Difficult economic situation in Italy and lower future growth lead to an impairment of Fastweb – Swisscom's net income reduced by CHF 1.2 billion

14 December 2011

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In brief

- The book value of Fastweb has been impaired based on the difficult economic situation in Italy and the resulting reduced prospects for growth. As a result, its overall value has dropped by around 35% since the acquisition
- Since the announcement of the acquisition of Fastweb, the Italian stock market index has dropped by 63%. The economic situation responsible for this also led to impairments at other Italian telecom companies
- Fastweb's updated business plan takes these developments into consideration with lower future growth and a focus on cost efficiency and financial results
- Fastweb's impairment is having an impact on Swisscom's net income (minus CHF 1.2 billion) and thereby also reduces its tax expense for 2011
- The impairment has no impact on Swisscom's cash flow, its Swiss business and capital expenditures in Switzerland
- As in previous years, Swisscom is proposing an increase in the dividend by CHF 1.00 to CHF 22.00 per share

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Limited growth in Switzerland

- Swisscom competes successfully in the Swiss market and offers one of Europe's leading network infrastructures and excellent service
- Swisscom is being affected by dropping prices in Switzerland and must generate new sources of revenue – however:
  - given that Swisscom is the market leader, opportunities for growth are limited for both economic and regulatory reasons
  - new business segments such as Swisscom TV, mobile surfing and IT outsourcing cannot completely compensate for the reduction in revenues
  - there are no opportunities for large corporate acquisitions in Switzerland
  - costs cannot be arbitrarily reduced
- If Swisscom were not able to compensate for annual price erosion through growth, the value of the company would be burdened and the share price will drop

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Reasons for the Fastweb acquisition in 2007

- Increase Swisscom's enterprise value
- Attractive broadband market in Italy with potential for growth
- Have its own network infrastructure without the need to be a basic service provider
- Above-average customer satisfaction
- Leader in fibre optic technology and in IPTV products
- Company with the potential to contribute to Swisscom's success with additional revenue and EBITDA
- A reasonable purchase price compared to other telecom companies and based on its own modern network infrastructure

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The economic environment in Italy has deteriorated

- The economic situation in Italy has deteriorated in the wake of the sovereign debt crisis
- Because of that, the risks for companies doing business in Italy have increased:
  - potential increase in corporate tax rates
  - stagnating or declining consumption
  - reduced consumption on the part of the government and public institutions
- In 2011, a number of telecom companies had to undertake exceptional impairment charges for their Italian subsidiaries: Swisscom by EUR 1.3 billion; Vodafone by EUR 0.9 billion and Telecom Italia by EUR 3.2 billion

Fastweb – how it developed since the acquisition

- Since the acquisition, Fastweb has developed quite positively: revenues and EBITDA each increased by around 50%
- With a market share of approximately 20%, Fastweb is the clear #2 among corporate customers:
  - since the purchase, the market share has been doubled
  - thanks to its own fibre optic infrastructure and very high customer satisfaction, Fastweb has been able to record steady growth
- In the private customer segment, on the other hand, after a growth phase, Fastweb has come under pressure in the last several quarters.
- The reasons for decreasing average revenues per customer user and the increased willingness to switch providers among private customers:
  - the difficult economic environment
  - increasing saturation of the broadband market
  - intense competition with the market entry of new suppliers providers
  - market consolidation

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Measures have been initiated and are showing success

- The new focussed business plan – following reduced revenues in the first two years – anticipates average annual growth rate (CAGR) in revenues of 2.5% measured over the entire 5-year planning period
- Factors driving revenues are, above all:
  - the continued positive development among corporate customers
  - the partnership with the pay TV supplier Sky
  - expansion of sales and marketing channels
  - expansion of the mobile phone services offering
  - compared to other competitors, higher quality of the services provided
- In addition, increased efficiency (reduction of costs by EUR 120 million over the next two years) and a reduction in the ratio of bad debts losses will lead to a higher operating margin
- Further, Fastweb will drop its level of capital expenditure because extensive preliminary work has already been done in the network infrastructure
- The measures initiated are showing success:
  - the number of non-paying customers has been cut in half within a year
  - In the third quarter, Fastweb booked the highest rate of customer growth compared to its competitors

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Impacts of the impairment

- Swisscom's net income is being reduced by CHF 1.2 billion
- Income tax expense will be lower

  (tax payments in Switzerland since the initial public offering, a total of CHF 4.6 billion)

- The value adjustment has ***no*** impact on
  - the operating result (EBITDA), cash flow or net debt
  - price policy in Switzerland: in 2011, Swisscom experienced a price erosion of more than CHF 400 million in the first nine months
  - dividend payments – to the contrary: as in previous years, Swisscom is proposing an increase in the dividend by CHF 1.00 to CHF 22.00 per share (federal government income since the initial public offering, CHF 17.3 billion)
  - investment activity in Switzerland

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Further high investments in Switzerland

- Each year, Swisscom invests more than a billion Swiss francs in the expansion of its infrastructure in Switzerland. These investments will also remain high in future
- In the first nine months of 2011, these investments were already CHF 200 million above the previous year
- Per-capita investments in the telecom infrastructure in Switzerland are very high compared to other countries
  (Position 4 according to the OECD Communications Outlook of July 2011)
- Roughly a fifth of Swisscom's investments are being put into expanding FTTH – more than any other European incumbents
  (JP Morgan, April 2011)

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Formation and presentation of goodwill

- Swisscom invested a total of EUR 4.6 billion to acquire Fastweb and refinance its debt
- For Swisscom's consolidated financial statements, at the time of the acquisition all of Fastweb's assets and debts were recognized at market value. In the process, previously not recognised intangible assets such as customer relationships and brands were recorded on the balance sheet
- The difference in the amounts between the purchase price (EUR 4.6 billion) and the market value of the recognized net assets (EUR 2.8 billion) was recorded on the consolidated financial statements as goodwill (EUR 1.8 billion)
- According to International Financial Reporting Standards (IFRS), goodwill is not subject to ordinary amortisation. Rather, the book value must be tested annually for impairment through a corporate valuation
- If the corporate value is less than the book value (including goodwill), an exceptional impairment charge must be recorded
- In case of a positive development in the value, an impairment charge may not be reversed in a later accounting period

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Reasons for and results of the impairment test

- Fastweb's book value was tested for impairment as part of the annual year-end closing process on the basis of a corporate valuation.
- The results of this impairment test revealed that Fastweb's corporate value at the end of 2011 was some EUR 1.3 billion below the book value of net assets including goodwill. Consequently, an extraordinary impairment loss was recognised in this amount.
- After ordinary annual depreciation and amortisation this resulted in a net book value of EUR 2.9 billion, representing a loss in value since the acquisition of around 35% in comparison with the total investment.
- The scale of this value decrease is similar to the changes in market valuation of other European telco shares and slightly better than the SMI.
- The EUR 1.3 billion impairment loss results in a reduction in net income of CHF 1.2 billion (after tax).
- The main reasons for the impairment loss are:
  - overall economic conditions in Italy, with a sharp rise in sovereign bond yields and yield spreads in recent months
  - a reduced growth outlook as a result of the economic environment (rising unemployment, intensified competition, regulation)

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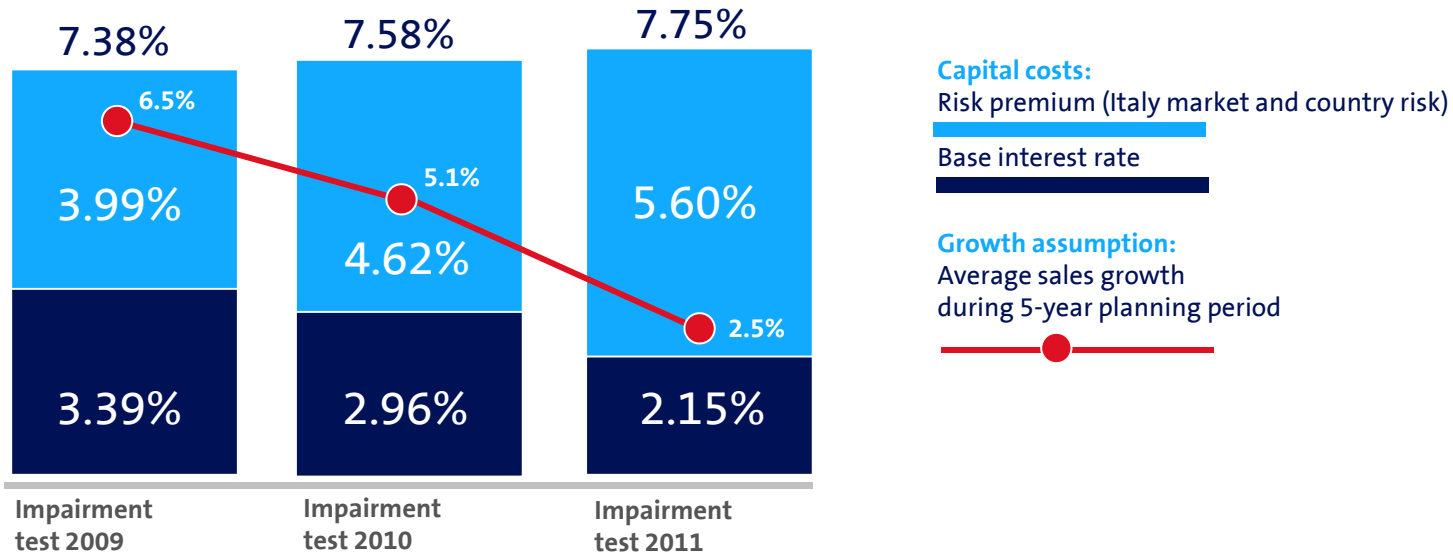
Trend in cost of capital and growth expectations

Change in the capital cost and sales growth value drivers:



- The low-risk euro interest rate has fallen since 2009 while the risk premium has increased due to higher country risk in Italy.
- At the same time, the future sales growth assumed in the business plan has dropped sharply.
- The trend in these two value drivers is what led to the extraordinary impairment loss.

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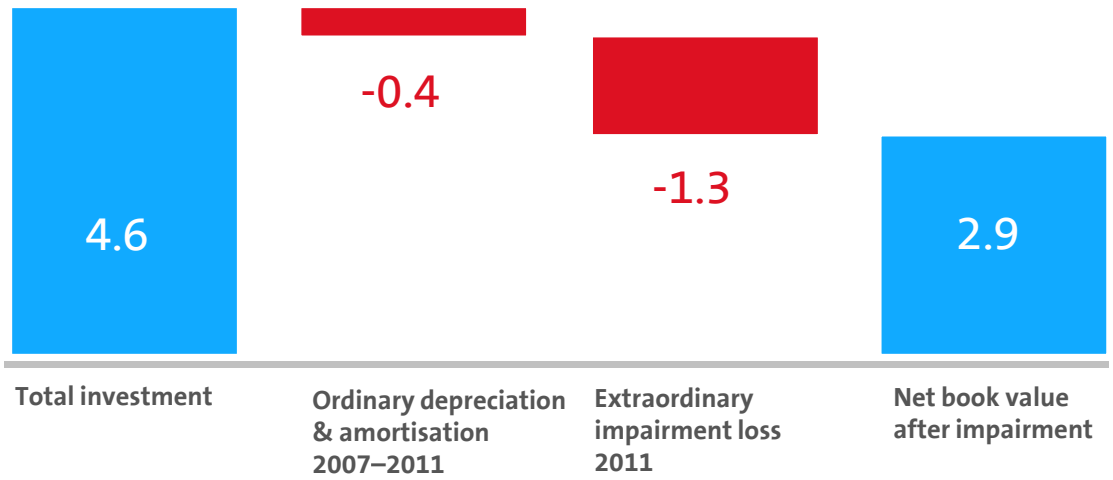
Total investment in Fastweb and book value

Reconciliation of total Fastweb investment with current book value in EUR billion



- Swisscom has invested EUR 4.6 billion to date in the purchase and subsequent financing of Fastweb.
- The book value after recognising the extraordinary impairment loss and ordinary annual depreciation and amortisation is EUR 2.9 billion. With reference to the total investment, this corresponds to a loss in value of around 35% since the acquisition.

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Fastweb value decline of around 35% since the acquisition

- Since the acquisition, Fastweb's value has declined by around 35%. The main reason is overall economic developments in Italy.
- Among exchange-listed companies, lower growth prospects have a continual impact on daily share price fluctuations and thus on shareholder value.
- For companies not listed on an exchange, by contrast, impairment losses are recorded via impairment tests carried out at certain time intervals.
- Such adjustments to the value of subsidiaries (Fastweb) impact on the mother company (Swisscom) both in their share price and in impairment losses through the income statement, but do not result in a cash outflow.
- The chart of share price movement in the next slide shows a comparable decline in the value of non-exchange-listed Fastweb and exchange-listed telecommunications enterprises and share indexes.

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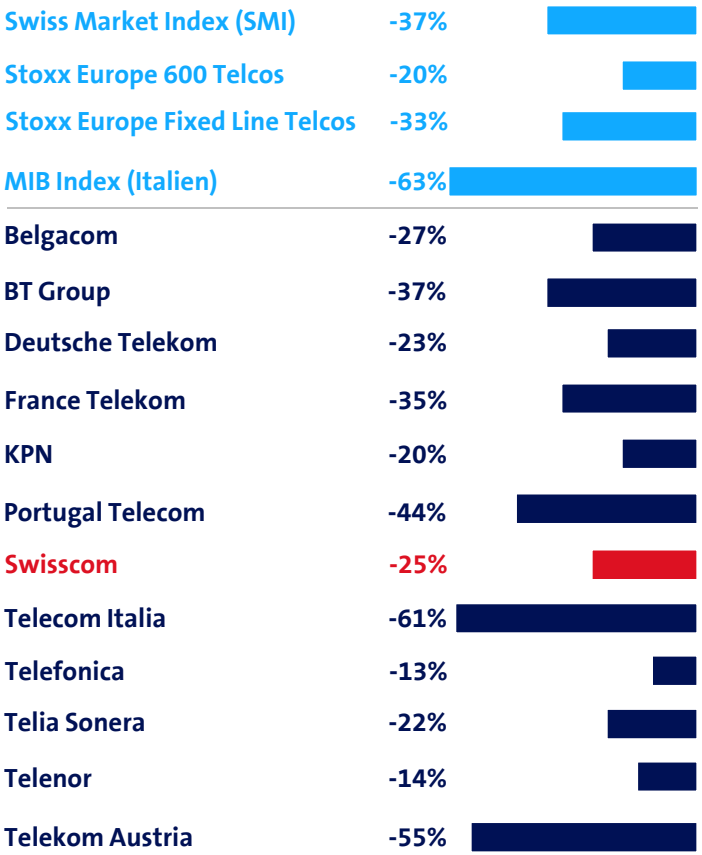
Fastweb impairment loss in comparison with share prices and indexes

Telco share price/indexes movements

in the period from 9 March 2007(1) to 30 November 2011



- The impairment loss for Fastweb since the acquisition is equivalent to around 35% of the total investment.
- The reduction in Fastweb's value is similar to that of other telecom companies and of the SMI.
- Many European telecom share prices have seen considerable declines since March 2007.
- The Stoxx 600 Telcos sectoral index is 20% below its level in March 2007.
- At minus 37%, the SMI fell still farther during the same period.

(1) Swisscom announced the launch of its public takeover bid for Fastweb on 12 March 2007.

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Impact on Swisscom financials

Pro-forma consolidated balance sheet after extraordinary impairment loss

Base: September 2011, CHF bn

Goodwill:		
- Swisscom Switzerland	3.9	
- Fastweb	0.6	
- Other	0.1	4.6
Other assets		14.9
Assets		**19.5**
Liabilities		15.6
Equity		3.9
Liabilities & equity		**19.5**
Market capitalisation		**17.8**

- After recognition of the extraordinary impairment loss, remaining goodwill on the consolidated balance sheet comes to CHF 4.6 billion.
- Goodwill for Fastweb amounts to CHF 0.6 billion.
- The largest goodwill component — CHF 3.9 billion — is associated with Swisscom Switzerland and is not exposed to impairment risk.
- Equity on the September pro-forma consolidated balance sheet is CHF 3.9 billion, for an equity ratio of roughly 20%.
- The market value of the equity (market capitalisation) is actually CHF 17.8 billion.
- Net debt CHF 8.8 billion (equal to 1.9 x EBITDA)
- Stable A rating

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Currency effects

- Swisscom financed the acquisition of Fastweb almost entirely by assuming financial debt in Swiss francs. This has resulted in substantial cost savings since Swiss franc interest rates are considerably lower than euro rates.
- Since the acquisition, the euro's exchange rate against the franc has fallen sharply. (May 2007: CHF 1.66; currently: CHF 1.24).
- The overall effect has been large fluctuations in shareholders' equity in the amount of the foreign currency translation differences for foreign holdings.
- In 2010, the cumulative effect was CHF 1.55 bn after tax (see p. 193 of the Annual Report). This amount was essentially unchanged in 2011.
- These differences are purely mathematical and have no impact on Swisscom's net income. If the euro exchange rate were to rise, the differences would fall back.
- Moreover, Swisscom also benefits from the weak euro when purchasing devices and equipment in euros.
- These effects have been more than offset by price erosion during the first nine months of the year.

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Strategic importance of Fastweb for Swisscom

- Swisscom's foreign operations are minor in comparison with other historical European providers.
- Nevertheless, the Fastweb investment remains strategically and financially important for Swisscom.
- In a world of steadily increasing bandwidth, Fastweb is very well positioned with its own modern fibre optic infrastructure.
- Forecast growth at Fastweb should offset at least a portion of the sales decline in Switzerland, which is a result of the competitive situation.