



EFG - Hermes

Emirates Integrated Telecommunications Co. (du) Finding Growth in a Mature Market

09 January 2007

UAE | Telecom

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ST Rec. : Neutral Current Price*: AED 6.34
LT Rec. : Neutral LT Fair Value : AED 6.06

- **We Initiate Coverage of EITC (du):** du is the UAE's second licensed telecommunication service provider launching early this year. du will initially provide mobile services all across the UAE based on a 3G/4G infrastructure while advanced fixed-line services, including triple play and Fixed-to-Mobile Convergence (FMC) services, will be launched later in phases.

- **Challenging Market, but Structurally Favorable:** The UAE has the highest mobile and fixed line penetration rates in the region of 125% and 30% respectively. However, with a commercially-driven management to take advantage of a monopolized market's imperfections, we believe du can build a significant market share with a business model set to benefit from a combination of fast growing population and one of the highest levels of per-capita spending on telecommunication services in the region.

- **Market Share in Mobile to Exceed 30% end-2010:** We expect du's mobile market share to reach 33% at end-2010. We are less bullish on du's fixed line market share and are forecasting 15% at end-2010. A supportive regulatory environment remains key to du's success.

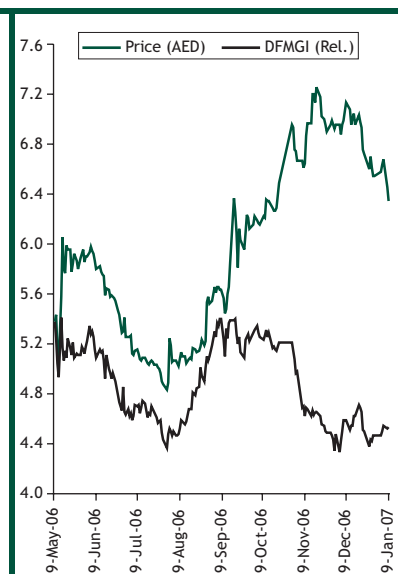
- **Achieve Breakeven after 24 Months of Operation:** We expect du to achieve positive EBITDA in 2009 and we are forecasting earnings of AED575 million in 2010. The main drivers for achieving breakeven at a relatively rapid pace are: i) projected strong subscriber growth, ii) high ARPU's in the late USD20s and iii) Relatively low cost of debt. We are forecasting, however, high debt levels to finance du's aggressive capex program and operating costs.

- **Start-up Forecast Risk:** While we believe that our forecasts are built on reasonable assumptions, there is a high degree of upside / downside risk to our forecasts, and consequently both our fair value estimate and our recommendation, due to the start-up nature of the operation.

- **Great Potential Priced-in, Initiate with a Neutral:** We estimate du's long-term fair value, based on a DCF valuation, at AED6.06 per share, 4.4% below the current market price. du's market capitalization is currently equal to 44.5% of Etisalat's market capitalization after excluding the value of the latter's non-UAE operations. We assign a ST/LT Neutral recommendation on du.

December year end	2007e	2008e	2009e	2010e
Operating Income (mn)	(1,310)	(689.9)	277.9	1,147
Net Attrib. Income (mn)	(1,345)	(852.0)	23.3	575.4
ROE	-53.3%	-51.0%	1.4%	25.4%
EPS	(0.34)	(0.21)	0.01	0.14
Earnings Growth	N/M	N/M	N/M	2369%
P/E (Attrib.)	N/M	N/M	1,088	44.07
DPS	-	-	-	-
Dividend Yield	0.0%	0.0%	0.0%	0.0%
BVPS	0.63	0.42	0.42	0.57
P/BV	10.1	15.2	15.0	11.2
CFPS(Operating CF)	(0.21)	(0.08)	0.22	0.38
P/CF	(30.3)	(83.1)	29.3	16.7
EBITDA (mn)	(956.8)	(189.8)	913.6	1,868
EBITDA Margin	-91.9%	-9.2%	26.3%	38.6%
EV/EBITDA	(28.1)	(152.5)	32.5	15.9
EV/Sub	43,631	20,233	13,825	10,682
Net Debt (Cash) (mn)	1,545	3,581	4,304	4,319
Net Debt (Cash)/ BV	61.2%	214.4%	254.1%	190.3%
Net Debt (Cash)/ Mkt cap	6.1%	14.1%	17.0%	17.0%

Figures are in AED unless otherwise stated



Estimate Changes

(AED mn)	2006e		2007e		2008e	
	Old	New	Old	New	Old	New
Revenue	N/A	N/A	1,041	N/A	2,067	
EBITDA	N/A	N/A	(956.8)	N/A	(189.8)	
EBITDA Margin	N/A	N/A	-91.9%	N/A	-9.2%	
Net Attrib. Income	N/A	N/A	(1,345)	N/A	(852.0)	

Stock Data:

Last Ex-Div Date	N/A
Mkt. Value (Local mn)	AED25,360
Shares (mn)	4,000
Av. Mthly Liqd. (mn)	AED1,635
52-Week High/Low	AED7.4 / 4.8
Bloomberg/Reuters	DU UH/DU.DU
Est. Free Float	20.0%

Wael Ziada
+20 2 332 1154
wziada@efg-hermes.com

Marise Ananian
+20 2 332 1152
mananian@efg-hermes.com

*As at 09 January 2007

KINDLY REFER TO THE IMPORTANT DISCLOSURES AND DISCLAIMER ON PAGE 39.

EXECUTIVE SUMMARY

Background

Emirates Integrated Telecommunications Company (EITC), branded as "du", is the UAE's second licensed telecom operator expecting to launch in the first quarter of 2007. du will initially offer mobile services including voice, data and video over a 3G/4G infrastructure. After launching its mobile business, du plans to offer advanced fixed line services, including triple play and fixed-to-mobile convergence (FMC) services, over a Next Generation Network (NGN). The offering of bundled and convergence services ahead of Etisalat will bear strategic significance for du as it positions the company as the UAE's first integrated telecom operator. du currently provides fixed line, internet and Pay TV services to more than 20,000 business and residential subscribers in Dubai Internet City, Dubai Media City, DIFC, Emirates Hills and Dubai Marina through the company's IP-based network which it bought early-2006 from TECOM Investments.

The government is the principal shareholder in du with 80% held both directly and indirectly through investment companies, while the remaining 20% is free float. We believe that the government's majority shareholding in du should provide a supportive regulatory backdrop which is important for the success of du, being a startup operator launching in a mature market.

Challenges and Opportunities of a Mature Market

We are cognizant of the major challenges that du will face in trying to build market share in a mature market with mobile and fixed line penetration rates running above 125% and 30% respectively. Moreover, du will be challenging the dominance of Etisalat, a well established monopoly with deep financial pockets and strong technical capabilities. The fact that most of the up-to-date telecommunication services have been introduced by Etisalat, (albeit on a different platform) leaves du with a little room for innovation in terms of bringing new services to the market. Although some value-added-services (such as video conferencing over mobile, Pay TV over broadband...etc) are not currently offered by Etisalat, one can argue that the scale of Etisalat will enable it to bring to the market any new service/technology in a relatively short period of time, which is likely to dilute du's attempt to gain a competitive edge through service innovation or differentiation.

That said, we believe that bringing 'choice' to customers in a monopoly market will play to the natural advantage of the second entrant and will shorten the critical market share build-up phase. Furthermore, we believe that du's trump card will be its ability to address the monopoly's existing areas of inefficiency in addition to adopting a different approach in providing services in the UAE in an innovative manner that would differentiate it from Etisalat. The main inefficiencies that we believe currently exist in the market that could provide a good opportunity for du are in the areas of: i) **Market segmentation**: especially in the mobile market which currently only has a single product offering for each of the postpaid and prepaid services, ii) **Advanced Value Added Services (VAS) penetration**: with 3G penetration of less than 2%, and iii) **Customer satisfaction**: similar to other monopoly markets, customer satisfaction is normally an area where a second entrant normally focuses on developing.

Forecasts

We expect du to capture a mobile market share of 9% by the end of 2007. However, it is important to bear in mind that subscriber additions may shoot up after du launches operations as existing Etisalat subscribers acquire a du account whilst maintaining their Etisalat account. This may result in the penetration rate exceeding our estimate for the size of the addressable market with reported subscribers coming higher than active revenue-generating subscribers. Subsequently, and with the introduction of mobile number portability (MNP), net additions would retreat significantly as some of the subscribers drop the service with one of the operators. We expect du's mobile market share to reach 33% by the end of 2010, which is inline with management's target to exceed 30% by 2010.

As expected, winning over some of Etisalat's subscribers is central for du to achieve its target market share and profitability and therefore a delay in the introduction of MNP beyond 2007 represents a risk to our subscriber forecasts.

du currently provides fixed line services to more than 20,000 subscribers in the Dubai Free Zones, Dubai Internet City, Dubai Media City, Dubai International Financial Center (DIFC), Emirates Hills, and Dubai Marina, all lying in the Dubai New Area. With a 100% market share in the aforementioned areas, we forecast an overall market share of 2% by the end of 2006. An important point to note is that most of du's existing fixed line subscribers are business customers. Although du will continue to focus on the business segment, we believe that a nation-wide roll out of the network will enable du to tap into the residential segment as well, especially after du fully launches its FMC services, which we expect to occur in early 2009. We expect du's fixed line coverage plan over the next 3 years to focus mainly on Dubai and Abu Dhabi, both together accounting for 69% of the UAE's total population. du's coverage will be dependent on full Local Loop Unbundling (LLU) at the incumbent exchanges to gain Last Mile access as we are not forecasting that du will build its own access network. We are forecasting that du's fixed line market share will reach 15% by the end of 2010.

We expect du to remain EBITDA negative in the first two years of operation. In 2009, the third year of operation, we expect du to generate a positive EBITDA of AED914 million (26% margin) and a barely positive bottom line of AED23 million. We expect the EBITDA margin to start rising afterwards and to stabilize in the high 40s.

We do not expect du to throw off free cash flow before 2010. According to our forecasts, du's peak-funding requirement of AED3.8 billion will be reached in 2009 which we expect the company to finance through debt. We are forecasting du's gross debt to increase gradually to reach a maximum of AED4.4 billion at the end of 2009 bringing the net debt/equity ratio to a high 2.54x. However, from 2010 onwards we are forecasting a steep decline in net debt as the company starts generating strong free cash flow.

Fair Value and Recommendation

We use a Discounted Cash Flow (DCF) model to value du and arrive at an estimated equity value of AED24.2 billion (USD6.6 billion), implying a long-term fair value per share of AED6.06. We use a cost of equity of 11.5% comprised of 4.5% risk free rate (RFR) and 7.0% equity risk premium (ERP) and a cost of debt of 6.0%.

Our long-term fair value estimate is 4% below the current market price of AED6.34. At the current market price, du is the 4th largest single-country operator in the region as measured by market capitalization. The current market capitalization for du is equal to 44.5% of Etisalat's adjusted market capitalization, after stripping out the equity value of the latter's non-UAE subsidiaries. This implies that, at current market prices, du is worth 30.8% of the combined market capitalization of UAE telecoms (the sum of du and the UAE operations of Etisalat).

Our assumptions for du's terminal mobile and fixed line market shares are 40% and 24% respectively by the end of 2015, which we believe to be quite bullish. Furthermore, we believe du will be less profitable than Etisalat as it is the second operator and it will take time to achieve that market share and steady state profitability. While we believe the stock to be expensive relative to its closest comparable, we believe it is fairly valued on an absolute basis. We therefore assign du a ST/LT Neutral recommendation.

I. BACKGROUND AND SHAREHOLDER STRUCTURE

Background

Emirates Integrated Telecommunications Company (EITC), commercially known as "du", is the UAE's second licensed telecom operator. The company was granted a full-fledged telecommunication license in May 2005. du plans to commence operations in the first quarter of 2007 offering voice, data, video, and content services over a 3G/4G mobile infrastructure. The company plans to achieve 100% coverage of the UAE upon launching operations, with at least 70% of the coverage provided through its own network and the rest to be secured through a national roaming agreement with the current monopoly operator Etisalat.

After launching its mobile business, du plans to offer nation-wide advanced fixed line services to residential and business customers through a Next Generation Network (NGN). du plans to establish itself as the UAE's first integrated mobile operator by offering triple play services (high-speed internet, telephone service, and video bundled over one broadband connection). Triple play is gaining popularity in Europe and is a much sought after standard by telecom operators. At an even later stage, du plans to offer fixed-to-mobile convergence (FMC) services which were recently introduced in a few Western European markets such as Italy and France.

du currently provides fixed line, internet and Pay TV services to some 20,000 business and residential subscribers in the free zones and Dubai Internet City, Dubai Media City, DIFC, Emirates Hills and Dubai Marina through an IP-based fixed line network that the company acquired in early 2006 from TECOM Investments.

Capital and Shareholder Structure

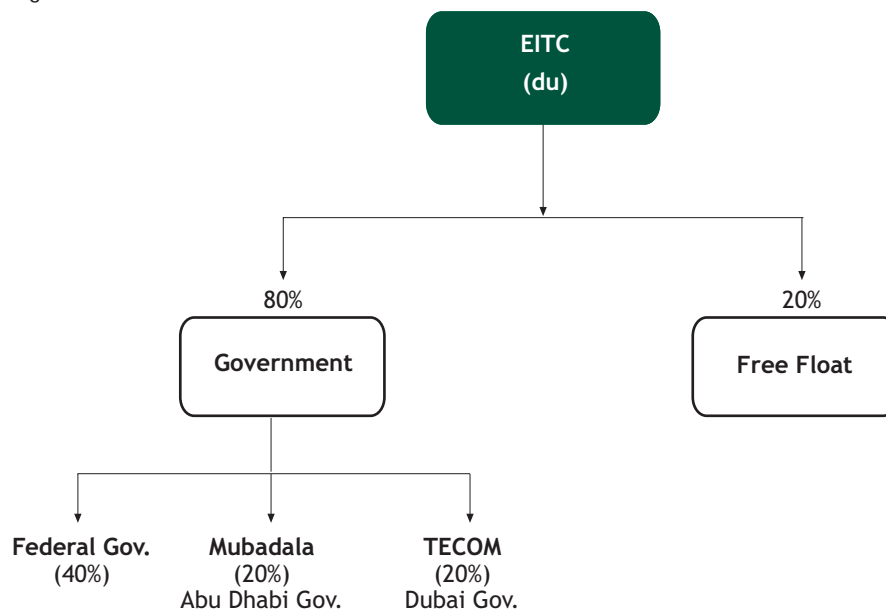
*du's AED2.4 billion IPO was
167 times oversubscribed*

du has a paid-in capital of AED4.0 billion distributed over 4 billion shares (par value: AED1.0). In April 2006 the founding shareholders (the Federal Government, Mubadala Development Company, and TECOM Investments) sold in an initial public offering (IPO) 20% of their shares (800 million shares) for AED3.03 per share. The AED2.4 billion IPO was oversubscribed by 167 times. du is listed on the Dubai Financial Market (DFM).

*The government is the
principal shareholder in du
with an 80% stake*

Following the IPO, the Government remains the main shareholder in du with a total of 80% held both directly and indirectly through wholly owned subsidiaries. It is worth noting that the UAE government is also the principal shareholder in Etisalat, the country's first telecom operator, with a 60% stake.

Figure 1.1: du Shareholder's Structure



Source: du

The UAE Federal Government (40%):

The UAE Federal Government is the largest shareholder of du through the Ministry of Finance. The UAE Federal Government is the highest ruling authority for the seven independent Emirates.

Mubadala Development Company (20%) - Government of Abu Dhabi:

Mubadala Development Company is a private equity company, 100% owned by the Government of Abu Dhabi with investments in various industries such as energy, real estate, basic industries, utilities, energy and services.

TECOM Investments (20%) - Government of Dubai:

TECOM Investments, also known as DIC Telecom, is a wholly owned subsidiary of Dubai Holding, which is in turn 100% owned by the Government of Dubai. TECOM owns and operates a tax-free commercial zone that was initially set up to support the development of knowledge-based industries. The area embraces Dubai Internet City, Dubai Media City, Dubai Knowledge Village, and other free zone city establishments. du acquired from TECOM telecom assets that TECOM held through three subsidiaries, Sama Communications Company, DIC Telecom and TECOM's technology division, for a total consideration of AED1.13 billion.

II. REGULATORY ENVIRONMENT IN THE UAE

UAE Regulatory Milestones

We present below a chronological account of the main regulatory milestones in the deregulation of the UAE telecommunication market:

1991 --- Federal Law No. 1 (1991) establishes Etisalat as the sole telecommunications provider in the UAE.

1998 --- Federal Law No. 28 (1998) extends Etisalat monopoly to other areas in the telecommunication industry giving it a total monopoly over the market.

2003 --- Federal Law No.3 (2003) calls for telecom reform and liberalization and establishes the Telecom Regulatory Authority (TRA).

2004 --- Government announces a plan to end monopoly of Etisalat, no deadline announced.

2005 --- TRA announces the issuance of a second telecommunication license.

2006 --- The TRA grants Emirates Integrated Telecommunication Company (du), a full services license for USD33.9 million to be renewed annually for a fixed sum of USD272,000.

Scope of the TRA

The Telecom Regulatory Authority (TRA) was established in the UAE in November 2004 as an independent entity following the government's decision in 2003 to liberalize the sector. Prior to that, the incumbent operator Etisalat carried out the regulatory function. The TRA is headed by a Supreme Committee that reports to the Ministry of Government Sector Development. The regulator indicated in a recent meeting that the following payments will be imposed on both du and Etisalat:

- i) Spectrum fees
- ii) Annual license fees
- iii) Contributions to ICT funds
- iv) Royalty fees

The Royalty fee has been paid by Etisalat even before the establishment of the regulator. As per the current regulations, the Royalty fee is equal to 50% of the consolidated net profit. However the minister of Telecommunication announced recently that the Royalty fees will be reduced gradually to 40% of net profit over the next 3-4 years. The amounts pertaining to the other payments have not been specified by the regulator, however we do not expect them to be as significant as the Royalty fee.

MNP and carrier pre-select services will be introduced following the entrance of du

The regulator also confirmed that Mobile Number Portability (MNP) would be introduced to the market as well as carrier pre-select services following the entrance of du. MNP enables subscribers of one operator to maintain their number (including prefix) when they transfer to another service provider. As for carrier select and pre-select services, they allow subscribers to choose between different fixed line providers for both local and international calls.

Concluding Remarks

We expect asymmetric regulation to support du at the beginning

It should be noted that Etisalat, with its current scale and financial strength, can withstand competitive onslaughts from almost any new entrant and may even be able to drive the entrant out of business. This makes it essential to have policies that support the new entrant. Therefore, we expect an asymmetric regulatory environment to prevail, at least in the beginning, in support of du over the well established incumbent Etisalat. We believe such an asymmetric policy will be very important for du's success, especially in the mobile market, where the penetration rate has exceeded 125%.

In the table below we present the TRA's main regulatory functions and how some of these functions can provide support to a start-up operator in an asymmetric regulatory environment.

Figure 2.1 : TRA Main Regulatory Functions

	TRA Role	Implication for a Startup (Asymmetric Scenario)
Tariffs	Approves all forms of tariff plans, services bundling, and promotional offers.	<ul style="list-style-type: none"> Prevents price wars while allowing the start up to offer more attractive prices.
Fees and Licensing	Determines all forms of fees & charges imposed on telecom operators.	<ul style="list-style-type: none"> du might initially be exempted from paying royalty fees until becoming more established. Moreover, a second entrant is naturally less privileged, and therefore one might expect du to pay lower royalty fees relative to Etisalat.
National Roaming & Infrastructure Sharing	Regulates access to networks & infrastructure sharing among operators.	<ul style="list-style-type: none"> Etisalat will have to provide national roaming in areas that will not be initially covered by du's network. This will enable du to achieve full coverage upon launching. Local Loop Unbundling (LLU), if mandated, will also enable du to access Etisalat's fixed line network.
Interconnection	Monitors and facilitates the process.	<ul style="list-style-type: none"> Call termination charges can be used as a tool to lower interconnection costs and/or increase revenues.
Dispute Settlement	Sets dispute resolution policies.	<ul style="list-style-type: none"> Ensuring the timely resolution of disputes which normally have a significantly worse impact on the start-up relative to the incumbent should they take a long time to resolve.
Numbering Plans	Allocates numbering plans and regulates number portability.	<ul style="list-style-type: none"> Introduction of MNP should enable du to grow its market share faster in addition to capturing high spending customers from the incumbent. Given the UAE's relatively small population, we do not believe that regulating numbering capacity should be an issue
Service Provision	Ensures that operators meet minimum quality standards.	<ul style="list-style-type: none"> This might be marginally positive for du as it is easier for the newcomer to apply required quality standards relative to the incumbent.
Spectrum	Manages and allocates radio spectrum.	<ul style="list-style-type: none"> As subscriber numbers grow, spectrum allocation becomes more important. We do not believe this can be an effective tool in an asymmetric regulatory environment.

Sources: TRA and EFG-Hermes

Winning over some of the incumbent's subscribers would be central for du's success

We believe that fast population growth in the UAE is an important driver enabling du to grow its subscriber base relatively fast. Nevertheless, as a new entrant into a fully saturated market, we believe du would depend greatly on churned customers from Etisalat to grow its subscriber base as well as winning over some of the high-spending customers from the incumbent.

Expect some resistance from Etisalat

That said, it should be noted that in markets with more than one operator, the negative impact of the introduction of both competition and asymmetric regulations tends to be diluted among existing players. Given that Etisalat is the only existing operator in the market, we expect some resistance from Etisalat with regard to the introduction of asymmetric regulation.

III. SECTOR OVERVIEW

A. Entry of the Second Player

Why Now?

We have chosen to start this section by addressing the frequently asked question: why introduce a second player to the UAE now? Mobile penetration has already surpassed 125%, 3G technology was introduced 2 years ago and fixed line penetration is above 30%, the highest within the GCC and other countries in the region.

The main driver is sector liberalization and...

We believe the main reason behind the introduction of a second operator now is to end the 30-year monopoly of Etisalat which is an important step toward full liberalization of the sector as per the UAE commitments to the World Trade Organization (WTO).

...chalking up bilateral agreements with the US

According to media sources, another very important reason for the UAE to liberalize the sector is to urge the US to open its markets to UAE companies in exchange for liberalizing the sector 5 years earlier than the deadline set by the WTO which is 2015.

UAE is a late mover to the liberalization of the telecom sector in the GCC

Moreover, with the exception of Qatar, all of the other GCC countries have either fully or partially liberalized their telecom sector, at least, in the area of mobile communication, leaving the UAE lagging behind in that respect.

Table 3.1: Number of Mobile Operators and Penetration in Arab Countries

Country	Number of Licensed Operators	Mobile Penetration Rate*	Date of Launch of 1st Operator	Date of Launch of 2nd Operator
GCC				
UAE	2	120%	Sep-94	-
Bahrain	2	118%	May-95	Dec-03
Qatar	1	99%	Feb-94	-
Kuwait	2	93%	Nov-94	Dec-99
Oman	2	64%	Nov-96	Mar-05
Saudi Arabia	2	63%	Jan-96	May-05
Other Arab Countries				
Jordan	4	67%	Aug-95	Sep-00
Tunisia	2	57%	Mar-98	Jan-03
Algeria	3	46%	Apr-98	Feb-02
Morocco	2	40%	Apr-94	Mar-00
Lebanon	2	29%	Mar-95	Jun-04
Egypt	3	20%	Nov-96	Nov-98
Syria	2	19%	Jan-01	Apr-01
Libya	2	4%	Dec-96	Sep-04

*As of June 2006
Sources: MEAWA and Company Reports

Is Etisalat silently eying the battlefield or lulled into inaction?

What is Etisalat's Stance?

In a recent meeting with Etisalat, we were surprised at the company's unruffled approach toward the entry of competition. We are cognizant of the fact that Etisalat is well-equipped for competition with both strong financial and operational capabilities. However, we believe that the company's unruffled stance toward the upcoming competition could also be attributed to the following:

- i) Competition by du is viewed largely as being local and not brought by an international player, such as Vodafone for instance, whose scale, marketing capabilities and brand recognition, especially in an expatriate environment like the UAE, could have constituted a greater threat for Etisalat.
- ii) The failure of du would essentially mean the failure of the liberalization process and could backfire at Etisalat should it result in the introduction of more competition into the market.
- iii) Etisalat is expanding outside the UAE, albeit with its local operations still representing more than 73% of the market value of the company, which should partially compensate for a loss in domestic market share.
- iv) The UAE government owns 80% of du, both directly and indirectly, and 60% of Etisalat, which, in our opinion, relieves management from the pressure of having to fight back aggressively against new competition which might have been the case if the principal shareholders had been different.

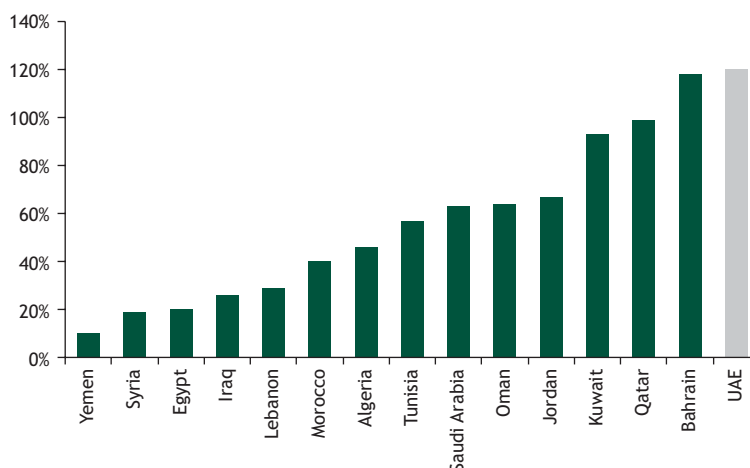
B. The Mobile Market

Overview

UAE has the highest penetration rate in the region

The UAE has the highest mobile penetration rate in the region, exceeding 120% at the end of June 2006, despite being only one of two countries in the region with a single mobile operator.

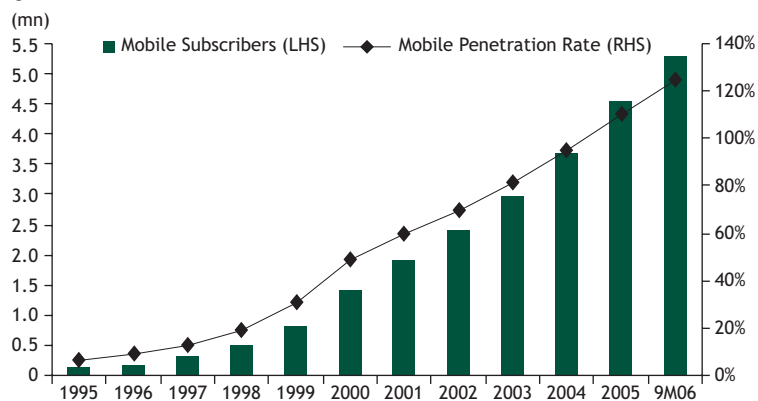
Figure 3.2: Mobile Penetration Rates Across the MENA Region - End June 2006



Sources: Etisalat and International Telecommunication Union (ITU)

Between 2000-2005 mobile subscribers grew at a CAGR of 26% on the back of strong growth in both the economy and population (driven primarily by the fast growing expatriate community).

Figure 3.3: Mobile Subscribers and Penetration Rate in the UAE 1995-9M2006



Sources: Etisalat and ITU

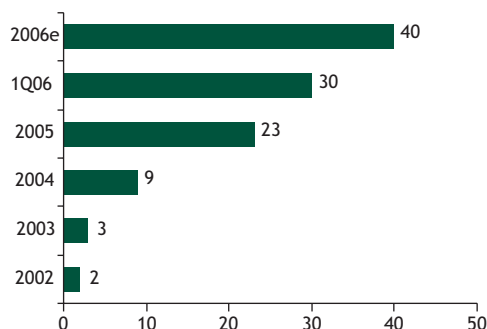
Prepaid subscribers represent around 85% of the total subscriber base. Etisalat was the first mobile operator to introduce 3G services into the MENA region in 2004. However, the take-up of the service was rather weak with 3G subscribers accounting for less than 2% of Etisalat's subscriber at the end 3Q2006.

The Mobile Addressable Market

What does an "above 100%" mobile penetration rate mean?

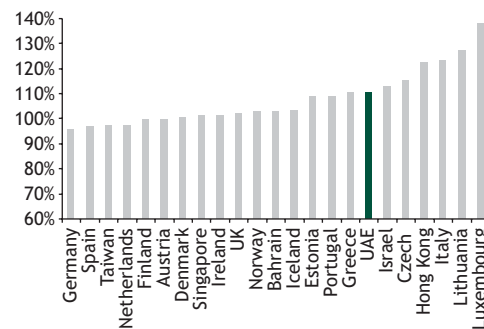
In 2003, only 3 countries in the world had a mobile penetration rate of more than 100%. At the end of 1Q2006 around 30 countries saw their mobile penetration rate exceed 100%. Moreover, it is estimated that by the end of 2006 more than 40 countries will have mobile penetration rates in excess of 100%.

Figure 3.4: Evolution of number of Countries with More than 100% Mobile Penetration



Sources: ITU and Informa Telecoms

Figure 3.5: Countries with Penetration of Approx. 100% or more (2005)



Due to multiple accounts per customer, reported penetration overstates actual human penetration...

The situation of a penetration rate approaching or even exceeding 100% is the result of customers having more than one account, also known as the multiple-SIM phenomena. In countries such as the UAE, with high income levels, owning two mobile accounts, both a personal and a business line, is becoming the norm. Moreover, the proliferation of business devices such as the Blackberry and data SIM cards has resulted in the number of accounts per user rising to even three or four.

Another factor which has contributed to the multi-SIM phenomena, however not currently relevant to the UAE, is subscribers of one operator buying a line from another operator to take advantage of promotional cheap-rate offers. Finally, the purchase of mobile lines by tourists during the duration of their visit, also contributes to the phenomenon of above-100% penetration, especially for a country like the UAE which receives around 7.0 million tourists per year, 1.5x the country's population size.

...and falsely indicates pre-mature saturation

Therefore, a serious shortfall in penetration as a measure of mobile service proliferation is that it does not compare like with like as it uses the number of accounts in the market (measured by SIM cards) against the headcount of the population. Market surveys indicate that in countries with mobile penetration exceeding 100%, the average number of accounts per person taking a mobile service is around 1.5.

Multiple-SIM masks the real human ARPU and understates the value of incremental customers

Moreover, the double-counting of subscribers understates the real human Average Revenue per User (ARPU) and exaggerates the dilutive impact of real new subscribers given that some of the new accounts are in fact existing subscribers buying in another line. Not taking this fact into account understates future ARPU forecasts. However, we leave the discussion of this point to the financial forecast section.

Estimating the size of the UAE Addressable Market

We define our addressable population as 'the group of individuals in a market who are eligible and economically capable of owning a mobile'. We would like to make a distinction between the "addressable market"; which is comprised of all the accounts to be sold in the market and the "addressable population"; which is comprised of all the individuals who will purchase these accounts.

Therefore, a good starting point for estimating the size of the addressable market in the UAE is to segment the population by age and economic status.

In countries with GDP/Capita similar to the UAE, it is usually estimated that around 70% of the population is addressable. This comes after stripping out both the under-10 and the above-70 age groups. This would normally result in an addressable population of around 70%.

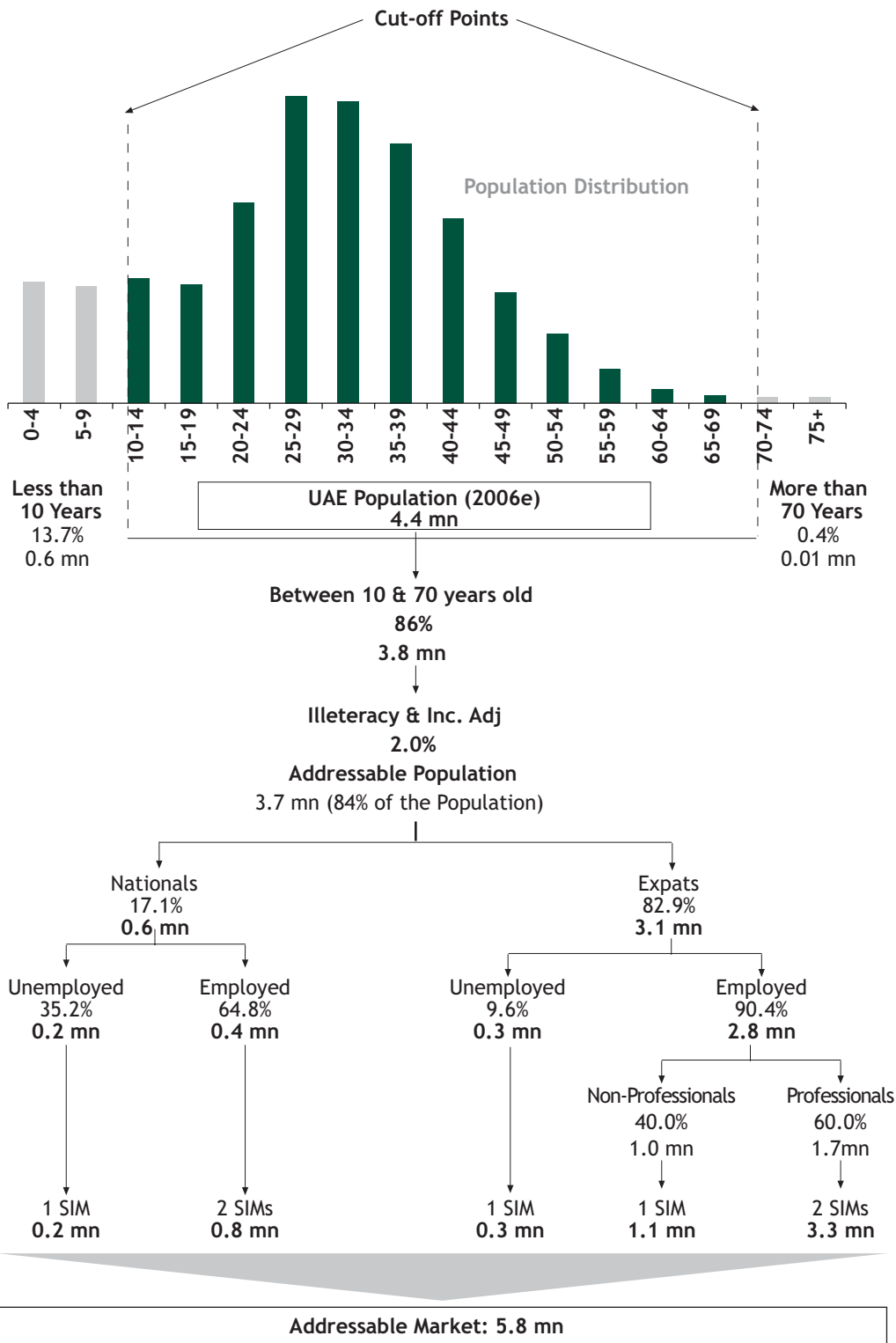
High number of expatriates in the population increases the addressable market as a percentage of the total

However, we argue that this figure would be higher in the case of the UAE due to the presence of a high number of expatriates in the population (80%+) which tends to lower both the under 10s and the above 70s age groups as a percentage of the total population relative to other countries with lower expatriate participation.

The Addressable Market - Main Assumptions

- 1- Potential market (Cut-off points): Below 10 and above 70 years old
- 2- Illiteracy and Income Factor: Reduces potential market size by 2% (Western Europe Standard)
- 3- Population below employment age will own only 1 Account
- 4- Employed Nationals will own 2 Accounts
- 5- Employed Non-Professional expatriates will own 1 Account
- 6- Employed Professional expatriates will own 2 Accounts

Figure 3.6: Flow Chart Depicting Our Main Assumptions Regarding the Mobile Addressable Market in the UAE



Sources: UAE Population Census 2005 and EFG-Hermes estimates

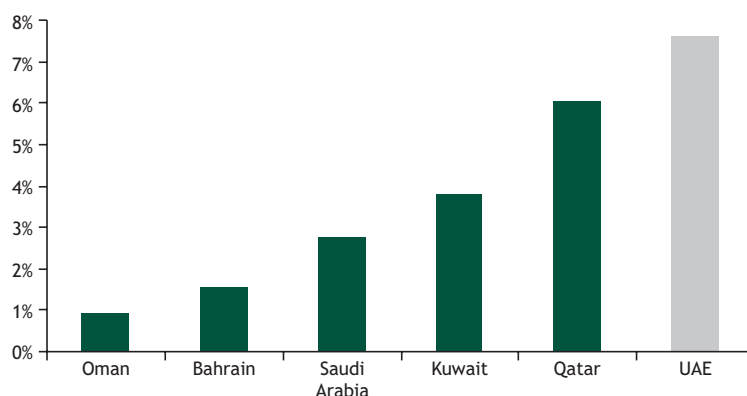
We estimate an addressable market of 5.8 million in 2006

Based on a 2006e population estimate of 4.4 million, we estimate an addressable mobile market of 5.8 million. This implies an average of 1.6 accounts for each person in the addressable population, slightly higher than the European average. More importantly, this ratio implies that the actual human penetration in the UAE (measured as real users/population) is less than 2/3 of the reported penetration figure. This takes penetration rate in the UAE from the reported 125% down to around 77%. As we are estimating that 84% of the population are actually addressable, our adjusted penetration figure of 77% implies that there is still an untapped potential in the market equal to 7% to the population or just under 10% of the existing subscriber base.

The UAE's fast-growing population increases du's chances of gaining market share rapidly

We agree that the residual untapped portion of the market is not very large and perhaps will not be the most lucrative. However this untapped base represents an opportunity for a start-up operator like du. Moreover, we argue that the UAE's fast growing population, with the highest growth rate in the GCC, will be another driver for subscriber growth in the medium term.

Figure 3.7: Population Growth in the GCC (5-year CAGR)



Source: IMF

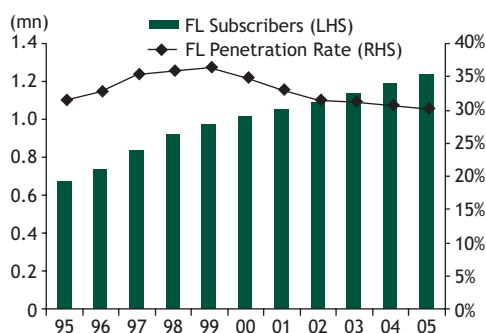
If the UAE's population continues to grow from 2006-2010 at the same growth rate of the past 5-years (a CAGR of 7.6%), the addressable market would add an average of 460,000 subscribers per year during this period. This implies that the number of subscribers that would correspond to a fully-penetrated market in 2010 would be estimated at 7.6 million, 31% more than the 5.8 million that we currently estimate for 2006.

C. The Fixed Line and Internet Market

Fixed Line

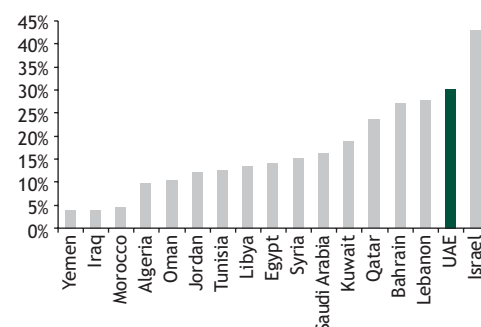
With 1.28 million fixed line subscribers in September 2006, the fixed line penetration rate in the UAE stands at 30%, the highest in the MENA region after Israel which has a population of 6.7 million, a GDP/Capita of USD18,303 and a fixed line penetration rate of 43%.

Figure 3.8: Historical Fixed Line Subscribers and Penetration Rate in the UAE



Sources: Etisalat and ITU

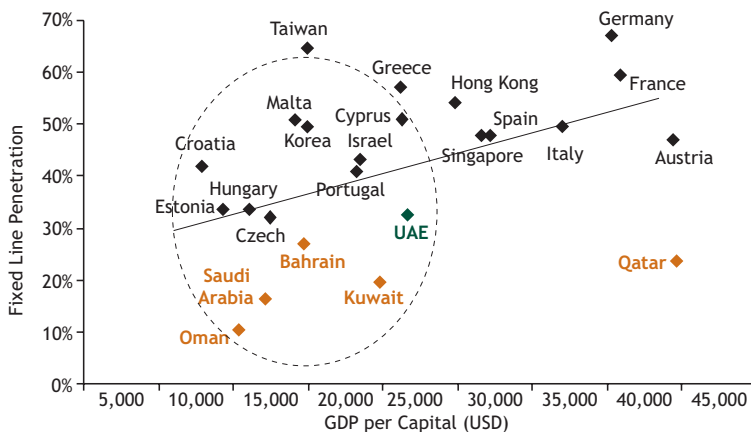
Figure 3.9: Fixed Line Penetration Rate in the MENA Region (2005)



Sources: ITU and Company reports

However, when plotted against GDP/per capita, fixed line penetration rate in the UAE appears to be relatively low compared to other European and Asian countries as shown in figure 3.10.

Figure 3.10: Fixed Line Penetration Rates versus GDP per Capita (2005)



Sources: ITU, IMF and Company operators

Introduction of competition is expected to boost fixed line growth

Figure 3.10 reveals an interesting fact: GCC countries, which all have monopoly fixed line operators, have a low penetration rate compared to European or Asian countries with similar GDP per capita but with more than one fixed line operator. This suggests that the introduction of competition from du would stimulate fixed line growth in the UAE.

Internet and Data

Dial-up

Etisalat is the only Internet Service Provider (ISP) in the UAE. Again, the UAE has the highest internet penetration rate in the region, which stood at 34% at the end of 2005 or 1.4 million internet subscribers.

Etisalat charges monthly dial-up subscription fees of AED20 (USD5.5) and usage fees of AED1.8 (USD0.5) per hour, which is relatively expensive when compared to a country like Egypt with no monthly fees and subscribers being charged for the duration of the local call only.

Broadband

Broadband market still not mature

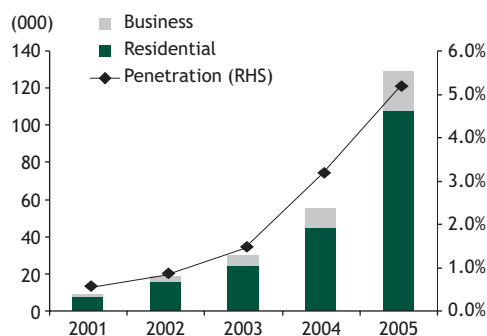
The broadband penetration rate in the UAE stood at an estimated 8% at the end of September 2006, in line with the region's average but lower than the European country range of 18-24%. In September 2005, Etisalat reduced its monthly broadband charges by 46%, which resulted in a leap in broadband growth which stood at 5.1% at the end of 2005.

Introduction of VoIP to boost broadband usage

Voice Over Internet Protocol (VoIP) services are currently banned by the TRA. Etisalat has been fighting illegal providers of VoIP over the past years due to the negative impact on the company's international traffic, which currently represents around 70% of the Etisalat's fixed line revenue. Again, due to the high number of expatriates in the country, a major source of revenue comes from international outgoing and incoming calls.

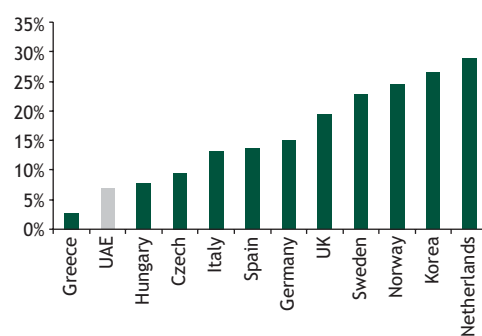
However, the introduction of VoIP should be a very important development for broadband usage growth. According to statistics, international VoIP traffic worldwide grew more than three times faster than international traffic from both mobile and fixed line services during the past three years.

Fig. 3.11: Breakdown of Broadband Subscribers and Broadband Penetration Rate in the UAE



Source: Etisalat

Fig. 3.12: Broadband Penetration Rate in Selected Countries (June 2006)



Source: Organization for Economic Co-operation and Development (OECD)

We estimate an addressable market equal to 44% of population

The Fixed Line and Internet Addressable Market

Generally, the fixed line addressable market is more straight-forward and easier to estimate than the mobile market. We are estimating a fixed line addressable market equal to 44% of the population. This implies an addressable market of 1.9 million lines based on the 2006 population estimate. The main assumptions underlying our estimate are:

- i) A Residential addressable market equal to 29% of the population based on an average household size of 3.1 and a service penetration to household (SPH) ratio of 90%.
- ii) A Business addressable market equal to 15% of the population as we are assuming one line per 5 employed members of the population which is in line with the European country average.

At this point of time we would like to make an important point: The emergence of IP-based networks has made it possible to provide traditional voice telephony, data and video over a single broadband connection. du is planning to offer its fixed line service through an IP-based Next Generation Network (NGN) and is planning to grab market share by offering triple play services. Moreover, Etisalat has recently indicated that it will be moving into an IP-based platform as well. Therefore, we believe that the distinction between a broadband line and the traditional fixed line will become increasingly blurred. Therefore, we are not formulating a separate estimate for the broadband market as we believe that eventually both services will fully converge.

Finally, the construction boom and the high population growth rate (driven primarily by the fast growing expatriate community) in both Dubai and Abu Dhabi are expected to provide further impetus for fixed line growth over the coming period. We forecast fixed line subscribers will grow at a CAGR of 9.2% over the coming five years leading to a fixed line penetration rate of 35% by 2011.

IV. THE BUSINESS MODEL

What is du going to do?

Offering the full suite of telecommunication services

du is planning to offer the full suite of communication services in the UAE which includes:

- Mobile Telephony (3G)
- Fixed line Telephony - Local, National and International over a NGN
- Internet and Broadband Services
- Media Services (Pay TV, Home Cinema etc...)

However, none of these services are new to the market

Alas, all of these services have been introduced by Etisalat (albeit on a different platform), which leaves du with a little room for innovation in terms of bringing in new services to the market. Although some value-added-services (such as live video conferencing over mobile, Pay TV over broadband...etc) are not currently offered by Etisalat, one can argue that the scale of Etisalat will enable it to bring to the market any new service/technology in a relatively short period of time which is likely to dilute du's attempt to gain a competitive edge through service innovation or differentiation.

So what is the case for du?

We are not trying to portray a negative picture for the prospects of du, however it is important to acknowledge the challenges that du will face in trying to grab market share from a monopoly such as Etisalat with deep financial pockets and strong technical capabilities.

du's trump card will be using areas of inefficiencies in the monopoly to its advantage

That said, we believe that du's main competitive edge will be its ability to address areas of inefficiency in the monopoly in addition to adopting a different approach to providing services in the UAE in an innovative manner that would differentiate it from Etisalat. We discuss below the areas where we believe inefficiencies currently exist and which we believe provide a good opportunity for du:

i) Market Segmentation

Evidence: This is very obvious in the mobile segment which has only a single offering for each of the prepaid and postpaid subscribers. We believe the current number of product offerings is very low especially for a cosmopolitan population such as that of the UAE, embracing virtually all income-brackets.

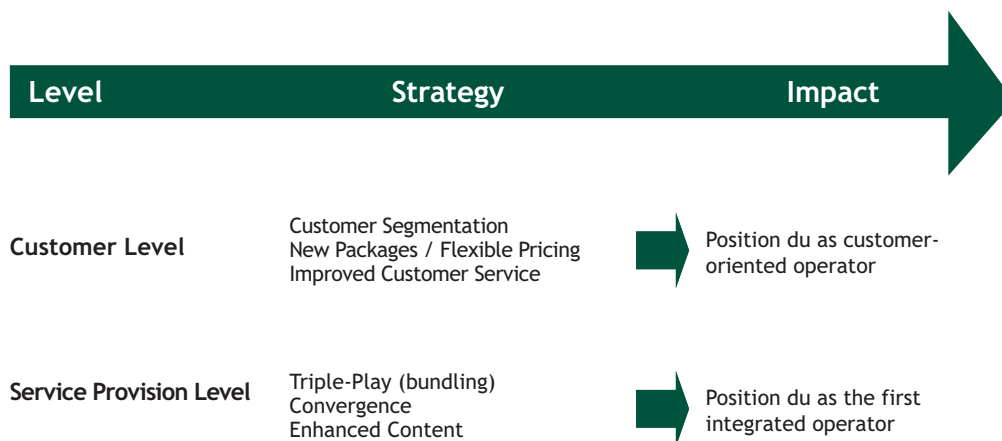
ii) New Services Penetration

Evidence: Despite being introduced more than 2 years ago, 3G penetration has not exceeded 2% in the UAE (fewer than 400,000 subs). In some European countries that have similarities to the UAE market, 3G penetration has reached 8-12%. Moreover, broadband penetration, despite picking up recently, remains below 8%. This is low, especially for an affluent economy and a business-oriented culture such as that of the UAE. Finally, the bundling of services is almost nonexistent. Double and triple play offerings are starting to generate some top line growth for operators in European and Asian countries that also operate in saturated telecom markets.

iii) Customer Satisfaction

Evidence: According to a non-commissioned market survey conducted by Emirates Today¹, nearly 25% of 524 participants polled have shown dissatisfaction with the customer service provided by Etisalat. We will provide the full findings of this report in a later section.

Therefore, and based on the previous discussion, we group the areas on which we believe du will focus on under two levels that we depict in the following chart:



Source: EFG-Hermes estimates

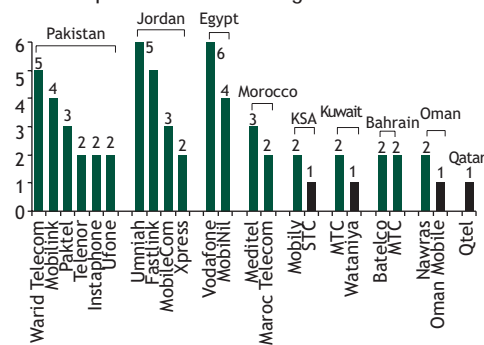
A Final Word on Pricing

A price war would be more damaging for du

We do not expect du to compete for market share, especially in the mobile market, by offering lower prices. Retaliation by Etisalat may ultimately deteriorate into a price war which will be more damaging for du given the much larger scale of Etisalat. We therefore, believe that the only way for du to offer more attractive pricing is by providing various packages that suit the different consumer spending patterns without having to resort to directly slashing headline tariffs. We believe that this strategy of pricing would be mostly relevant to the prepaid segment, where the demand for usage and validity differ among different income classes.

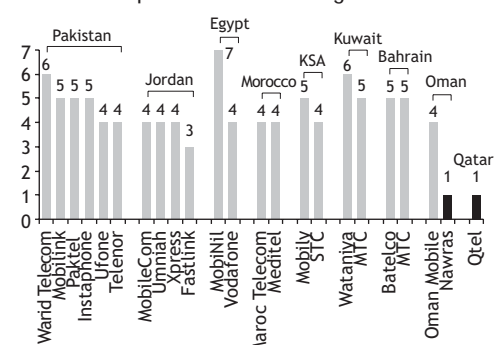
As we have previously indicated the absence of market-segmented offerings in the UAE represents an opportunity for du, especially in the mobile market which has only a single offering for each of the prepaid and postpaid services. Figures 4.1 and 4.2 illustrate the number of prepaid and postpaid offerings for different operators in the region. We believe that a market with segmented offerings will help du to gain market share from Etisalat, especially in the middle and low income brackets which, like almost all markets, constitute the bulk of the subscriber base.

Fig. 4.1: Number of Prepaid Packages for Mobile Operators in the Region



Source: Operators

Fig. 4.2: Number of Postpaid Packages for Mobile Operators in the Region



Source: Operators

Etisalat could face restrictions on service bundling

Moreover, the bundling of services such as offering triple and quadruple-play could help du to gain market share, assuming Etisalat does not launch these services before du, without having to resort to any form of price wars. In an asymmetric regulatory environment, Etisalat, being classified as a dominant operator, may face restrictions with regard to service bundling.

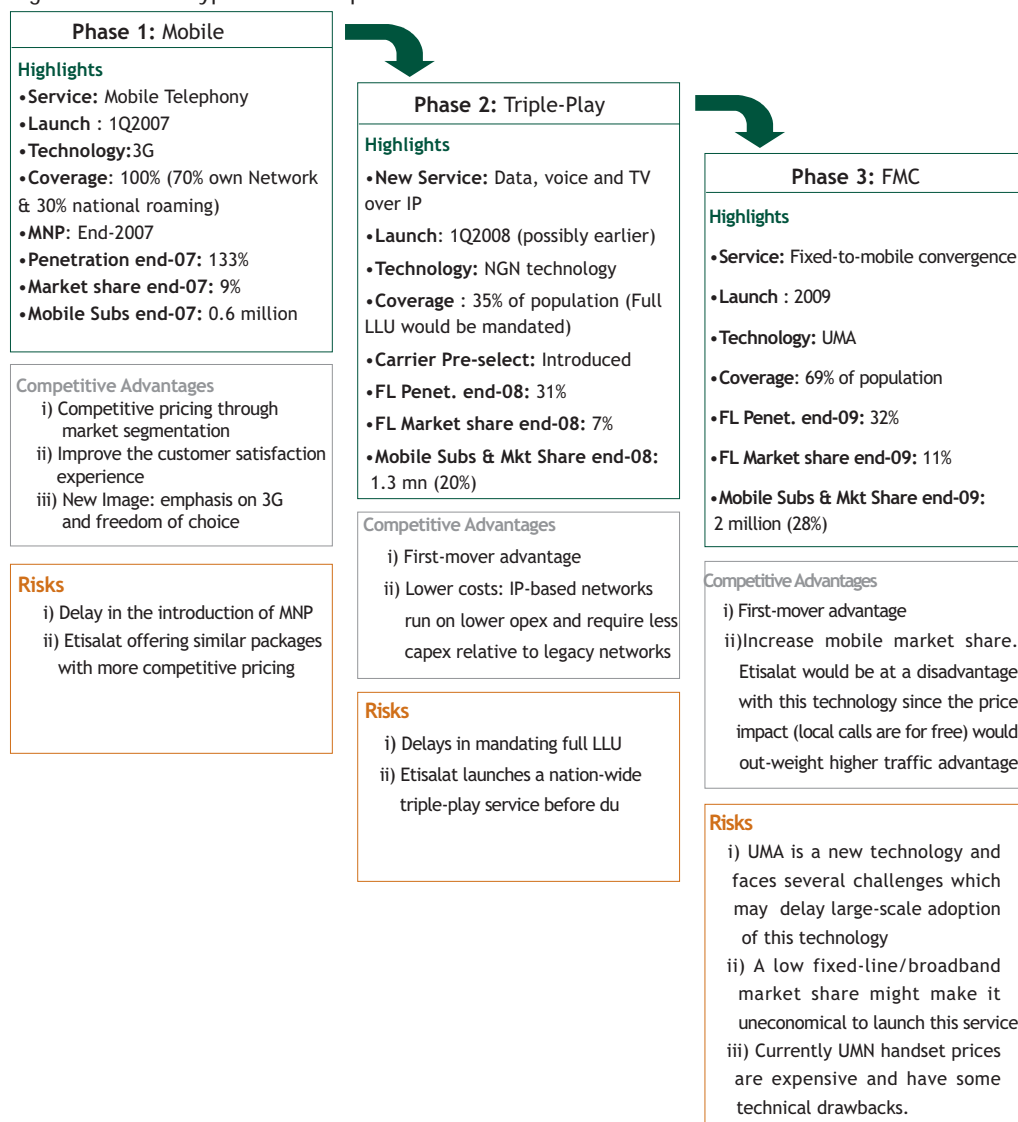
Better quality of customer service can make a difference

Finally, we believe that providing a better customer service relative to Etisalat would help du to grab subscribers from the incumbent. The factors influencing the ability of an operator to retain customers change with the level of market maturity. When operators are on an equal footing with regard to coverage and prices, customers switch focus to service quality which then becomes an important factor in choosing the service provider.

Tying it all Up

From our discussion with management we formulated a 3-phase hypothetical plan with our main technical and operational assumptions for each phase. We have also provided the risk that we see relevant to each phase.

Figure 4.3: du's Hypothetical 3-phase Business Model



Source: EFG-Hermes

APPENDIX A - OVERVIEW OF TECHNICAL TERMS

Next Generation Network (NGN)

NGN is all about building an IP-based network that is capable of supporting all traffic types: voice, data and video, over the same physical infrastructure. The NGN business case is primarily about cost reduction (both opex and capex). Moreover, services bundling is seen by many operators as an important driver for broadband growth and for increasing the return on invested capital (ROIC) of the fixed line business.

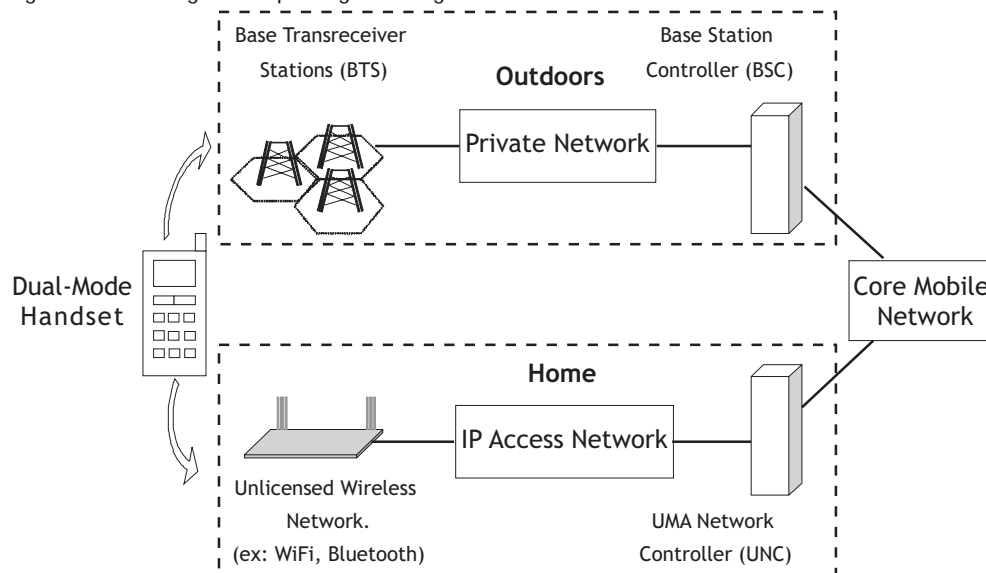
Triple and Quadruple-Play

Triple Play is simply the provisioning of the three services: high-speed internet, television (Video on demand or regular broadcasts) and telephone service over a single broadband connection (can be cable or copper connection). Convergence technology (which we will explain below) made it possible to introduce wireless access to the triple play service to achieve quadruple play. While individual quadruple play may vary, the basic concept remains the same: It involves using the broadband pipe into the home to carry mobile and fixed voice, broadband, video and broadcasting services into home. Content will be piped around the home by WiFi.

Convergence Service

In its simplest terms, convergence service allows users to make calls over a fixed-line (broadband) connection when they are at home and over a mobile network when outside home. The service uses Unlicensed Mobile Access (UMA) technology to facilitate a handover between the internet/fixed line and the mobile network. In essence, this means that a user speaking on the phone over his or her broadband link could leave the home without dropping the call: it would "seamlessly" move the call onto the mobile network.

Figure 4.4: A Diagram Depicting Convergence Network Architecture



Source: EFG-Hermes

Will FMC Take-up in the UAE

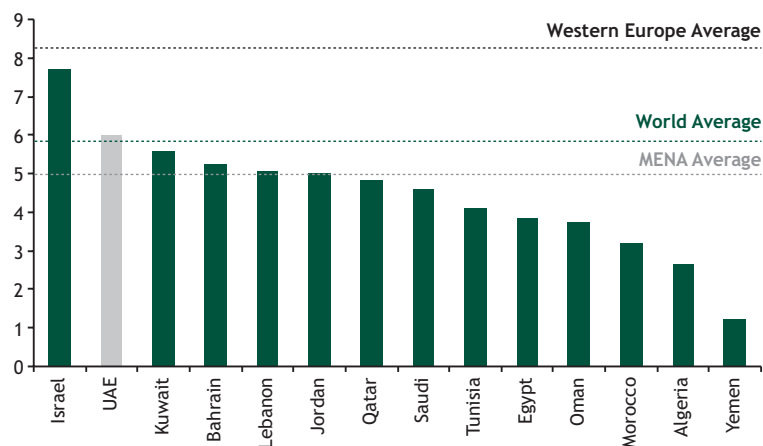
From a consumer perspective, the incentive to subscribe to this service is in the cost savings. Taking Orange's convergence package "Unik" as an example, subscribers are able to make an unlimited number of calls to landlines and Orange mobiles when they are at home for a fixed monthly fee. Moreover, the UAE market has strong demand for new technologies, evident in country's high global ranking (above world average) in terms of its knowledge and technology readiness. We present some of the main technology readiness indicators in Appendix B.

APPENDIX B - UAE TECHNOLOGY INDICATORS

In this section, we provide some indicators showing the UAE's ranking in terms of knowledge and technology readiness compared to global and regional benchmarks.

The UAE has a well-developed, technologically-advanced telecommunications infrastructure. The country's readiness for a knowledge economy is the highest in the Arab world. According to the Knowledge Economic Index (KEI), a benchmarking tool created by the Knowledge for Development Program to help countries identify the challenges and opportunities they face in making the transition to a knowledge-based economy, the UAE ranks in the 42nd position among 128 countries covered, which is above the world average and the highest in the Arab World.

Figure 4.5: Knowledge Economy Index for MENA Region Countries



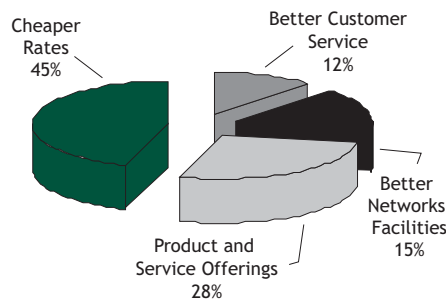
Source: World Bank

The Network Readiness Index (NRI) is another benchmarking tool developed by the World Economic Forum (WEF) used to assess the progress of a country's environment for Information and Communication Technology (ICT) as well as its readiness for usage of ICT. In the 2005-2006 report, the UAE was ranked the 28th among 115 countries.

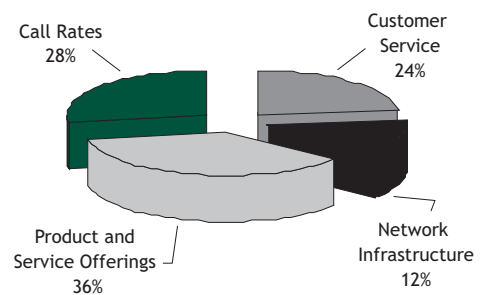
APPENDIX C - CONSUMER SURVEY PUBLISHED ON EMIRATES TODAY ON 30 OCTOBER 2006

Illustrated below are the findings of the survey that was conducted by Emirates today on 524 participants between the ages of 18 and 50.

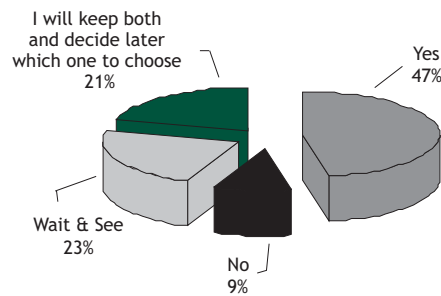
1. Which areas do you think du needs to focus on most to compete with Etisalat?



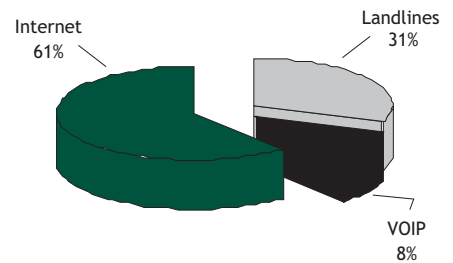
2. Which areas do You think will have the biggest impact after the launch of du's services?



3. Would you switch to du when it starts its mobile services before the end of the year?



4. Which service should du focus on after the launch of its mobile offering?



Source: Emirates Today

V. FORECASTS

A. Mobile Subscribers and Revenue Forecasts

Subscribers

du is expected to launch operations during the first quarter of 2007

du is expected to launch services toward the end of 1Q2007. The company had originally planned to launch operations before the end of 2006, however media sources (Gulf News 29 November 2006), citing management, have indicated that technical difficulties encountered in network roll-out was the main reason behind a delay in the launch date to the end of the first quarter of 2007. In 26 December 2006, du's CEO, Mr. Osman Sultan, announced to media sources (Dow Jones Newswire) that the company would launch services in 10-12 weeks.

du aims to exceed 30% market share by 2010

As indicated earlier, winning over some of Etisalat's subscribers is central for du to achieve its target market share and profitability. du management have indicated that they are aiming to exceed 30% market share by 2010. The regulator has recently indicated that MNP will not be introduced till the end of 2007 rather than with the launch of du as had previously been expected. We believe that any further delay in the introduction of MNP beyond 2007 will have a serious impact on both our forecasts and management's market share target.

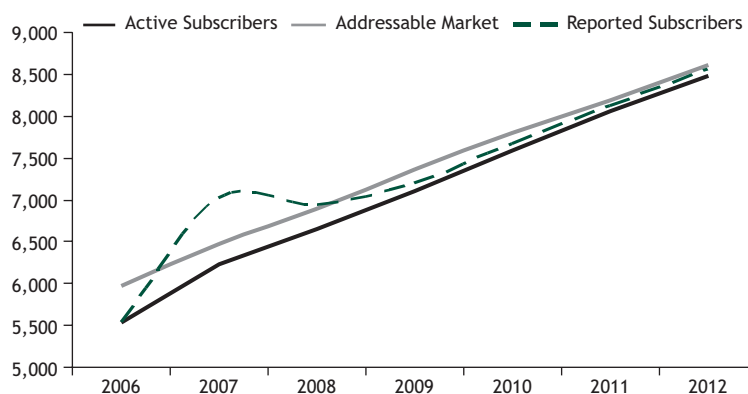
du signs up 7.6% of existing subscribers in pre-launch number booking

In November 2006, and in order to overcome the delay in the introduction of MNP, du allowed number pre-booking to enable existing subscribers of Etisalat to book the same number as with Etisalat, but with du's '055' prefix. According to media sources (Emirates Today), du signed up more than 400,000 prospective subscribers with this campaign, equal to 7.6% of the market's subscribers. However, it remains to be seen what percentage of the reported prospective subscribers will convert to active revenue-generating subscribers as we do not expect all of the reported prospective subscribers to become active subscribers at least in the first year.

Penetration rate could exceed our estimate of the size of addressable market after du launches

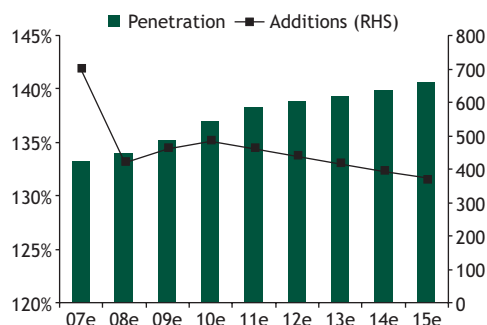
Therefore, we expect subscriber additions may shoot up after du launches operations if existing Etisalat subscribers acquire a du account whilst maintaining their Etisalat account. This may result in the penetration rate exceeding our estimate for the size of the addressable market. Subsequently, and with the introduction of MNP, net additions may retreat significantly as some of the subscribers drop the service with one of the operators.

Fig. 5.1: Forecast of Reported and Active Subscriber relative to Addressable Market 2006-2012e



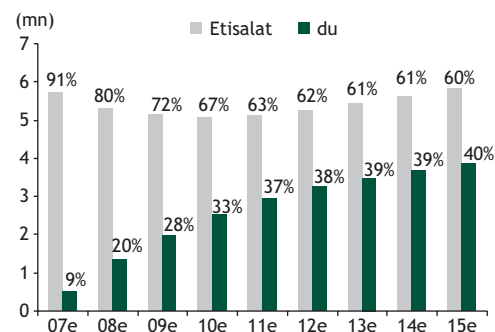
Source: EFG-Hermes estimates

Fig. 5.2: Mobile Market Net Additions and Penetration Rate 2007e-2015e



Source: EFG-Hermes estimates

Fig. 5.3 du & Etisalat Mobile Subscribers and Market Share Forecasts 2007e-2015e



Source: EFG-Hermes estimates

We forecast du will add 569,000 active subscribers in 2007 (first year of operation) which would give it a market share of 9% by the end of the year. We are forecasting that 57% of du's additions in 2007, or 325,000 subscribers, will come from Etisalat. This corresponds to a churn rate of 5.7% for Etisalat.

In 2008 we are forecasting du will add 757,000 subscribers, 78% of which will be churned from Etisalat as we are forecasting the churn rate at Etisalat to rise to 11.1% after MNP is introduced at the beginning of 2008. This would give du a total of 1.33 million subscribers by the end of 2008 or a market share of 20%. By 2010 we forecast du's market share will rise to 33%.

Going forward we expect du's market share to continue to rise driven solely by the growth in population as we are projecting du to grab 50% of net additions from 2010 onwards. We expect du's market share to stabilize at 40% by the end of 2015.

Table 5.4: Mobile Market Forecasts 2007e-2015e

	2007e	2008e	2009e	2010e	2011e	2012e	2013e	2014e	2015e
Population (mn)	4.7	5.0	5.3	5.5	5.8	6.1	6.4	6.6	6.9
Addressable Mkt. (mn)	6.5	6.9	7.4	7.8	8.2	8.6	9.0	9.4	9.7
% of Population	138%	139%	140%	141%	141%	141%	141%	141%	141%
New Additions (000's)	698	419	461	484	460	437	415	394	374
Total Subscribers (000's)	6,230	6,648	7,109	7,593	8,053	8,489	8,904	9,298	9,673
Penetration to Addressable	96%	96%	97%	97%	98%	99%	99%	99%	100%
Penetration Rate	133%	134%	135%	137%	138%	139%	139%	140%	141%
Etisalat									
Share of New additions	65%	61%	55%	50%	50%	50%	50%	50%	50%
Net Churn (000's)	(325)	(593)	(426)	(302)	(196)	(95)	(8)	-	-
% of Subscribers (Y/E)	6%	11%	8%	6%	4%	2%	0%	0%	0%
Net additions (000's)	129	(338)	(172)	(60)	34	123	199	197	187
Etisalat Subscribers (000's)	5,661	5,323	5,150	5,090	5,124	5,247	5,447	5,644	5,831
Market Share	91%	80%	72%	67%	64%	62%	61%	61%	60%
du									
Share of New additions	35%	39%	45%	50%	50%	50%	50%	50%	50%
Net Churn (000's)	325	593	426	302	196	95	8	-	-
% of Subscribers (Y/E)	57%	45%	22%	12%	7%	3%	0%	0%	0%
Net additions (000's)	569	757	633	544	426	313	215	197	187
du Subscribers (000's)	569	1,326	1,959	2,503	2,929	3,242	3,457	3,654	3,842
Market Share	9%	20%	28%	33%	36%	38%	39%	39%	40%

Source: EFG-Hermes estimates

du to charge customers per second

Revenues

du announced that it will charge customers on a per-second basis starting from the first minute, for both local and international voice services. Etisalat, which charges customer per 30-seconds slots after the first minute, announced that it will also move to per-second billing which we expect to take place starting 2007.

With expatriates constituting more than 80% of the UAE population, we expect du to offer cheaper international voice tariffs relative to Etisalat in order to gain market share. The highest international tariff currently present in the market is AED9.47 (peak) while the lowest is AED2.12 (off-peak). We estimate a global international tariff for du (incoming and outgoing) of AED2.5.

We forecast a mobile revenue CAGR of 56% from 2007-2012

We are forecasting total mobile revenues of AED446 million in 2007. Both local and international traffic revenues (including interconnection) constitute the bulk of our revenue forecast, representing 57% of our revenue forecasts. Between 2007 and 2012 we are forecasting a 5-year revenue CAGR of 56%.

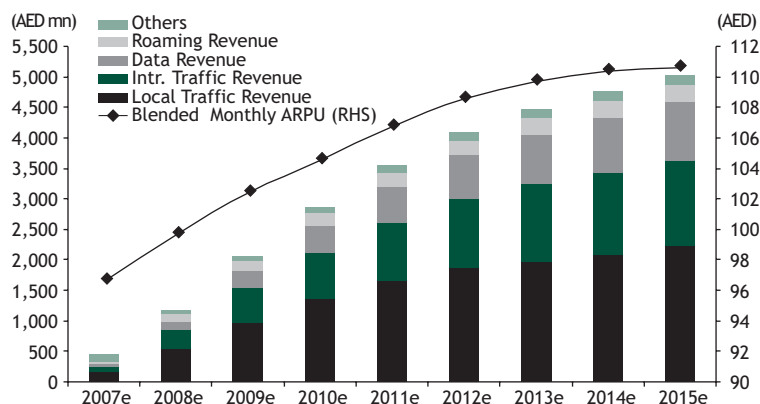
Despite forecasting strong growth of non-voice revenues, we expect voice revenue (excluding roaming) will continue to be the major revenue earner as we forecast it would constitute 73% of our 2015 revenue forecast.

ARPU trending upward

Our forecasts imply a trend of rising ARPU. This might seem unconventional given that ARPU normally declines with subscriber growth. However, we argue that the case for du would be different due to the following: i) some of the subscribers who will take on a du account would continue to use their Etisalat account until they drop one of the service providers which would boost usage for the chosen operator and result in a rise in ARPU, ii) we expect that most of the high-spending customers that du will attract from Etisalat would only join after the introduction of MNP which is expected by the end of 2007, iii) the growing coverage of the fixed line service, which would take longer than the mobile, will enable the offering of bundled innovative services (FMC) that should boost ARPU at a later stage.

Our forecasts imply an ARPU of AED97 (USD26.5) in 2007 which increases to AED106 (USD28.8) in 2010 and stabilizes at AED112 (USD30.6) from 2014 onwards. We estimate Etisalat currently has an ARPU of AED150 (USD40.9).

Figure 5.5: Breakdown of Revenue Forecasts 2007e-2015e



Source: EFG-Hermes estimates

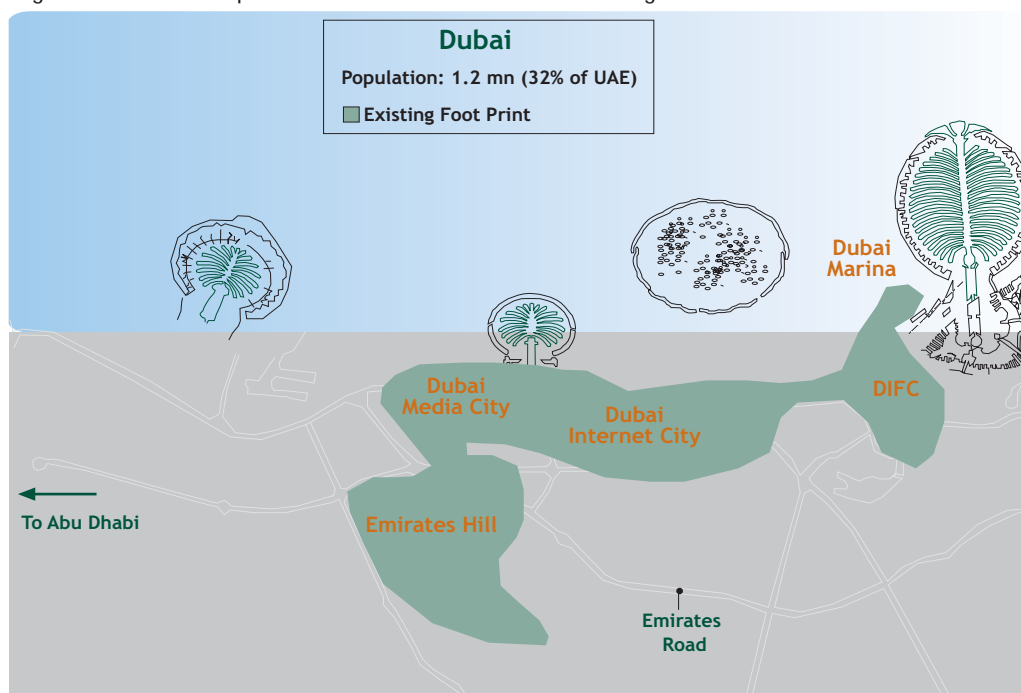
B. Fixed line Subscribers and Revenue Forecasts

Subscribers

du currently covers the New Dubai area

du currently provides fixed line services to more than 20,000 subscribers in the Dubai Free Zones, Dubai Internet City, Dubai Media City, Dubai International Financial Center (DIFC), Emirates Hills, and Dubai Marina, all lying in the Dubai New Area. With a 100% market share in the aforementioned areas, we forecast that by the end of 2006, du will have a market share of just under 2% of the fixed line market in the UAE. An important point to note is that most of du's existing fixed line subscribers are business customers. Although du will continue to focus on the business segment, we believe that a nation-wide roll out of the network will enable du to tap into the residential segment as well, especially after du fully launches its FMC services, which is expected to occur in early 2009.

Figure 5.6: Dubai Map with du's Current Fixed Line Coverage



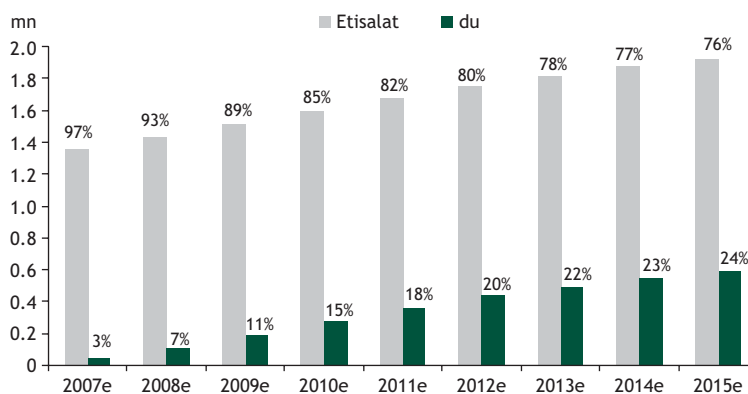
Source: EFG-Hermes

du will target Dubai and Abu Dhabi

We believe du's fixed line coverage plan over the next 3 years will focus mainly on Dubai and Abu Dhabi, both together accounting for 69% of the UAE's total population. At this point of time it is important to note that full Local Loop Unbundling (LLU) which would provide du with Last Mile access is a central assumption to our forecast as we are not forecasting that du will build its own access network.

We believe that by 2009, du will be able to fully cover Dubai and Abu Dhabi through LLU. We also believe that du will continue to focus on the newly built areas in Dubai lying in the Jebel Ali area. We expect du will reach a market share of 11% in 2009.

Figure 5.7: du and Etisalat Fixed Line Subscribers and Market Share Forecasts 2007e-2015e



Source: EFG-Hermes estimates

We believe du's fixed line additions will not rely heavily on churned subscribers from Etisalat. As a general trend, the churn rate of fixed line operators is relatively low compared to that of mobile operators, standing at an average of 1%. PCCW and Hutchison in Hong Kong have a fixed line churn rate of 1.1% and 1.2% respectively. We forecast that du fixed line additions that are won from Etisalat will not exceed 1% of the latter's subscriber base per annum.

Table 5.8: Fixed Line Market Forecasts 2007e-2015e

	2007e	2008e	2009e	2010e	2011e	2012e	2013e	2014e	2015e
Population (mn)	4.7	5.0	5.3	5.5	5.8	6.1	6.4	6.6	6.9
Addressable Mkt. (mn)	2.1	2.2	2.3	2.4	2.6	2.7	2.8	2.9	3.0
% of Population	44%	44%	44%	44%	44%	44%	44%	44%	44%
New Additions (000's)	92.2	133.7	167.1	172.1	163.5	147.1	125.1	110.1	96.9
Total Subscribers (000's)	1,403	1,537	1,704	1,876	2,039	2,186	2,311	2,422	2,518
Penetration to Addressable	68%	70%	74%	77%	80%	81%	82%	83%	83%
Penetration Rate	30%	31%	32%	34%	35%	36%	36%	36%	37%
Etisalat									
Share of New additions	75%	70%	60%	55%	55%	55%	55%	55%	55%
Net additions (000's)	69.1	93.6	100.2	94.6	89.9	80.9	68.8	60.5	53.3
Net Churn (000's)	-	(16.6)	(15.4)	(11.6)	(12.2)	(7.7)	(5.3)	(2.8)	(1.7)
%	0.0%	0.8%	0.7%	0.5%	0.5%	0.3%	0.2%	0.1%	0.1%
Etisalat Subscribers (000's)	1,355	1,432	1,517	1,600	1,678	1,751	1,814	1,872	1,924
Market Share	97%	93%	89%	85%	82%	80%	78%	77%	76%
du									
Share of New additions	25%	30%	40%	45%	45%	45%	45%	45%	45%
Net additions (000's)	23.0	40.1	66.8	77.4	73.6	66.2	56.3	49.5	43.6
Net Churn (000's)	-	16.6	15.4	11.6	12.2	7.7	5.3	2.8	1.7
%	0.0%	15.9%	8.2%	4.2%	3.4%	1.8%	1.1%	0.5%	0.3%
du Subscribers (000's)	48	104	187	276	362	435	497	549	595
Market Share	3%	7%	11%	15%	18%	20%	22%	23%	24%

Source: EFG-Hermes estimates

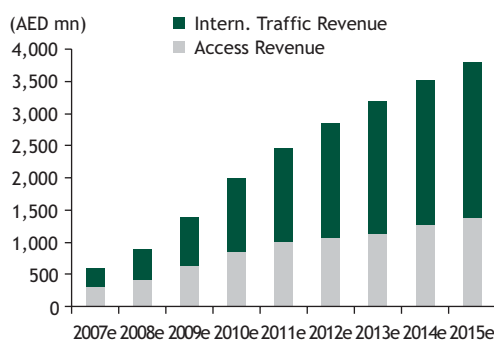
The bulk of fixed line revenue will come from the monthly subscription

Revenues

As previously mentioned in the section dealing with our assumptions regarding the fixed line addressable market, we are forecasting that du will offer bundled packages (triple play) with monthly subscriptions. Packages would include voice, broadband internet and TV services (triple play). We forecast that access revenues (subscription and connection) would represent the bulk of our fixed line revenue in the first two years of operation. Afterwards, we believe the international voice revenue would constitute a higher percentage of our revenue forecasts, 57% of total fixed line revenues in 2010, up from 48% in 2007 due to: i) Downward pressure on subscription fees which are relatively high, ii) Strong growth in international traffic driven by the expansion in the fixed line network coverage.

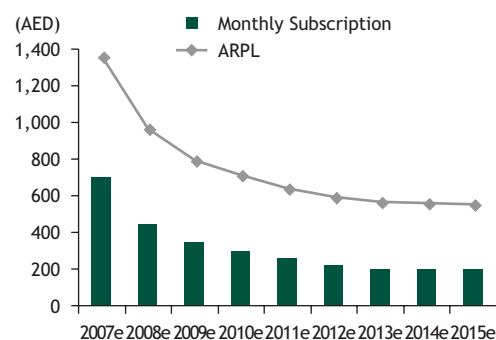
du currently charges a monthly fee of AED200 for each of the voice, broadband and TV services separately. However, we believe that with the full-scale launch of triple play services, the bundle price for the three services will be at least 25% cheaper than the price for each service taken individually. We forecast an average of AED450 to be charged on bundled services for 2007. It is important to note that the monthly fees that we are forecasting do not include international voice fees, as we are forecasting that they will be charged separately. However, going forward, we believe that international voice services will be included in the bundled products which we are forecasting would put downward pressure on international tariffs.

Fig. 5.9: du Fixed Line Revenue Breakdown for 2007e-2015e



Source: EFG-Hermes estimates

Fig. 5.10: du Monthly Subscription Fees and ARPL for 2007e-2015e



Source: EFG-Hermes estimates

From 2007 to 2015 we expect total fixed line revenue to grow at a CAGR of 26%. Average Revenue per Line (ARPL) will, however, decrease at a CAGR of 11% for the same period to reach AED552 (USD150.5) in 2015, AED200 (USD54.5) excluding international voice revenues. Monthly subscriptions for triple play offerings in Europe have a wide price range with the lowest being USD24, in Italy, and the highest USD120, in Germany.

C. Costs

The main costs components

The main cost components for telecom operators are: i) interconnect and other network operating costs (leased lines, infrastructure sharing, maintenance etc...) ii) staff costs, iii) G&A which include marketing, dealers commissions, subsidies, consultancy fees, network subcontracting, and iv) payments to the government/regulator which include spectrum fees universal service fees, R&D...etc

It is worth noting that the classification of the different expenses that make up the main cost items between Cost of Services and Selling, General and Administrative (SG&A) expenses differ from one operator to the other. Therefore, any difference between our forecasts and reported figures arising 'solely' from the difference in the classification of costs should not have an impact on EBITDA forecasts.

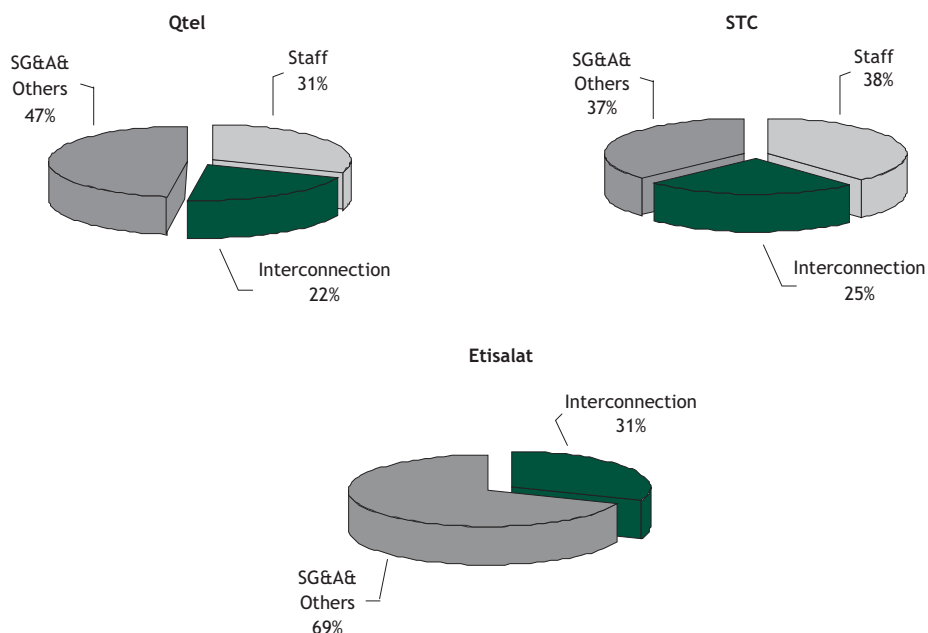
There is a significant forecast risk given the start-up nature of du

At this point of time it is important to draw attention to the significant risk inherent in our forecasts given the start-up nature of du. Although we believe that our forecasts are based on reasonable assumptions and management guidance at various points in time, one should not preclude the possibility of material differences between our forecasts and reported numbers in the company's early years of operations.

Interconnect is a major cost component

Interconnect constitutes around 25% to 35% of the costs of relatively established operators with dominant subscriber market share. Interconnect costs as a percentage of total costs are lower in the case of a monopoly as they are limited to out-payments to international operators given that all fixed line and mobile traffic is terminated on the same network.

Figures 5.11-12-13: Breakdown of Costs of Qtel, STC and Etisalat (2005)



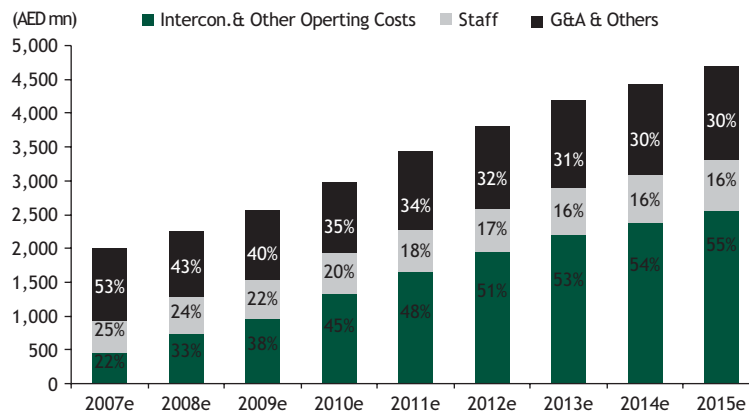
Source: Operators

We forecast a higher interconnect to total costs ratio for du

Details regarding the interconnect costs between the UAE operators have not been disclosed. We are assuming a fixed interconnect cost for local mobile traffic of AED0.08 per minute (USD0.022). For international voice revenues, we expect the interconnect cost would increase and eventually exceed 40% of total revenues, up from an estimated 30% as we are forecasting competition in this segment will drive down prices.

We are forecasting that interconnect costs, as a percentage of total costs for du, will be higher due to its relatively low subscriber base which would result in a relatively higher off-net/on-net traffic ratio relative to Etisalat. Another relatively important cost component for du would be costs related to LLU and national roaming. Both, however, have not been revealed by the company while their magnitude depends on several variables that introduce a higher element risk to our cost forecasts.

Figure 5.14: Breakdown of du's Costs 2007e-2015e



Source: EFG-Hermes estimates

du is expected to have a lower number of employees relative to Etisalat

du is expected to have a lower number of employees relative to Etisalat and other GCC incumbents, which provides du with a cost advantage relative to Etisalat. We are forecasting a total of 1,450 employees for du in 2007 which would rise to 2050 by 2012 implying a lines/employee ratio of 1,794 versus 625 for Etisalat and 710 for STC. Moreover, all other things being equal, NGN network operating costs are much lower than those of the PSTN operators and are highly scalable, which would also provide du with a cost advantage relative to Etisalat.

However staff expenses will be a significant overhead

We expect staff expenses to comprise around 25% of pre-EBITDA costs in 2007. However, due to the relatively fixed-cost nature of this expense item we expect the overall staff costs as a percent of pre-EBITDA costs to decline to 20% in 2010 and then stabilize at 15-16% of total costs.

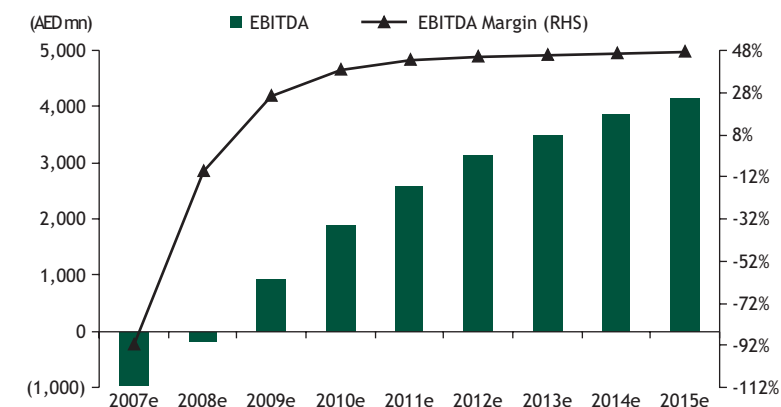
D. EBITDA Forecasts

We are projecting a negative EBITDA in the first two years of operations. In 2007 we are forecasting a total cost of services of AED448 million or 43% of revenues and a total SG&A of AED1,550 million. We expect one-off items related to consultancy and network building, to constitute around 12.4% of 2007 total SG&A or AED192 million.

In 2008 we expect one off items to drop significantly to around 6.5% of SG&A or less than AED100 million. However, as seen with other-startups, many of the costs could be capitalized which would result in our some differences between our forecasts and the actual numbers.

We expect du to move into EBITDA positive territory in the third year of operations with an EBITDA margin of 26%. We expect the EBITDA margin to rise thereafter and stabilize at 47%. We estimate Etisalat has an EBITDA margin (based on gross revenues) of 63% which we forecast will drop following the entry of du.

Figure 5.15: du's EBITDA and EBITDA Margin 2007e-2015e



Source: EFG-Hermes estimates

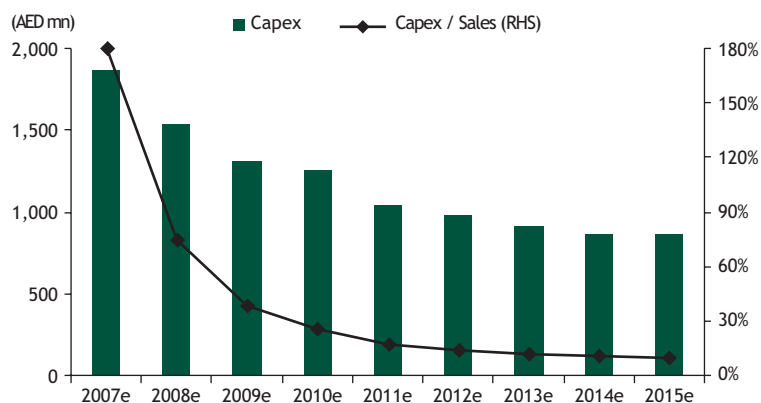
E. Capex and Free Cash Flow

du is expected to spend a total of AED4.7 billion on both mobile and fixed line capex during the first three years of operation. du acquired an IP-based network from TECOM Investments for AED1.13 billion (USD314 million) at the beginning of 2006. At the end of September 2006, du had a total capex spend of AED1.6 billion.

Nokia to supply GSM network equipment for at least USD190 million

Nokia has won a managed services contract from du and will also supply the entire core and a large proportion of the radio access network (RAN) for GSM/GPRS/EDGE and WCDMA 3G. According to Nokia, the value of the contract is at least USD190 million (AED700 million). Nokia is also taking a large systems integration responsibility.

Figure 5.16: du's Capex and Capex/Sales 2007e-2015e

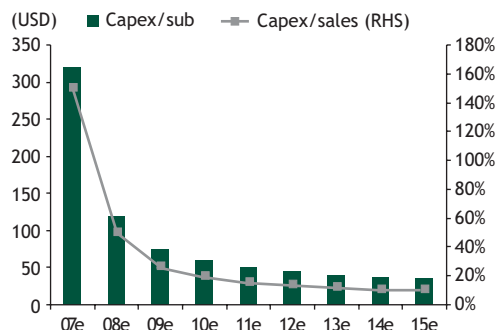


Source: EFG-Hermes estimates

Italtel and Cisco to provide full NGN solution for du's fixed line network

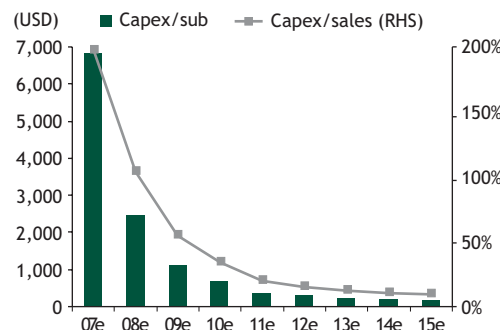
du awarded Italtel and Cisco Systems the tender for the implementation of a network solution based on VoIP technology. Through this solution, du will be able to use a convergent infrastructure for voice traffic over IP. The value of the deal has not been disclosed by any of the parties.

Fig. 5.17: Forecast Capex per Subscriber and Capex per Sales for Mobile Services



Source: EFG-Hermes estimates

Fig. 5.18: Forecast Capex per Subscriber and Capex per Sales for Fixed Line Services



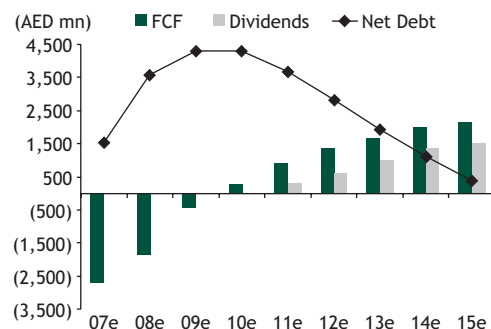
Source: EFG-Hermes estimates

We forecast du to breakeven at a FCF level in 2010

We expect du to breakeven at a free cash flow level in 2010. According to our forecasts, du's peak-funding requirement of AED3,757 million will be reached in 2009 which we expect the company to finance through debt. We are forecasting du's gross debt to increase gradually to reach a maximum of AED4.4 billion at the end of 2009. However, from 2010 onwards we are forecasting a steep decline in net debt as the company starts generating strong free cash flow.

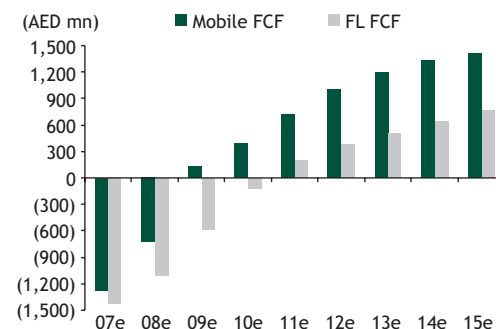
Starting 2011, we forecast du will start paying a dividend with a payout ratio of 30%, which we forecast will rise gradually to 80% in 2015.

Fig. 5.19: du's FCF, Dividends and Net Debt (2007e-2015e)



Source: EFG-Hermes estimates

Fig. 5.20: du's Mobile and Fixed Line FCF (2007e-2015e)



Source: EFG-Hermes estimates

As the second entrant, we expect du will pay a lower royalty fee relative to Etisalat

Finally we are assuming that du will pay a royalty fee equal to 35% of its net profit once it reaches breakeven at the net profit level, which we forecast will be in 2009. Although we are assuming higher royalty fees for Etisalat of 40%, we believe that du, as the second entrant, would pay lower royalty fees.

VI. VALUATION

We estimate du's long-term fair value at AED6.06 per share

We use a Discounted Cash Flow (DCF) model to value du and arrive at an estimated equity value of AED24.2 billion (USD6.6 billion) implying a long-term fair value per share of AED6.06.

Table 6.1: du Discounted Cash Flow (DCF) Model

(AED mn)	2007e	2008e	2009e	2010e	2011e	2012e	2013e	2014e	2015e
EBITDA	(957)	(190)	914	1,868	2,591	3,148	3,504	3,904	4,181
Royalty/Taxes	-	-	(13)	(310)	(547)	(740)	(853)	(991)	(1,092)
Change in WI	120	(116)	(34)	(37)	(87)	(40)	(42)	(38)	(23)
Capex	(1,868)	(1,534)	(1,319)	(1,251)	(1,037)	(985)	(908)	(866)	(868)
FCF	(2,705)	(1,839)	(452)	270	920	1,382	1,701	2,008	2,198
Weight of Equity	58%	31%	28%	34%	42%	52%	60%	68%	75%
Weight of Debt	42%	69%	72%	66%	58%	48%	40%	32%	25%
WACC	9.2%	7.7%	7.5%	7.9%	8.3%	8.9%	9.3%	9.7%	10.1%
Discount Factor	1.05	1.12	1.21	1.31	1.44	1.61	1.80	2.02	2.20
EV	23,009								
Net Debt (Cash) Y/E 2006	(1,240)								
Equity	24,249								
Price Per share (AED)	6.06								

Source: EFG-Hermes estimates

We use a variable WACC as we forecast significant changes in du's capital structure

For our weighted average cost of capital (WACC) assumptions, we use a cost of equity of 11.5% and a cost of debt 6.0%. Given the start-up nature of du, we use a moving WAAC in our DCF valuation model due to our forecast of significant y-o-y changes in the capital structure (Debt/Equity) during our first five years of projections.

As per our estimates, we are forecasting a maximum net debt/equity ratio of 254% which du would reach in 2009. We forecast that the net debt/equity ratio would fall significantly in 2010 to 190% as we expect du to start generating positive free cash flow during that year. We are forecasting a net debt to equity ratio in our terminal forecast year of 6% and a gross debt to equity ratio of 25%

Table 6.2: WACC and Terminal Growth Rate Assumptions

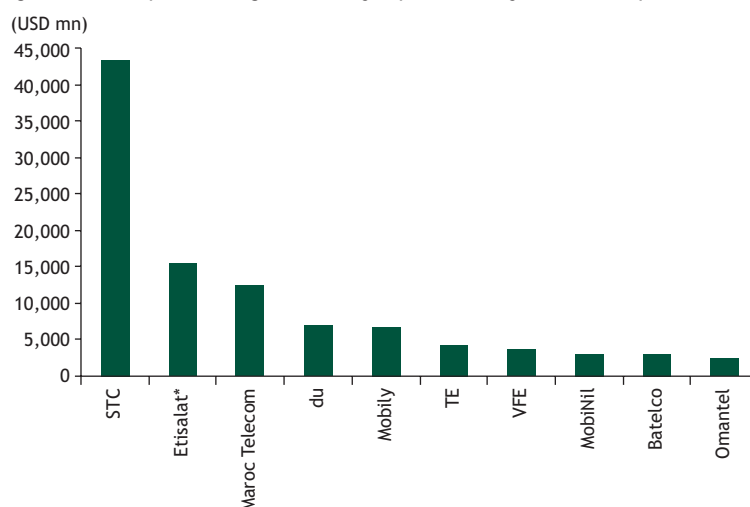
	Assumption	Rationale
Cost Of Equity	11.5%	
Risk Free Rate (RFR)	4.5%	Based on the US Government 10-year bond
Equity Risk Premium	7.0%	200bp higher than Etisalat's ERP due to the start-up nature of du
Cost of Debt	6.0%	
		We are assuming that most of the debt will be FX-denominated. The average rate for FX-denominated debt is 5.8% while the average rate for local currency debts is 6.5%
Terminal Growth Rate	6.0%	
		We are assigning a relatively high growth rate given the start-up nature of du. The FCF growth in our last year of projection is 7.0%

Source: EFG-Hermes

How does our fair value estimate compare with the current stock price?

Our long-term fair value estimate is 4.4% below the current market price of AED6.34. At the current market price, du is the 4th largest single-country operator in the region as measured by market capitalization. As we believe Etisalat to be an important benchmark for the valuation of du, we have included it in chart 6.3 after stripping out the value of its stakes in its major non-UAE operations in Saudi, Pakistan and Egypt which account for 25.9% of Etisalat's market capitalization and imply a market value of AED57.0 billion for Etisalat's UAE operations.

Figure 6.3: Top Ten Single-Country Operators by Market Capitalization



*Excluding the market value of its non-UAE operations
Sources: Reuters and EFG-Hermes estimates

A "Sanity Check" on the Valuation

Given the high risk inherent in valuing start-up operations, we thought it wise to compare both our estimated fair value for the equity of du and the current market capitalization for du with the adjusted market capitalization of Etisalat that excludes the value of the latter's non-UAE operations.

Table 6.4: Etisalat's Adjusted Market Capitalization Relative to du's Market and DCF Valuations

Company	Valuation Method	Etisalat's Stake	Value (AED mn)	Proportionate Value (AED mn)
Etisalat	Market Cap	N/M	76,916	76,916
less				
Saudi Operation (Mobily)	Market Cap	35%	25,928	9,075
Pakistan Operation (Paktel)	Market Cap	26%	14,558	3,785
Egypt's Third Mobile License	Cost	66%	10,640	7,023
Etisalat Adjusted Market Cap				57,033
du Market Capitalization				25,360
% of Etisalat's adjusted Mkt. Cap.				44.5%
% of Etisalat's adjusted Mkt. Cap + du Market Cap.				30.8%

Sources: Reuters and EFG-Hermes estimates

Our long-term fair value estimate for du is 4% below the current market price of AED6.34. Our estimated equity value for du is equal to 44.5% of Etisalat's adjusted market capitalization. This implies that, at current market prices, du is worth 30.8% of the combined market capitalization of UAE telecoms (the sum of du and the UAE operations of Etisalat).

Our assumptions for du's terminal mobile and fixed line market shares are 40% and 24% respectively by the end of 2015 which we believe to be quite bullish. Assuming our assumptions are correct, we believe that the market is assigning a high value to du relative to the implied value of Etisalat's UAE operations, which we believe to be relatively undervalued.

Even if one assumes that du will eventually capture 40% market share, in both the mobile and fixed line businesses, we do not believe that this should translate into 40% of the combined market capitalization of UAE telecoms due to the following: i) As a second entrant into a saturated market du is expected to be less profitable than Etisalat. We are forecasting that du's ARPU at the steady-state period will be 20% lower than that of Etisalat's and its EBITDA margin to be 7% lower, which we already acknowledge as bullish, ii) du will take time to achieve this market share and profitability relative to Etisalat which is already well-established. iii) One should use a higher discount rate for du given the start-up nature of the operation.

In light of all of the above, while we believe du to be expensive relative to its closest comparable, we believe it to be fairly valued on an absolute basis. We therefore assign the stock a ST/LT Neutral recommendation.

Key Sensitivities

A- Cost of Equity and Terminal Growth Rate

Our valuation is sensitive to the choice of both the cost of equity and the terminal growth rate. DCF valuation models are normally sensitive to the choice of the terminal growth rate which has a relatively greater impact on the valuation of start-ups relative to the impact on the valuation of more mature companies with relatively stable or lower cash flow growth. This is due to the fact that the terminal value of the start up constitutes a larger portion of the total valuation due to the generation of negative free cash flow in the first years of operation.

It is interesting to note that the sensitivity of the DCF model to the cost of equity increases significantly beyond a terminal growth rate of 6%, which is our chosen terminal growth rate, with the difference between the highest and lowest values in Table 6.5 being 277% at a terminal growth rate of 7.0%.

Table 6.5: DCF Sensitivity Analysis

		Cost of Equity					
		9.5%	10.5%	11.5%	12.5%	13.5%	
Terminal Growth	4.0%	6.06	4.85	3.95	3.25	2.70	124%
	5.0%	7.82	6.05	4.80	3.88	3.17	146%
	6.0%	10.94	7.95	6.06	4.76	3.82	186%
	7.0%	17.87	11.46	8.13	6.11	4.75	277%
		195%	136%	106%	88%	76%	High/Low Var. (%)

Source: EFG-Hermes estimates

B- Subscriber Forecasts

In table 6.6, we test the sensitivity of our valuation to a 10% and a 20% change in subscriber forecasts for both the mobile and fixed line businesses. As expected, our valuation is more sensitive to the change in mobile subscriber forecasts relative to the change in fixed line subscriber forecasts.

Table 6.6: Sensitivity Analysis of Subscriber Forecasts

		Change in Mobile Subs. Forecast					High/Low Var. (%)
		-20.0%	-10.0%	0.0%	10.0%	20.0%	
Change in Fixed line Subs. Forecast	-20.0%	4.40	4.63	4.97	5.37	5.82	32%
	-10.0%	4.79	5.12	5.50	5.94	6.40	34%
	0.0%	5.27	5.64	6.06	6.52	6.99	33%
	10.0%	5.78	6.19	6.64	7.10	7.58	31%
	20.0%	6.33	6.76	7.22	7.69	8.17	29%
		32%	32%	31%	29%	28%	

Source: EFG-Hermes estimates

C- ARPU Forecasts

In table 6.7 we test the sensitivity of our valuation to a 10% and a 20% change in ARPU forecasts for both the mobile and fixed line businesses. We have also adjusted our usage-related variable costs to change with the change in our ARPU assumptions.

Table 6.7: Sensitivity Analysis of ARPU Forecasts

		Change in Mobile ARPU Forecast					High/Low Var. (%)
		-20.0%	-10.0%	0.0%	10.0%	20.0%	
Change in Fixed line ARPU Forecast	-20.0%	4.48	4.97	5.48	5.99	6.50	45%
	-10.0%	4.76	5.26	5.77	6.28	6.80	43%
	0.0%	5.05	5.55	6.06	6.58	7.10	41%
	10.0%	5.34	5.84	6.36	6.88	7.39	38%
	20.0%	5.63	6.14	6.66	7.17	7.69	37%
		18%	17%	15%	14%	13%	

Source: EFG-Hermes estimates

D- EBITDA Forecasts

In table 6.8 we test the sensitivity of our valuation to a 10% and 20% change in EBITDA forecasts for both the mobile and fixed line businesses

Table 6.8: Sensitivity Analysis of EBITDA Forecasts

		Change in Mobile EBITDA Forecast					High/Low Var. (%)
		-20.0%	-10.0%	0.0%	10.0%	20.0%	
Change in Fixed line EBITDA Forecast	-20.0%	3.19	4.12	5.05	5.97	6.90	116%
	-10.0%	3.70	4.63	5.55	6.48	7.41	100%
	0.0%	4.21	5.14	6.06	6.99	7.91	88%
	10.0%	4.72	5.64	6.57	7.50	8.42	79%
	20.0%	5.23	6.15	7.08	8.01	8.93	71%
		41%	33%	27%	24%	21%	

Source: EFG-Hermes estimates

Financial Statements (December year end)

(AED mn)	2007e	2008e	2009e	2010e	2011e	2012e	2013e
Balance Sheet							
Cash & Liquid Assets	255	219	96	81	385	655	956
Total Receivables & Other Current Assets	487	534	554	573	613	650	678
Total Current Assets	742	752	649	654	999	1,306	1,634
Net Plant	3,559	4,653	5,397	5,988	6,304	6,530	6,602
Intangibles	816	755	695	634	574	514	453
Total Assets	5,116	6,161	6,741	7,276	7,877	8,349	8,689
Total Payables & Accruals	617	548	534	516	470	466	452
CPLTD	-	-	-	350	580	600	600
Total Current Liabilities	617	548	534	866	1,050	1,066	1,052
Fees Payable	177	142	113	91	73	58	46
LTD	1,800	3,800	4,400	4,050	3,470	2,870	2,270
Dividend Payable	-	-	-	-	305	619	1,030
Total Liabilities	2,594	4,490	5,048	5,006	4,897	4,613	4,399
Net Worth	2,522	1,670	1,694	2,269	2,980	3,736	4,291
Income Statement							
Mobile Revenue	446	1,176	2,073	2,858	3,552	4,104	4,502
Fixed Line Revenue	595	890	1,395	1,985	2,467	2,853	3,181
Total Revenue	1,041	2,067	3,468	4,843	6,020	6,958	7,683
COGS	(448)	(746)	(965)	(1,344)	(1,662)	(1,943)	(2,195)
SG&A	(1,550)	(1,510)	(1,589)	(1,631)	(1,767)	(1,867)	(1,985)
EBITDA	(957)	(190)	914	1,868	2,591	3,148	3,504
<i>EBITDA Margin</i>	<i>-91.9%</i>	<i>-9.2%</i>	<i>26.3%</i>	<i>38.6%</i>	<i>43.0%</i>	<i>45.2%</i>	<i>45.6%</i>
Depreciation and Ammortization	(353)	(500)	(636)	(721)	(782)	(820)	(896)
Net Operating Profit	(1,310)	(690)	278	1,147	1,809	2,328	2,608
<i>NOP (EBIT) Margin</i>	<i>-126%</i>	<i>-33%</i>	<i>8%</i>	<i>24%</i>	<i>30%</i>	<i>33%</i>	<i>34%</i>
Net Interest Income (Expense)	(35)	(162)	(242)	(262)	(248)	(213)	(170)
Earnings before Taxes	(1,345)	(852)	36	885	1,562	2,115	2,438
Royalty Fees	-	-	(13)	(310)	(547)	(740)	(853)
Net Profit after Taxes	(1,345)	(852)	23	575	1,015	1,375	1,585
Cash Flow Statement							
Cash Operating Profit after Tax	(957)	(190)	901	1,558	2,044	2,408	2,650
Change in Working Investment	120	(116)	(34)	(37)	(87)	(40)	(42)
Cash Flow after Chg. in WI	(837)	(305)	867	1,521	1,957	2,367	2,608
Capex and Acquisition of Investments	(1,912)	(1,569)	(1,348)	(1,274)	(1,056)	(1,000)	(919)
Free Cash Flow	(2,749)	(1,875)	(481)	247	902	1,367	1,689
Net Financing	1,765	1,838	358	(262)	(598)	(1,097)	(1,389)
Change in Cash	(985)	(37)	(123)	(15)	304	270	301

Source: EFG-Hermes estimates

DISCLOSURES

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EFG-Hermes (UAE), Level 6, The Gate, West Wing, DIFC , P.O. Box 30727, Dubai - UAE
Tel: +971 4 363 4000 | Fax: +971 4 362 1170 | Website: www.efg-hermes.com
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