of net sales in 2017 and 66k in 2018, assuming an appropriation rate of 35%. Secondly, the merger could create a **dominant position for the new group in landline ultra-fast broadband customers.** On our calculations to end Q3 2015, Orange would move from a market share of 35% in landline ultra-fast broadband to a 52% market share with Bouygues Telecom' landline ultra-fast broadband customers. (Note that a significant proportion of Bouygues Telecom' landline ultra-fast broadband customers do not rely on the operator's proprietary infrastructures but on the wholesale contract signed with Numericable). This point, taken together with the risk of a dominant position outlined above on the Quadruple Play market, shows that **landline will also be at the heart of the Competition Authorities' concerns.**

Optical fibre matters (customers and/or infrastructures) may thus be a part of the discussions on the mobile network between Iliad and Orange/Bouygues. For reasons of caution, **we do not assign any value here to the effects** ensuing from any associated disposals. Notably, as with the mobile network, we assume that the recovery of such assets would be done at a fair value not impacting our DCF.

6.2. Managing the price spat

In early 2014, Bouygues Telecom rocked the market with a price repositioning in landline, introducing a 3P price point of €19.99, i.e. 30% below the standard market tariff. **This positioning destablised the market,** opening the way to low cost landline offers like Red DSL/Fibre at SFR and Freebox Mini at Free, but also a **very marked increase in promotional intensity**. Free was able to maintain a very high level of commercial performance without at face value passing on the tariffs practiced by Bouygues Telecom, but at the price of **downwards pressure** on its ARPU trajectory. This downwards pressure was mainly due to the proliferation of Exclusive Sale-type promotional initiatives in response during H2 2014 and 2015. This new strategy led to year-on-year ARPU declines of around -3% over the three first quarters of 2015. In our view, we have **now almost seen the full effects of this new strategy**, which we expect to continue over time on the same basis, and thus forecast a re-stabilisation of landline ARPU as of end 2016.

Fig. 23: Trend in Free Landline ARPU



Source: Company Data; Bryan, Garnier & Co ests.

Within this context, a Bouygues Telecom/Orange merger looks to have very significant benefits. The tariff move from Bouygues Telecom was justifiable on the part of a player who **1/** was fighting to survive **2/** did not dispose of an adequate landline customer base (vital to the recruitement and securing the loyalty of mobile customers in a convergent world), and **3/** had little to lose in terms of landline revenue cannibalisation. In a market reconstituted around the Bouygues Telecoms/Orange merger, **this type of price strategy no longer looks necessary** particularly when faced with the need to generate more value from optical fibre investment as outlined above**.**

We thus expect such a merger to **rein in the intensity and frequency of the promotional activity** prevailing since the Bouygues Telecom prepricing move, to return by the end of 2018 to a **Free ARPU equivalent to its level of early 2014,** i.e. upside of €1.5 relative to a stand-alone scenario. We assume **no change to the Free tariff structure** aiming to explicitly introduce a pricing premium notably on fibre.

7. M&A: Starting a family

After organic growth, time for external growth.

While the materialisation of a merger between Orange and Bouygues Telecom would give Free a second wind, **we don't see Xavier Niel contenting himself with managing a national Free as its revenues stabilise** especially since his competitors Orange and Altice are pressing ahead with their groups' development by seizing international opportunities. This is what Iliad has started to do with the 50% shareholding in the Telecom Reunion Mayotte group. We don't however expect him to stop there. The missed T-Mobile US opportunity shows, firstly, Xavier Niel's intention of developing his company in an opportunistic manner and, secondly, the scale of his ambitions.

Iliad has a low level of debt, with net debt estimated at close to €1.1bn at the end of 2015 (which does not include the payment of licenses in 2016) and a net debt/EBITDA ratio below 0.8. Assuming a maximum leverage ratio of four times 2015 EBITDA, Iliad could raise additional debt of €4.8bn. Furthermore, by accepting dilution of Xavier Niel while leaving him with 50.01% of the share capital, Iliad could raise €1.1bn by way of a capital increase, based on the current share price at a 10% discount. This **brings Iliad's acquisition war chest to around €6bn** (this amount may imply the renegotiation of some covenants, in particular the ones attached to EIB loans, which limit leverage ratio to 2-3).

Besides, we can also assume a leverage at the target level, as was the case with T-Mobile US. A theoretical calculation shows that Iliad's maximum acquisition capacity then amounts to €12.9bn, assuming a debt net of target at €6.85bn, a net debt/EBITDA ratio of 4.00 and a EV/EBITDA ratio of 7.5. Naturally even larger companies could be targeted but for less than 100% of the share capital, or even in partnership with other investors.

Fig. 24: Iliad's maximum acquisition capacity (100% of the share capital)

EURm	2015e
Iliad EBITDA	1507
Max. leverage ratio (net debt / EBITDA)	4
Iliad net debt	1123
New debt capacity at Iliad	4904
Capital increase capacity (dilution of Xavier Niel to 50.01%)	1090
(1) Total Iliad's acquisition capacity (cash/debt free target)	**5994**
EBITDA of target (cash/debt free)	799
(2) Total Iliad's acquisition capacity (target with net debt 4xEBITDA)	**12844**
Net debt capacity of target	6850

Source: Company Data; Bryan, Garnier & Co ests.

We estimate that an ideal target, involving value creation for Iliad, would need to meet the following criteria as much as possible: 1/ be a challenger operator in its market, sharing a corporate culture similar to that of Free, **2/** offer significant opex and capex synergy potential from the application of the Free model (high degree of insourcing, in-house development) and/or the reutilisation of Free products/developments, **3/** operate in a market offering sufficient economic space for the introduction of disruptive pricing. When a target meets most of these criteria, as was the case for T-Mobile US and Telecom Reunion Mayotte, it is eligible in our view for a bid attempt. Some targets meeting fewer of these criteria but offering other opportunities (in terms of innovation for example) may nonetheless hold some attractions for Xavier Niel via his personal holding company NJJ. This is the case for Monaco Telecom, Salt and Telecom Italia.

8. Appendices

Fig. 25: Iliad's 2015-18e P&L, stand-alone case

	2015e	2016e	2017e	2018e
Revenues	**4 428**	**4 727**	**5 005**	**5 253**
Fixed	2 590	2 665	2 754	2 825
Mobile	1 849	2 071	2 259	2 437
Eliminations	(10)	(9)	(9)	(9)
Cost of goods sold	**(2 262)**	**(2 326)**	**(2 326)**	**(2 315)**
Gross Margin	**2 166**	**2 401**	**2 679**	**2 938**
% of revenues	**48,9%**	**50,8%**	**53,5%**	**55,9%**
of wich Fixed	56,4%	56,4%	56,9%	58,1%
of which Mobile	38,4%	43,8%	49,6%	53,6%
Total expenses	**(660)**	**(685)**	**(729)**	**(766)**
Labour expenses	(223)	(236)	(250)	(263)
External expenses	(285)	(304)	(322)	(338)
Taxes	(61)	(55)	(60)	(66)
Provisions	(75)	(80)	(84)	(89)
Other operating revenues and expenses	(17)	(10)	(13)	(12)
reported EBITDA	**1 507**	**1 715**	**1 949**	**2 171**
% of revenues	**34,0%**	**36,3%**	**39,0%**	**41,3%**
Non monetary labour expenses	(5)	(6)	(6)	(6)
Depreciation & amortisation	(812)	(941)	(980)	(1 003)
Current operating profit	690	768	964	1 163
Other operating revenues and expenses	(4)	(4)	(4)	(4)
EBIT	**686**	**764**	**960**	**1 159**
% of revenues	**15,5%**	**16,2%**	**19,2%**	**22,1%**
financial result	(66)	(66)	(82)	(69)
Other financial revenues and expenses	(23)	(22)	(22)	(22)
income tax	(247)	(278)	(347)	(427)
consolidated net income after tax	**350**	**398**	**509**	**640**
non controlling interests	(1)	(1)	(1)	(1)
consolidated net income, Group share	351	399	510	641

Source: Company Data; Bryan, Garnier & Co ests.

Fig. 26: Iliad's 2015-18e P&L, base case

	2015e	2016e	2017e	2018e
Revenues	**4 428**	**4 782**	**5 149**	**5 512**
Fixed	2 590	2 705	2 852	2 987
Mobile	1 849	2 087	2 306	2 533
Eliminations	(10)	(9)	(9)	(9)
Cost of goods sold	**(2 262)**	**(2 334)**	**(2 351)**	**(2 364)**
Gross Margin	**2 166**	**2 449**	**2 798**	**3 148**
% of revenues	**48,9%**	**51,2%**	**54,3%**	**57,1%**
Total expenses	**(660)**	**(688)**	**(736)**	**(778)**
Labour expenses	(223)	(236)	(250)	(263)
External expenses	(285)	(304)	(322)	(338)
Taxes	(61)	(56)	(63)	(70)
Provisions	(75)	(81)	(89)	(96)
Other operating revenues and expenses	(17)	(10)	(13)	(12)
reported EBITDA	**1 507**	**1 761**	**2 062**	**2 370**
% of revenues	**34,0%**	**36,8%**	**40,0%**	**43,0%**
Non monetary labour expenses	(5)	(6)	(6)	(6)
Depreciation & amortisation	(812)	(941)	(980)	(1 003)
Current operating profit	690	814	1 077	1 361
Other operating revenues and expenses	(4)	(4)	(4)	(4)
EBIT	**686**	**810**	**1 073**	**1 357**
% of revenues	15,5%	16,9%	20,8%	24,6%
financial result	(66)	(65)	(76)	(55)
Other financial revenues and expenses	(23)	(22)	(22)	(22)
income tax	(247)	(296)	(392)	(508)
consolidated net income after tax	**350**	**427**	**583**	**772**
non controlling interests	(1)	(1)	(1)	(1)
consolidated net income, Group share	351	428	584	773

Source: Company Data; Bryan, Garnier & Co ests.

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Positive opinion for a stock where we expect a favourable performance in absolute terms over a period of 6 months from the publication of a recommendation. This opinion is based not only on the FV (the potential upside based on valuation), but also takes into account a number of elements including a SWOT analysis, positive momentum, technical aspects and the sector backdrop. Every subsequent published update on the stock will feature an introduction outlining the key reasons behind the opinion.

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