

Swisscom: „Sense and Sensibility“

Dear Shareholder,

A company best known for its “solid as a rock” characteristics can not always avoid addressing the softer edges of its rocky profile. This shareholder letter has been devoted to two themes:

- **„Sense“**: what again is our view of the world. And what do we think is the sense of our strategy?
- **“Sensibility“**: does this strategy mean that we don’t listen to other views? Or are we sensible to other angles when looking at the opportunities for the company?

Sense

Swisscom has been known for years for having a very “down-to-earth” view of the world. One that is based on a stance of “facing the facts”. Repeatedly have we stated our goals, and the beliefs you should share with us to justify an investment into our shares. In short, these goals and beliefs compare as follows:

Swisscom’s Goals and Beliefs
1. Optimize free cash flow	1. Swisscom’s core competence must be to balance short term with long term cash flow generation. Asset sweating while daring to innovate and explore adjacencies is the prime challenge. Every day.
2. Create value while securing a balanced risk-reward profile	2. When thinking “out of its own box”, Swisscom has a strong desire to find value enhancing investment opportunities that would fit into the very same box. “Size matters”, especially in that potential acquisition should not significantly alter the company’s own (risk) profile.
3. Combine strategic flexibility with attractive yield	3. Swisscom offers an attractive yield to shareholders through its return policy, whilst ensuring that it has sufficient strategic flexibility and financial strength

If you also think that these views make **sense**, you are also likely to agree that:

1. Focusing on anything else than sweating our existing assets to optimize the efficiency of our current operations, is unlikely to contribute to our immediate free cash flow profile. Continued rationalization and further cost cutting will have to stay high on the agenda. As will be the delicate question of how much to invest to stabilize our current market shares in key businesses. However, finding innovative ways to secure future business is equally important. Significant efforts and time have to be invested in process-, product- and market-related innovation. And in further developing venture types of businesses. And in exploring the options that may arise from convergence: both between fixed and mobile networks as well as between our core telecoms business and direct adjacencies such as multimedia, entertainment, IT. All of this as prerequisites for our “stand-alone” sustainability.

2. Finding acquisitive options that make a difference and yet leave the risk profile of Swisscom largely unchanged is quite a challenge. The only simplicity is that we can obviously not do this in the domestic core market without facing insurmountable regulatory risks. This – considering the limited size of Switzerland – still leaves a lot of foreign territory open for exploration. The challenge lies in the identification of businesses that are (a) for sale; (b) can be controlled by buying a majority; (c) also have a strong prospective free cash flow profile; (d) come at a justifiable price that ensures value accretion and (e) are within our funding capabilities such that a strong credit rating is secured.
3. Meanwhile, not returning all annual equity free cash flow is not shareholder friendly if a company has a strong balance sheet already. A company should not pile up more cash than strictly required, and hence either return this to shareholders, or find alternative ways to invest such that its future cash flow profile improves. Cash, while being the single most important asset, only has value if it is deployed intelligently. Swisscom doesn't count "cash that sits idle on the balance sheet" as value creation to shareholders:
 - Our **default** is: return everything to shareholders
 - Our **alternative** is: find investments that improve the future cash flow profile

Having said all this does not imply that we are not "sensible" for other views. Let us list a few of those in what follows.

Sensibility

Swisscom has proven to be able to sweat its assets extremely well. As a matter of fact, its returns on invested capital are among the very best in the industry. This is – we believe – largely a result from living consistently by our own rules, especially the "focus on cash flow generation from current operations".

However, we also have to be sensible. And think of other ways to further improve the capital efficiency. One very obvious way has been suggested by many of you, and bears a lot of truth in it: to make better use of the funding potential of our existing balance sheet. Here are some of our thoughts on this matter:

- Swisscom carries no net debt on its balance sheet. As a matter of fact, the net cash position at 30 June 2005 was CHF 2.4 billion.
- By applying its return policy, Swisscom returns all of the annual equity free cash flow to shareholders. In doing so, Swisscom factually prevents that more cash is piled up on its balance sheet. In line with the thoughts set out earlier in this letter.
- A well capitalized balance sheet would however not carry net-cash, but a sensible level of net-debt as the (after tax) cost of debt are well below the cost of equity.
- The obvious thing to do, would therefore be:
 - a) Get a sensible level of debt funding in place, still allowing for a strong balance sheet with sufficient strategic flexibility.
 - b) Return the proceeds from this funding to shareholders. For instance through share buy backs and/or other payments.
- Swisscom's "dilemma" (albeit a very nice dilemma to have) is that we cannot easily do this. Simply because Swiss corporate law prohibits payments to shareholders higher than the level of retained earnings on its balance sheet. With currently some CHF 3.2 billion in retained earnings, the funds that can be returned to shareholders fall significantly short of the proceeds an optimal level of debt would bring.

Swisscom hence has substantial funding capacity that is not deployed in an optimal fashion. Call that “**the opportunity cost of our balance sheet**”.

However, if we talk about “opportunity costs” that also implies that there are opportunities. What are the **alternatives**?

1. The default is to continue with our current strategy of returning full equity free cash flow to shareholders in the form of dividends and share buy backs. In the first half of 2005, we paid CHF 861 million in dividends and also launched a CHF 2 billion share buy back. Since Swisscom’s annual free cash flow is higher than its net income, we hence reduce our retained earnings gradually by making it available to shareholders. Within a few years time, we will see an inflection point where net income and free cash flow will not significantly diverge anymore, simply because the level of depreciation will come down to the amount of Capital Expenditure. This makes the current Return Policy sustainable, also in the long run.
2. Alternatively we can try to find ways to increase the level of retained earnings at the holding company. We have already done this in 2002 and 2004, improving the level of reserves by CHF 1.1 billion and CHF 0.8 billion respectively. Although further options to increase the level of retained earnings are not very obvious, we do explore more alternatives.
3. A third option (although some of you think that this should be “option 1”) would be to find alternative investment possibilities, which allow us to buy into accretive free cash flows. In this situation, we would basically generate shareholder value by acquiring assets that promise to yield better than the related cost of capital. However, we feel that any such scenario would have to fulfill the whole string of investment criteria set out repeatedly in the past.

In **conclusion**, whereas we share the view with many of you that improving capital efficiency through sensible leverage could be beneficial to shareholders, we also hope to have pointed out that the alternatives to do so are limited. However, we believe that there are still attractive investment opportunities around in the coming years and therefore it is not the time to draw on our last resort measure of artificially increasing retained earnings at the holding level for accelerated cash distribution to our shareholders. Until we are able to deploy our full funding potential, the continued application of our Return policy poses the “worst-case scenario”. With a yield of well over 10% p.a. on current market capitalisation this, we would argue, is an excellent “fall-back” to have.

Swisscom: “Sense and sensibility”

Yours sincerely,



Dr. Markus Rauh
Chairman of the Board of Directors



Jens Alder
CEO

Contact details

Swisscom AG
Group Communications
Postfach
CH – 3050 Bern
T+41 31 342 36 78
F+41 31 342 27 79
E swisscom@swisscom.com

Investor Relations

Swisscom AG
Investor Relations
CH – 3050 Bern
T+41 31 342 64 10
F+41 31 342 64 11
E investor.relations@swisscom.com