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Stock Rating
Overweight

Industry View
Attractive

KPN

Room for More Upside, Upgrade to Overweight

What's Changed	
Rating	**Equal-weight to Overweight**
Price Target	**€12.50 to €14.00**

Room for more upside: Revisiting our KPN forecasts and operational trends has given us conviction in the potential for positive surprises and value creation. We anticipate the three following operational catalysts and, together with a compelling valuation and LBO potential, these lead us to upgrade to Overweight.

1. Eplus margins: Ongoing SAC/SRC reduction and network outsourcing should keep margins above 35%. This is 3 pp above consensus and we cannot rule out further expansion. We expect higher visibility on this from 2Q07 to be reported on July 31.

2. Domestic mobile margins: Lower than we expected F2M rates cut, Telfort integration and potential in-market consolidation should widen margins above 40%. We are 2 pp above consensus and visibility will increase in 2H07.

3. The worst is over in fixed telephony this year: The issues around KPN's VoIP offer that resulted in weaker than expected wireline results in 1Q07 have been sorted out. We expect earnings improvement from 3Q07.

Very attractive valuation: KPN trades below 10x 2009e adjusted earnings and at a 19% discount to the sector. We estimate a 23% total return (sector 15%) — 14% from upside to our price target plus 9% FCFE yield.

LBO looks feasible now: Despite increasing interest rates, a 15-25% IRR at €14-15/share seems sensible.

M&A is the main risk to our call: We see M&A as very unlikely and management is price sensitive but interest in ONE and Bouygues Telecom has been declared.

Key Ratios and Statistics

Reuters: KPN.AS Bloomberg: KPN NA ADR: KPN.N
Telecommunications Services / Netherlands

Price target	**€14.00**
Shr price, close (Jun 13, 2007)	€12.23
Mkt cap, curr (mn)	€23,579
52-Week Range	€12.84-8.47
FCF yld ratio (07e) (%)	9.6
EV/EBITDA (07e)	6.5
EV/net op assets (07e)	2.5
EV/rev (07e)	2.7
Net debt/EV (07e) (%)	27.5
P/BV (07e)	6.9
ROE (07e) (%)	45.1
RNOA (07e) (%)	12.3

Fiscal Year (Dec)	2006	2007e	2008e	2009e
ModelWare EPS (€)*	**0.88**	**0.87**	**0.99**	**1.12**
Prior ModelWare EPS (€)	**0.87**	**0.90**	**0.97**	**1.09**
P/E	**12.3**	**14.0**	**12.4**	**10.9**
Consensus EPS (€)	**0.75**	**0.81**	**0.88**	**0.97**
Div yld (%)	4.3	4.2	4.6	4.8

* = Please see explanation of Morgan Stanley ModelWare later in this note.
e = Morgan Stanley Research estimates

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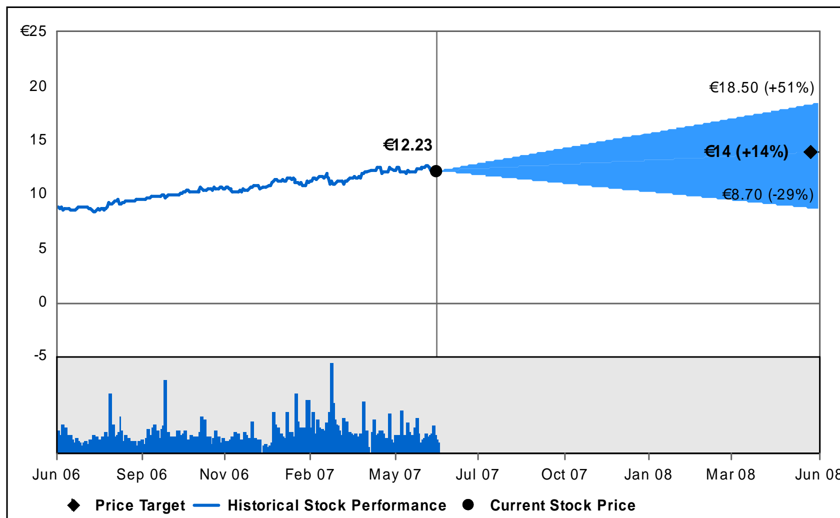
Risk-Reward Snapshot: KPN (KPN.AS, OW, PT €14)

Greater conviction on positive surprises and value creation tilts the risk/reward scenario to the upside



Price Target €14	Mid point between bull and bear case is €13.6 per share. We think the area of interest in an LBO scenario is €14-15. We therefore set our price target at €14 per share, also in line with our fair value.
Bull Case €18.5	**PSTN Line Loss 06-10e**: -2.7% (€0.8/share). This is assuming 85% penetration of VoIP over DSL connections by 2010. **Dutch Mobile Service Revenue Growth 06-10e**: 7.3% (€1.5/share). This assumption implies voice flat with SMS revenues down around 2% per year and non-SMS growing around 60% per year. **Eplus Service Revenue Growth 06-10e**: 8.9% (€1.4/share). (Similar to Dutch mobile assumptions from a lower starting point). New share buy-back of €3bn to meet 2.5x debt metric (€0.8/share)
Base Case €14	**PSTN Line Loss 06-10e**: -4%. This is assuming 75% penetration of VoIP over DSL connections by 2010. **Dutch Mobile Service Revenue Growth 06-10e**: 4.3%. This assumption implies voice flat with SMS revenues down around 2% per year and non-SMS growing around 30/40% per year. **Eplus Service Revenue Growth 06-10e**: 6% (similar to Dutch mobile assumptions from a lower starting point).No new buy-back additional to the around €1 bn per year.
Bear Case €8.7	**PSTN Line Loss 06-10e**: -5% (€-1.1/share). This is assuming 50% penetration of VoIP over DSL connections by 2010. **Dutch Mobile Service Revenue Growth 06-10e**: -0.7% (€-2.2/share). This assumption implies voice 5% down with SMS revenues down around 2% per year and non-SMS growing around 25% per year. **Eplus Service Revenue Growth 06-10e**: +1% (€-2/share). No new buy-back.

Source: FactSet (historical data), Morgan Stanley Research estimates

Why We Are Upgrading to OW:

- We have revisited our forecasts and operational trends for KPN and we have strong conviction that there is further room for positive surprises and value creation.
- Our earnings upgrades (4% above consensus for EBITDA 09e) feed into our new fair value and hence new price target of €14/share.
- With 7% underperformance of the industry in the last two months on the back of weaker than expected fixed telephony results in the 1Q07, the current price provides an attractive entry point.
- The stock is trading at a 19% discount to the industry on adj. 09e PE (below 10x) and 08e FCF yield of 9%, which is fully distributed to shareholders.
- LBO scenario looks feasible now with 15-25% IRR at a price range of €14-15, providing downside support.

3 Operational Catalysts

- Eplus: we see margins as sustainable above 35%, which is 3 pp higher than consensus, and we expect increased visibility from 2Q07.
- Domestic mobile: lower F2M rates cut and in-market consolidation will boost margins further too. We expect higher visibility from 3Q07.
- Fixed telephony: The worst is over this year. Issues around VoIP have been settled. 4Q07 will be the first with no one-off charges at all but 3Q07 should improve in both operating trends and lower one-off charges.

Investment Case

We see room for further upside — Upgrading to Overweight

KPN has been one of the best performers in the sector in the last couple of years. This performance appeared to be driven by ongoing improvement in operational momentum, a solid management team and strong shareholder remuneration.

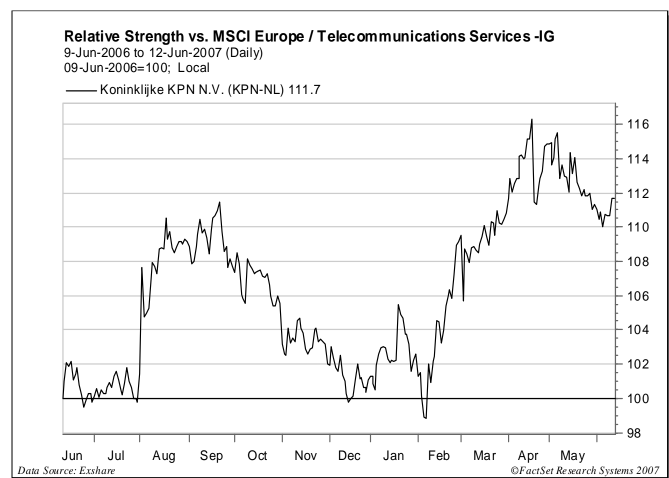
In addition, we think ongoing speculation in the market and the press about KPN being a potential LBO candidate together with the attractive remuneration policy was providing downside protection and indeed added to the stock's appeal.

Now we have revisited our forecasts and operational trends for KPN and we have strong conviction that there is further room for positive surprises and value creation. We anticipate three main operational catalysts, with a very compelling valuation and continued support from the potential LBO scenario.

All of this has led us to upgrade our long-term EBITDA numbers by 4% and our normalised long-term FCF by 9% (when the double tax penalty from the recapture process is over, around 2013 on our estimates). This has given rise to a 12% equity value increase and a new price target of €14 per share (previously €12.5). We upgrade the stock from Equal-weight to Overweight.

Exhibit 1

KPN stock relative to the sector (-12m): Great performance until 2 months ago



Source: Facset

We see 3 key operational catalysts

1. **Eplus margins, with room for long-term expansion and potential for consensus upgrades:** We see margins as sustainable in the current 35-36% range and the company believes that it can widen margins further in the next few years. Consensus is still very low at 32-33% for 2007-10 and this therefore represents a source of potential upgrades, in our view. The main margin drivers should be a continued reduction in subscriber acquisition and retention costs, as well as headcount reductions and network outsourcing. We do not factor in a big margin expansion from current levels, however, due to competitive pressures and lower roaming tariffs from September 2007. However, if margins were to reach 40% in the long term this would add €0.5 per share to our valuation (this is implicitly included in our Bull case for Eplus).

2. **Domestic mobile margins to benefit from Telfort integration and lower-than-expected F2M rate cuts; Dutch consolidation could provide further upside:** The benefit to the group operating margin of the acquisition of Telfort will have a bigger impact from the second half when the accelerated depreciation of Telfort's network will be over. In addition, the recently announced cut to fixed to mobile (F2M) interconnection rates was lower than expected, which also helps revenues and EBITDA margins. Finally, in-market consolidation in the Netherlands (Orange/T-Mobile) looks like a plausible outcome to us as T-Mobile would generate synergies that third parties can not justify and makes of it the natural buyer for Orange (officially for sale). This would reduce the number of players from 4 to 3 and creating a more rational market. Overall, we have raised our EBITDA margin estimates by 2 pp to 42% by 2010 without factoring in any benefits from in-market consolidation. If we assume 45% long-term margins, this would raise our valuation by €0.4 per share.

3. **Fixed telephony – the worst seems to be over this year:** One of the reasons for the underperformance since the company reported the 1Q07 numbers was the poor result in fixed telephony. The company attributed this to stronger VoIP demand than it anticipated, which resulted in customer complaints and a slow down in installations. €25-30 million in one-off charges were needed to sort out the problem, which also resulted in higher line loss than expected. KPN says that the one-off charges will not fully disappear until the 4Q07, but the situation seems to have

been sorted out now and the company has moved up again from 3,000 installations per week to 15,000, with a focus on quality growth. This should have a positive impact on the line loss starting from Q2 and hopefully on the revenue trend from 3Q onwards.

In addition, we think further catalysts will come from the agreements with the unbundlers that KPN expects to announce before the end of June (as ruled by the regulator OPTA), which will clarify the migration to an all-IP network, and the real estate disposals.

Attractive valuation and defensive nature

We are raising our price target by 12% to €14 per share, implying 14% upside potential. As we explain in detail later in the note, our higher valuation for Eplus and the Domestic Mobile business is partially offset by lower value in fixed telephony. Overall, this price target increase reflects our 4% long-term EBITDA upgrade, which translates into a 9% higher enterprise value (EV) and 12% higher equity value.

In terms of total return, if we include the 4.6% dividend yield that we expect for 2008 and the 4.5% announced and ongoing share buy-back, we get to a total 12-month return of around 23%, well above the 15% total return that we estimate for the sector.

In relative terms the stock has underperformed the industry since April, which together with our earnings upgrade leads to quite attractive market metrics, as detailed in the table below.

Exhibit 2
Market metrics comparison

	KPN	Sector	Premium/ (Discount) (%)
EV/EBITDA 08e (x)	5.9	6.0	-2
EV/EBITDA 09e (x)	5.2	5.5	-5
FCFE yield 08e	9.2	8.9	-3
FCFE yield 09e	11.1	10.3	-8
PE 08e (x)	10.8	12.9	-16
PE 09e (x)	9.6	11.9	-19
DY 08e	4.6	5.0	8
DY 09e	4.8	5.5	13

Note: PE excludes license amortisation and FCFE yield is normalised by taxes and restructuring charges
Source: Morgan Stanley Research estimates

Finally, we believe a 9% annual return from dividends and share buy-backs will be sustainable in the long term and provides a strong element of defensiveness. This would make it even more attractive in the event of a market correction, which is expected by our Strategy team.

LBO speculation makes sense, in our view

As well as being defensive in nature due to shareholder returns, the fact that KPN is perceived as the main candidate in the sector for an LBO provides increasing downside protection. As anyone with any familiarity with KPN will be aware, such speculation has been going on for several years. The rumours intensify periodically, as highlighted by a *Financial Times* mergermarket.com article on April 26, 2007 in connection with renewed speculation at that time. As the article indicates, the rumours do not focus on any particular potential acquirers. KPN has acknowledged that the rumours exist, but has not commented otherwise. The qualities that lead to this speculation include KPN's size, its overseas assets that could be targeted for quick disposal, debt to EBITDA below 2x and the fact that it is a fully privatised company.

The company's improving actual and forecast earnings and the significant value of Eplus as its main overseas asset would be particularly key to KPN's attractiveness to private equity, in our view. We also note that the sector re-rating is allowing for higher exit multiples (although acquisition metrics are also rising in line), which we think makes a potential LBO look more feasible, even assuming some increase in interest rates.

We present two detailed hypothetical LBO scenarios — one in which assets are retained and one in which Eplus is disposed of upfront. We determine that an LBO would need to take place in the €14-15 per share range to generate an IRR above 15%, which we see as the minimum required by private equity firms.

Main Risk: M&A

We believe that the main risk to our call is that the company, which has declared its intention to investigate investment opportunities, goes for expensive or dilutive acquisitions and puts shareholder returns at risk. However, we believe that a transaction is unlikely to happen in the short term and we also note KPN's conservative approach in the past. We also believe that, contrary to other companies in the sector, investors would tend to give KPN the benefit of the doubt if it were to invest abroad due to its excellent track record so far.

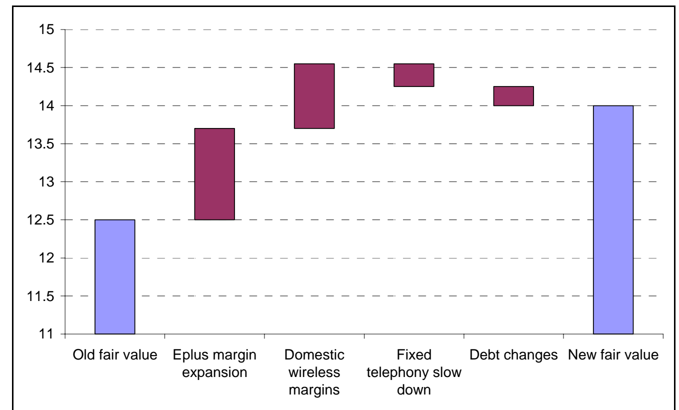
Declared interest in One33 in Austria and Bouygues Telecom in France

The company has repeatedly declared that is looking for options abroad in terms of both an asset light approach (MVNO, reseller) and/or a network operator. Among the latter, the company has stated its interest in One, the mobile operator in Austria, and has also declared that if Bouygues Telecom was for sale in the future it would look at it.

In our view both deals are financially feasible as detailed later in this report (KPN at 1.8x debt to EBITDA 08e but targeting 2-2.5x, which provides further €3.5 billion flexibility). However, in the case of One we see FT as the most plausible buyer and think that it would be very difficult for KPN to be successful in the bid. Bouygues Telecoms is not really for sale now and if it was this could be an even more difficult deal for KPN as there would be other potential buyers with greater financial flexibility.

Exhibit 3

Change in fair value: From €12.5 to €14 per share



Source: Morgan Stanley Research estimates

Company Description

KPN is the Dutch telecoms incumbent. It has more than 8 mn fixed network customers and more than 8.6 mn mobile customers in the Netherlands. KPN owns 100% of E-Plus, the third mobile operator in Germany with 12.6 mn subscribers, and BASE, the third mobile operator in Belgium with more than 2 mn subscribers.

Telecommunications Services/Netherlands

Industry View: Attractive

GICS Sector: Telecom Services

Strategists' Recommended Weight: 8.4%

MSCI Europe Weight: 6.4%

E-plus: Margin Expansion Is Here To Stay

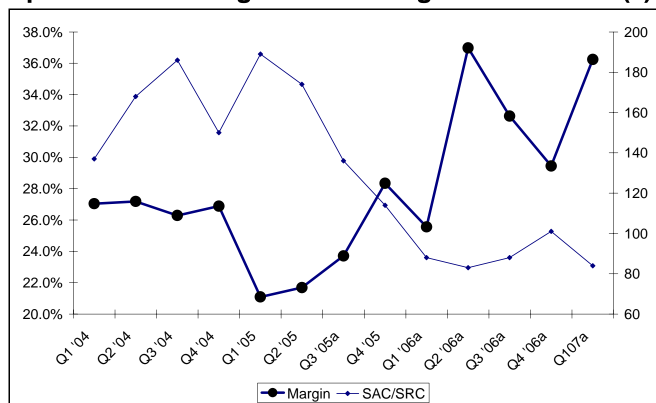
Very strong correlation between margins and SAC/SRC
On our estimates SAC/SRC has come down at Eplus from 36% of total operating costs to around only 30%. Furthermore, it has come down from 26% of revenues in 2004 to 21% in 2006. This has therefore been the main reason behind the margin expansion from 27% for FY04 to 31% for FY06. As shown in Exhibit 4Exhibit 3, on a quarterly basis this correlation is very clear over 2004-2006.

Segmentation strategy resulting in lower SAC/SRC, which we see continuing
The multi-brand strategy that was launched around mid 2005 has been a clear success in increasing consumption (MOU) and reducing SAC/SRC. As of 1Q07 more than 5.1 million customers or 39% of the total were coming from these new brands. This compares with only 1 million customers by YE05 and implies that most of the net additions in this period (2.3 million net adds) have come from the new brands (internal churn exists).

This trend does not look set to change in the short term as in 1Q07 another 800 thousand customers joined the new brands with a similar run-rate to the previous 5 quarters. The company acknowledges that all the growth is now coming from this source and that, although we will see some slow down sooner or later, we should expect similar trends for the next few quarters at least.

The reason behind reduced SAC/SRC from these multi-brands is that most of them are based on no-frill tariffs with SIM-only propositions and internet sales, which obviously imply very low commercial costs. This multi-brand strategy has also proven to be very successful in increasing consumption, with MOU up 33% YoY in the 1Q07 with flattish ARPU for both the postpaid and prepaid segments (blended down 5% due to higher prepaid contribution) despite aggressive tariff cuts.

Exhibit 4
Eplus EBITDA margin evolution against SAC/SRC (€)



Source: Company data, Morgan Stanley Research

This strategy has also proven to be very successful when facing competition from T-Mobile or Vodafone, each with circa 35% market share. Any tariff reaction from these leading operators could be followed by some or even only one of the brands from Eplus with positive commercial results and without diluting all the customer's ARPU. As a result, revenue share went up by 1.4% in the last 12 months to around 13.5% with an impressive service revenue growth of 8% in the 1Q07 and 9.6% for the FY06.

Network outsourcing should start delivering in 2Q07
E-Plus signed an agreement with Alcatel-Lucent to take over a number of E-Plus' network divisions. On 1 March 2007, E-Plus transferred operational divisions that deal with the construction, operation and maintenance of its mobile network to Alcatel-Lucent. As part of the outsourcing process Alcatel-Lucent took on around 750 E-Plus staff in Germany.

E-Plus will maintain responsibility for strategic network planning and network development, including the selection of mobile communications locations and their technical equipment. This will ensure the high quality and efficient roll-out of its mobile network in the long term. Leveraging Alcatel-Lucent's experience and expertise will mean that future network construction and maintenance requirements can be met with greater speed, flexibility and cost synergies than E-Plus could otherwise achieve on its own.

What the equipment vendors do is to try to win as many deals as possible in a given country in order to leverage scale. For example, it can leverage its field maintenance engineer at 3 base stations versus 1 (for a particular operator) — along similar lines, each operator will have its own network operating centre, whereas the equipment vendor could consolidate into one. Also in certain instances support and maintenance can be transferred over to another time zone versus having to work shifts in the specific country.

According to the company this network outsourcing should have an annual impact on EBITDA margins between 1-1.5 percentage points (a few tens of million euros). Although the

deal was signed in February, this should start having a positive impact already in the 2Q07.

According to Ericsson, it can save up to 15% of a mobile operator network costs. We estimate that for an average operator in Europe network costs including repair, maintenance, lease lines, rentals and others could amount up to 8-10% of all the operating costs and around 4-5% of revenues. As a result, a 15% cut to this would imply around 0.75 percentage points of margin expansion. For Eplus, which is a third player with lower scale than the average, it makes sense that the impact is higher and between the range provided by the company.

Restructuring is also behind widening margins
Following the 750 people transferred to Alcatel -Lucent as part of the outsourcing deal, the objective is to make headcount come down by a further 300 people or slightly above 10% of the total in 2007/08. This restructuring will end up with around 70% of the workforce being 'customer facing' against 42% one year ago. This has also been supportive of stronger margins and the benefits should also be seen in 2007/08. However we want to stress that the reduction in SAC/SRC is much more important as personnel expenses represent around 9% of total operating costs and only 6% of revenues, on our estimates.

Forecast changes for Eplus: raising EBITDA margins
In terms of revenues we have increased the number of net additions from 1.2 to 1.6 million in 2007 (489 thousand net adds in the 1Q07 already), from 500 thousand to 1 million in 2008 and then growing by 3% annually. This is leading us to a customer base of 16 million customers by 2010 or 7% above our previous forecasts. This is reflecting the continuing success in the multi-brand strategy from Eplus.

In terms of EBITDA margins, we have cut our assumptions for SAC/SRC especially for postpaid customers (around 46% of total but only 5% of net additions in 1Q07). While we had SAC/SRC going up by 3% in line with inflation, it is clear now as explained earlier that these will continue trending down. In fact it came down by 9% in the 1Q07, a similar reduction to the one we used for our FY07 forecasts.

We think we should expect some slow down in the growth from this multi-brand strategy sometime next year and therefore further growth should come from more costly customers. We are therefore expecting SAC/SRC to go up again with inflation from 2008 although from a lower level. This has explained around 1.5 percentage points of margin expansion in our model.

In 2008 and despite the full benefit from the network outsourcing we have EBITDA margins similar to 2007. The reason is that the 1-1.5 pp of margin accretion should be offset by the around €50 million negative impact that we estimate from new roaming regulation.

The combined impact of lower SAC/SRC with a higher customer base allows the EBITDA margin to reach 36% by 2010 against our 33% previous estimate. Although there is no official guidance for long-term margins, the company seems to be very confident of sustaining margins above the current 36% level and even achieving further expansion when customer growth slows down in the future.

Exhibit 5
Eplus earnings forecasts changes (€ millions)

	2007e	2008e	2009e	2010e
Revenues old	3,048	3,146	3,262	3,363
Revenues new	3,014	3,162	3,322	3,502
Change (%)	*-1*	*1*	*2*	*4*
EBITDA old	1,024	1,051	1,094	1,110
EBITDA new	1,056	1,118	1,176	1,258
Change (%)	*3*	*6*	*8*	*13*
EBITDA margin old (%)	*33.6*	*33.4*	*33.5*	*33.0*
EBITDA margin new (%)	*35.0*	*35.3*	*35.4*	*35.9*

Source: Morgan Stanley Research estimates

Impact on valuation is €1.2 per share
On the back of our earnings changes we are upgrading our DCF valuation for Eplus by 30% from €7.1 billion to €9.3 billion (please note that upgrades in EBITDA imply around twice the impact on FCF). This implies a €1.2 per share valuation impact.

The implied EBITDA multiple is now 8.8 times 2007e against the previous 7.0 times. We believe that this new metric makes more sense for a company growing its EBITDA by 34% in 2006 and by almost 10% CAGR 07-09e on our estimates. In fact, by 2010 when we are assuming just a 2% residual growth, the implied metric comes down to slightly above 7 times and more in line with the industry average.

As mentioned the company appears confident that margins can expand further. If we assume long-term margins at 40%, our valuation would increase by €0.5 per share.

Domestic Mobile: Lower F2M Rates Cut And In-market Consolidation

Lower than expected fixed to mobile rates cut: 1 percentage point higher EBITDA margins
OPTA, the Dutch regulator, announced around mid 2006 that termination rates should come down from €11 cents to €5.5 by July 2008. This was a very aggressive and unexpected announcement that was put on hold by the competition authority. Following this decision, a few other countries such as the UK and Spain were cutting rates much less than initially expected as they were starting to reflect in the termination rates the cost of the 3G license and spectrum costs.

Finally, OPTA approved a new set of termination rates that are much more benign than the previous set. In mid May, the regulator announced that termination rates for KPN should come down from the current €11 cents per minute to €10 cents by July 07, €9 cents by July 08, €8 cents by July 09 and €7 cents by July 10.

This will reduce termination rates by 27% by July 08 against the previous 50% cut. The CAGR 06-08e will therefore be 10% against the previous 20% cut. On our estimates, incoming revenues from termination rates accounted for around 17% of total revenues for KPN in Holland in 2006. As a result, a lower annual cut of around 10% will improve revenues by 1.7% in 2007 (a bit lower in subsequent years). Taking into account that part of the traffic is mobile to mobile, which is generating interconnection expenses, not all this benefit is translated into the EBITDA level but we have ended up with an EBITDA margin 1 percentage point above the previous one in our explicit period of forecasts just for this reason.

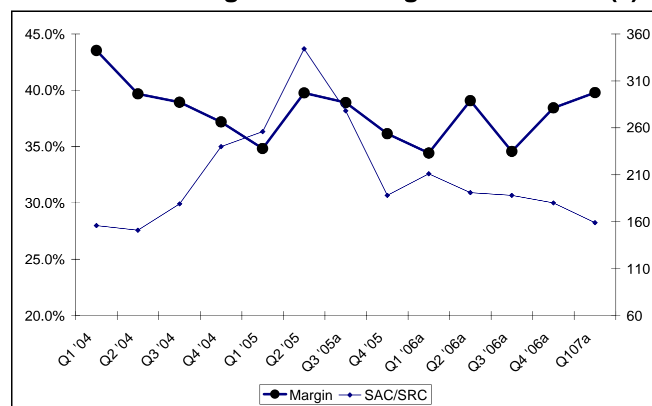
SAC/SRC coming down in The Netherlands too, but KPN also benefits from the Telfort integration: another 1 pp
Although for different reasons than in Germany, the fact is that SAC/SRC has been coming down aggressively in The Netherlands too, as reflected by the chart below. Obviously this has translated into a margin expansion for the reasons explained in the previous section of this report.

Part of this declining trend is due to the acquisition of Telfort by KPN in 4Q05, which created a much more rational market as Telfort was the number 3 and by far the most aggressive operator in the market at that time. This reduced the number of players from 5 to 4 and definitely had an impact on the competitive environment and EBITDA margins. But furthermore, the current competitive environment has improved very much and most competitors are exhibiting quite rational behaviour with no aggressive offers or big subsidies.

According to the company, 1 million Telfort customers have already been migrated to the KPN network and this should derive in further synergies from the second half of this year, although these have not been quantified. Furthermore, the accelerated depreciation of the Telfort network will also finish by 3Q07, which should also improve profitability at the EBIT level, in our view.

According to the company this should provide savings of “tens of millions”, with a higher impact in 2008, a full year after the network switch-off. A few tens of millions for a company with above €3 billion in revenues would imply around 1 percentage point of higher EBITDA margin, on our estimates.

Exhibit 6
KPN EBITDA margin evolution against SAC/SRC (€)



Source: Company data, Morgan Stanley Research

Potential in-market consolidation to help margins further
France Telecom has made it official that is seeking to sell its subsidiary in The Netherlands (Orange). Mergermarket reported on June 8 that a person familiar with the company and with knowledge of the situation said that France Telecom (FT) is waiting for advice from the Works Council of Orange Netherlands before confirming its talks with Deutsche Telekom as exclusive. According to the article, France Telecom's board met after a Deutsche Telekom board meeting approved the Orange and ya.com deals (the ya.com deal has already been confirmed by both parties, with FT paying €360 million to DT for the Spanish ISP). This news was also published in Le Figaro the same day, mentioning that DT had approved the deal and made an offer for Orange

Netherlands. DT has not made any official comment in this regard.

As reported in the article, although FT has recommended the Orange deal, it cannot sign a contract or call its agreement with DT "exclusive" until the works council process is complete. The article said that as part of the works council process, DT will need to discuss branding and infrastructure as well as staff issues, and the process could take some time.

A spokesperson for FT was quoted in the article as saying: "No decision has been taken by the board of France Telecom, which will examine the advice of the works council before taking any decision in connection with the intended sale of shares of Orange Netherlands to Deutsche Telekom."

Although according to different press articles some private equity groups might have shown interest too, we think that it is reasonable to view DT as the natural buyer for this asset. According to our estimates, KPN's subscriber market share was 50% in 2006, with Vodafone 22%, DT 16%, and Orange 12%. We think it makes a lot of sense for DT to gain critical mass and become the second operator in The Netherlands in order to grow. This should result in operating synergies too, which would allow DT to offer a higher price than any other competitor in the bidding process.

We therefore believe that the most likely outcome is that DT ends up buying Orange Netherlands and reducing the number of players from 4 to 3. We see 3 players as a much more sensible figure for a small market like the Netherlands (17 million customers). Although Orange was certainly not an aggressive player as was the case with Telfort, reducing the number of participants should result in a more rationale market with some kind of oligopolistic behaviour, in our view. We believe that this should help KPN to further increase EBITDA margins.

Forecast changes: raising EBITDA margins 2 pp

We have changed our forecasts for subscriber revenue by less than 1%, with most of the the total revenue uplift coming from a lower than expected termination rates cut and its cumulative effect.

We estimate that the lower fixed to mobile termination rates cut will have a positive impact of around 1 pp on EBITDA margins (less than half in 2007), with another 1 pp coming from synergies from the full integration of Telfort (running two networks at the same time normally implies 1-2 pp of margin according to our estimates, so this assumption might be conservative).

We are not including any assumption for higher margins in the event of in-market consolidation but we cannot rule out that margins get closer to the 45% level already achieved in early 2004.

Exhibit 7

Domestic mobile forecasts changes (€ millions)

	2007e	2008e	2009e	2010e
Revenues old	3,158	3,178	3,269	3,363
Revenues new	3,235	3,312	3,408	3,490
Change (%)	*2*	*4*	*4*	*4*
EBITDA old	1,231	1,225	1,287	1,358
EBITDA new	1,277	1,347	1,415	1,474
Change (%)	*4*	*10*	*10*	*9*
EBITDA margin old (%)	*39.0*	*38.5*	*39.4*	*40.4*
EBITDA margin new (%)	*39.5*	*40.7*	*41.5*	*42.2*

Source: Morgan Stanley Research estimates

Impact on valuation is €0.85 per share

On the back of our earnings changes we are upgrading our DCF valuation for the domestic wireless business by 15% from €9.99 billion to €11.55 billion (please note that upgrades in EBITDA imply around twice the impact on FCF). This implies a €0.85 per share valuation impact.

Now the implied EBITDA multiple is 9.0 times 2007e against the previous 8.1 times. We believe that a higher metric makes sense as we are now estimating a CAGR 07-09e of 5% for EBITDA against the previous 3% and again long-term metrics are just around 7.5x in the outer years when we expect just 1% residual growth.

As mentioned, the company seems confident that margins can expand further, especially in the event of in-market consolidation. If we assume long-term margins at 45% this would increase our valuation by €0.4 per share.

Fixed Telephony: The Worst Is Over This Year

1Q07 provided more negative than expected trends
1Q07 was substantially weaker than expected in fixed telephony earnings, especially at the EBITDA level, with a 9% lower than expected figure and down 22% YoY. Revenues were down 12%, 3% weaker than we expected, but the company has recently changed the way of reporting and this is now including what was previously called 'Other revenues', and is also net of intragroup transactions (previously disclosed). As a result the revenue comparison is much less relevant although it is definitely also behind the EBITDA decline. On a clean basis revenues came down 8% and EBITDA fell 15% after stripping out the book gain reported in the 1Q06 and that made the headline comparison much worse.

One-off costs from stronger than expected VoIP demand are the main reason behind the weakness
The demand for KPN's VoIP product exceeded company expectations and the fact is that they could not cope properly with such a high request for installations. The company started to receive complaints from customers who were not receiving good service from a commercial standpoint due to bottlenecks in the call centres. New people were hired to try to sort out the issues but according to the company these new hires were not necessarily well trained.

As a result, the company had to significantly slow down the run-rate of installations, and focus on quality and customer care, calling each customer that had put in a complaint and even pay compensation.

In the last quarter of 2006, KPN was installing 20,000 VoIP packages per week and this was reduced to only 3,500 packages at some point in the 1Q07. This was having a negative impact on the net line loss, which went up to 140 thousand in the 1Q07, up 10 thousand on a sequential basis. This is not massive in absolute terms but it was substantial in relative terms, breaking the positive trend of reducing between 10-25 thousand the line loss every quarter since 2Q06 and due to VoIP new installations.

This derived in additional costs that the company had to incur to sort out all these issues and increase customer satisfaction. In 1Q07 the company charged €25-30 million for this reason, which explains 5% of the lower than expected EBITDA. The remaining 4% miss was due to higher line loss and traffic decline, which derived in lower revenues as above mentioned.

According to KPN, similar costs will be recorded in 2Q07, with only around €10 million to be recorded in 3Q07 and nothing in 4Q07, when it is expected to have fully solved the problems. KPN stated that it has an uncompromising focus on VoIP quality and customer satisfaction, which is leading it to focus on clean orders, intentionally lower the order intake and increase customer satisfaction.

Problems have been sorted out now …
KPN says the situation is much better now. The problems have been almost fully sorted out and they are back to 10-15,000 installations per week in June. This is the run-rate that the company considers to be providing healthy growth and it is not planning to return to the 20,000 installations per week that caused all the problems.

The change in revenue and EBITDA trends probably will not be seen until Q3, in our view, when the run-rate will be higher for a full quarter and there will be a reduction in the one-off charges as above mentioned. We are expecting Q2 to report similar growth rates to those of the 1Q07 with revenues down around 8% and 17% EBITDA decline on a clean basis. On a reported basis this growth rates will probably be much lower as again, the company will include a book gain in 2Q07 from the sale of towers to TDF, which will make the comparison more positive this quarter. We detail our quarterly estimates later in this report.

However, despite similar clean earnings trends to 1Q07, we believe that the company will clarify all these points at the 2Q07 results conference call on July 31 and will provide further comfort to investors in this regard.

… and KPN is not losing VoIP market share
The positive news is that KPN is not losing market share in the VoIP business. It says that it has become something similar to a 'market-maker' and whenever it slows down the run-rate of installations the other competitors do the same thing. This is positive for KPN, which despite all these issues managed to increase its market share of VoIP from 36% in 4Q06 to 37% in 1Q07, which was 23 pp higher than 1Q06.

As a result of the continued slow down in installations in 2Q07 for the whole market, we also expect a lower number of VoIP installations from KPN. However, we think the market slow down should result in a reported line loss in 2Q07 lower than the 140 reported in 1Q07 and probably close to 100 thousand

only. This should be seen as another positive for the 2Q07 results.

Fixed telephony earnings forecasts changes

As noted, the company recently changed the way it reports and our new revenue figure is difficult to compare on a clean basis with the previous one (including other revenues, real estate and other assets book gains and net of intragroup transactions, which are also affected by subsidiaries disposals like Xantic or Towers). However, the comparison at the EBITDA level is much cleaner as all the above is having little impact on EBITDA.

As mentioned earlier, 1Q07 EBITDA was 9% lower than expected but 5% was explained by one-off charges. These charges will disappear in 4Q07 and we are cutting our EBITDA for 2007 by 5.6% (we slowed down the run-rate of VoIP installations and included one-off charges as discussed). For the following years we assume that the VoIP issue will be sorted out. However, we have decided to take a more conservative approach with voice traffic, which was also declining a bit above our expectations in 1Q07, deriving in further EBIDA reduction.

Exhibit 8

Fixed Telephony EBITDA changes (€ millions)

	2007e	2008e	2009e	2010e
EBITDA old	2,397	2,428	2,476	2,225
EBITDA new	2,263	2,317	2,393	2,155
Change (%)	*-5.6*	*-4.6*	*-3.3*	*-3.1*

Source: Morgan Stanley Research estimates

Impact on valuation: cut our fair value by €0.3 per share

On the back of the above changes we reduce our valuation for the fixed telephony business by 5% to €12.7 billion. This has a negative €0.3 per share impact on our fair value. Our valuation for the fixed business implies 4.9 times EBITDA 07e, which compares with the 6x at which BT is trading now, the only pure fixed operator which is quoted in our universe. We believe that such discount is fair as the competitive environment and cable pressure is fiercer in The Netherlands.

Positive catalyst soon: agreements with unbundlers

OPTA, the Dutch regulator, requested in March that KPN reached agreements with the unbundlers in order to create an acceptable alternative for the current local loop access. This is in relation to the migration to an All-IP network by KPN, which could result in difficulties for the unbundlers to access the last mile in the absence of these negotiations.

This agreement has to be reached by the end of 2Q07 and according to KPN these negotiations are well on track to meet the deadline. OPTA will use these agreements to formulate its position. Since the beginning of the process KPN has been very open to offer wholesale access at sensible prices to the unbundlers and we believe that the outcome will be positive for KPN and will clarify the regulation on migration to All-IP.

This will eliminate some investor uncertainties and will increase the visibility on the €1 billion in proceeds that the company is targeting from real estate disposals, making it easier to free-up space in the central offices.

Attractive Valuation and Defensive Nature

Increasing our fair value to €14 per share …
We are upgrading our fair value by 12%, from €12.5 to €14 per share, on the back of the earnings changes that we summarise in Exhibit 9. This new fair value implies 14% upside potential at current levels.

At the group level we increase our long-term EBITDA by close to 4%, which translates into a 9% higher enterprise value and, due to the gearing effect, into a 12% higher equity valuation. We summarize our sum of the parts valuation in Exhibit 10.

… and we set our price target at €14 per share too, with a bull case of €18.5 and bear case of €8.7 per share
We continue to set our price target at our fair value. However, there is some more substance behind it.

In Exhibit 12 we summarise our Bull and Bear analysis for KPN. The drivers of our Bull and Bear assumptions are also shown on page 2, and are discussed in greater detail in our report *Limited Downside, Limited Upside* dated June 22, 2006

On the back of our earnings changes and fair value change we get to a new bull case of €18.5, which implies 51% upside potential from current levels. Our bear case of €8.7 per share implies 29% downside potential. and therefore, we have higher upside than downside potential now. This represents a change to our risk/reward balance, which was previously skewed to the downside.

The mid point between our Bull and Bear scenarios is €13.6 per share, while we see an area of interest from potential LBO schemes in the €14-15 per share range but closer to the low end of the range (see next section). Everything seems to be taking us to a level around €14, which we think supports our our new price target for the stock.

We are also contemplating a Blue Sky scenario in which Eplus would achieve the 25% revenue share by 2015 (quite unlikely in our view but mentioned by the company as a long-term target) against our current 15-16% long term assumption. This would add €2.6 per share to our intrinsic value as a standalone exercise. Taking into account that part of this scenario has already been reflected within our Bull case (€1.2/share), we get to a Blue Sky value of €19.9 per share.

Risks to our price target
The main risks to our price target are a tougher competitive scenario or regulatory environment in fixed telephony in the Netherlands or a weaker economic environment in markets where the companies operate, as well as a negative outcome to the consolidation process. We consider the Netherlands to be a leading country in regulation and competition and VoIP competition could have a greater negative impact than we expect. This could result in lower revenues and higher capex than initially expected with a negative impact on our intrinsic value.

Another risk could come from higher than expected cost cutting potential, which could in turn result in higher value in an LBO scenario.

Exhibit 9
Consolidated earnings forecasts changes (€mn)

	2007e	2008e	2009e	2010e
Revenue old	12,230	12,272	12,436	12,609
Revenue new	12,084	12,186	12,431	12,686
Change (%)	*-1.2*	*-0.7*	*0.0*	*0.6*
EBITDA old	4,915	4,971	5,130	4,973
EBITDA new	4,843	5,022	5,234	5,148
Change (%)	*-1.5*	*1.0*	*2.0*	*3.5*
EBITDA margin old (%)	*40.2*	*40.5*	*41.3*	*39.4*
EBITDA margin new (%)	*40.1*	*41.2*	*42.1*	*40.6*

Source: Morgan Stanley Research estimates

Exhibit 10
Sum of the Parts valuation summary (€ millions)

	EV (€ mn)	EV/ share (€)	2007 EV/ EBITDA	Valuation methodology
Dutch business	11,552	6.3	9.0	DCF WACC 7.6%; LTG 1.0%
E-plus	9,315	5.1	8.8	DCF WACC 7.4%; LTG 1.5%
Base	1,727	0.9	7.0	7x EBITDA 2007
Total Consolidated Mobile	22,593	12.3	10.0	
Fixed Telephony	12,747	7.0	4.9	DCF WACC 7.6%; LTG 1%
Total Consolidated Fixed	12,747	7.0	4.9	
ENTERPRISE VALUE	35,340	19.3	7.3	
Net debt	(8,850)	-4.8		
Pension liabilities, net	(210)	-0.1		
Present value of tax credit	(671)	-0.4		
PROPORTIONATE NET DEBT	(9,731)	-5.3		
FAIR VALUE	25,609	14.0		

Source: Morgan Stanley Research estimates
Note.- Base at 7x EBITDA as valuation average for mobile stocks in our universe

Total return around 23% against 15% for the sector
In terms of total return, if we add the 4.6% 2008e dividend yield and the 4.5% share buy-back currently ongoing and tht we expect to be repeated next year, to the 14% upside potential to our price target, we get to a total return of around 23% and well above the 15% total return that we estimate for the sector.

Also attractive in relative terms to the industry
As shown in Exhibit 1, following substantial performance in the last 12 months, the stock has been underperforming the industry by around 7% since April this year. This together with our earnings upgrade has again positioned KPN as one of the most attractive stocks from a market metric standpoint.

Exhibit 11 indicates that the stock is cheaper than the average for most metrics excluding dividend yield, on our numbers. However, the company expects to continue to distribute most its FCFE through dividends but also buy-backs which complements the shareholder remuneration policy.

Especially striking is the double-digit discount on Adjusted PE (excluding license amortisations) and the below 10x metric in 2009.

Exhibit 11
Market metrics comparison

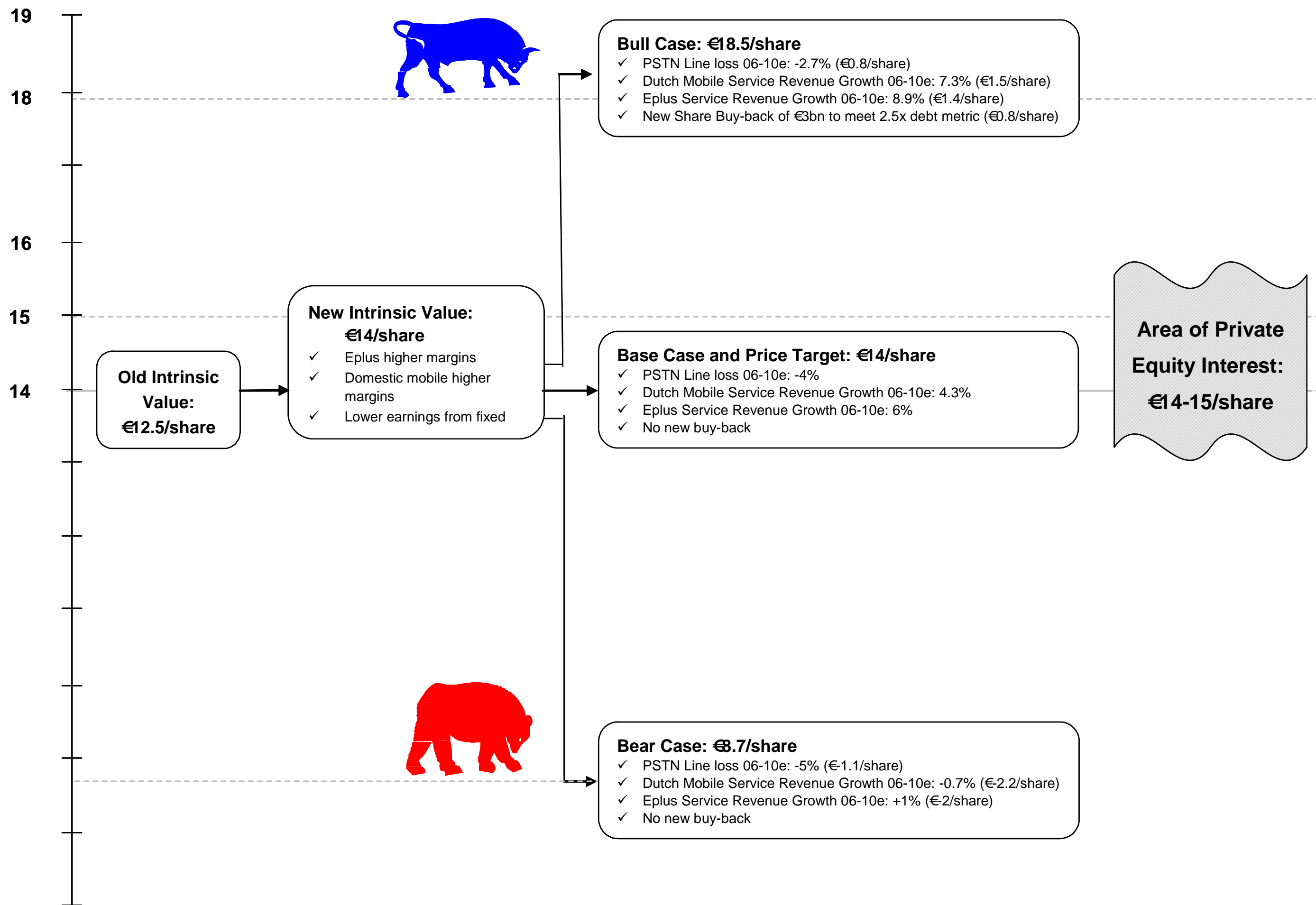
	KPN	Sector	Premium/ (Discount) (%)
EV/EBITDA 07e (x)	6.6	6.5	2
EV/EBITDA 08e (x)	5.9	6.0	-2
EV/EBITDA 09e (x)	5.2	5.5	-5
FCFE yield 07e	7.1	7.5	5
FCFE yield 08e	9.2	8.9	-3
FCFE yield 09e	11.1	10.3	-8
PE 07e (x)	12.1	14.0	-14
PE 08e (x)	10.8	12.9	-16
PE 09e (x)	9.6	11.9	-19
DY 07e	4.1	4.7	13
DY 08e	4.6	5.0	8
DY 09e	4.8	5.5	13

Note: PE excludes license amortisation and FCFE yield is normalised by taxes and restructuring charges
Source: Morgan Stanley Research estimates

Defensive nature in volatile markets
Finally, we believe a 9% annual return from dividends and share buy-backs will be sustainable in the long term and provides a strong element of defensiveness. This would make it even more attractive in the event of a market correction, which is expected by our Strategy team.

Exhibit 12

Bull and Bear summary: Setting our price target at €14 per share



Source: Morgan Stanley Research

LBO Schemes Look More Feasible Now

Scenario 1: LBO with no immediate disposals

We think that of all the mid to small caps in our coverage universe, there would theoretically be the fewest impediments to an acquisition of KPN by another player. KPN's market cap of around €23 billion and enterprise value of around €31 billion could be affordable for a few companies in the sector, we believe. There is no government stake and the golden share was sold and cancelled, making a theoretical transaction a purely private negotiation. Finally, its presence in the Netherlands, Belgium and Germany is providing it with a quality European footprint that could be interesting for a few other companies in the industry, in our view.

However, we think we can rule out the largest players as potential acquirers for the foreseeable future. Telefonica, which might fit well as such an acquisition would increase its critical mass in Germany, has ruled out any big M&A in 2006 and 2007 and we believe that it has other priorities now. France Telecom would overlap mobile operations in Netherlands (although for sale now) and Belgium, and seems not to be in acquisition mode, in our view. DT would face regulatory problems in Germany due to control of more than 50% of the market share in the mobile business for a theoretical combined entity, plus there would be overlap in the Dutch mobile business too. Telecom Italia is the most geared company among the large caps in the sector and the company's main target is to reduce debt, in our view.

Therefore, it seems unlikely that any theoretical potential interest in the next 12 to 18 months would come from anywhere other than private equity funds. In fact, we have seen recent LBO announcements such as the one for Alltel for a total consideration of $27.5 bn and a 23% premium over market valuations, which are not that different in size to a theoretical KPN acquisition. We therefore analyse the different options for a leveraged buy-out (LBO).

Main assumptions

Obviously our starting point is our earnings forecast for KPN under our base case scenario. Exhibit 21 shows the main assumptions for a theoretical exercise in which we assume an acquisition at €14 per share with a 15% equity consideration and 6.5x exit multiple.

We are assuming a theoretical KPN LBO acquisition on December 31, 2007 with a disposal in a five-year period. We estimate that whatever the debt/equity structure, the debt would be split 50/50 between bank debt and non-investment grade debt with average costs of 5% and 10% respectively. We are also assuming debt covenants of 7 times net debt to EBITDA and at least 2 times EBITDA to interest charges. All these assumptions apply to all the sensitivity analysis made.

Flexing the equity consideration and exit multiple for different levels of share price premium

Exhibit 13 shows the different levels of IRR for different equity considerations, while Exhibit 14 shows the same data in a chart format. For this analysis we fix the exit multiple at 6.5 times EBITDA 2012e, which is in line with the current sector average.

Exhibit 13

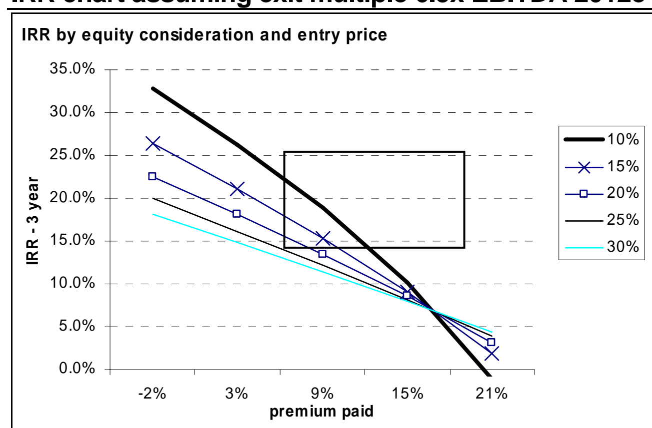
Scenario 1:
IRR assuming exit multiple 6.5x EBITDA 2012e

		IRR for equity consideration of:				
Premium	Share price	10%	15%	20%	25%	30%
-2%	12	32.8%	26.4%	22.5%	20.0%	18.2%
3%	13	26.2%	21.1%	18.1%	16.2%	14.8%
9%	14	18.9%	15.4%	13.5%	12.3%	11.4%
15%	15	10.2%	9.1%	8.5%	8.2%	8.0%
21%	16	-1.1%	1.8%	3.1%	3.9%	4.4%

Source: Morgan Stanley Research estimates

Exhibit 14

Scenario 1:
IRR chart assuming exit multiple 6.5x EBITDA 2012e



Source: Morgan Stanley Research estimates

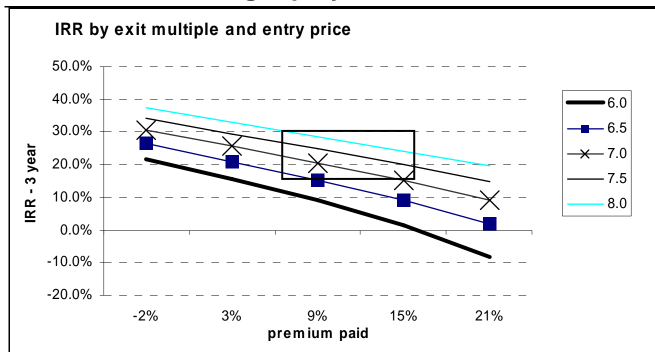
Exhibit 15 and Exhibit 16 fix the equity consideration at 15%, in line with our estimate of the equity consideration for similar transactions, and flex the exit multiple for different share price premiums.

Exhibit 15
Scenario 1:
IRR assuming equity consideration of 15%

		Exit multiple				
Premium	Share price	6.0	6.5	7.0	7.5	8.0
-2%	12	21.7%	26.4%	30.4%	34.1%	37.3%
3%	13	15.7%	21.1%	25.6%	29.5%	33.1%
9%	14	9.1%	15.4%	20.5%	24.9%	28.7%
15%	15	1.4%	9.1%	15.1%	20.0%	24.2%
21%	16	-8.4%	1.8%	9.1%	14.8%	19.5%

Source: Morgan Stanley Research estimates

Exhibit 16
Scenario 1:
IRR chart assuming equity consideration of 15%



Source: Morgan Stanley Research estimates

Range between €13 to €14 per share in order to get a IRR above 15%

From the tables and charts above we can conclude that in the scenario of not selling assets and with sensible ranges for exit multiples between 6-7x and equity considerations between 10-30%, we get a range of prices between €13-14 per share to get an IRR above 15%, which seems to us like the minimum required by a private equity firm.

Scenario 2: LBO assuming Eplus disposal

In addition to the assumptions described above, this scenario also assumes that the theoretical private equity fund would manage to sell Eplus one year after having acquired KPN (i.e. on January 1, 2009). We are assuming one year after, as dealing with the potential buyers and the potential regulatory issues arising would probably take some time. We are assuming that Eplus would be sold at €10.3 billion or roughly at a 10% premium over our current fair value of €9.3 billion.

Range between €14 to €15 per share in order to get an IRR above 15%

The tables and charts below have the same structure as in Scenario 1 but include the disposal of Eplus. We are getting to a price range of between €14-15 per share in order to justify an IRR above 15%. In this scenario we get around 5 pp higher IRR thanks to the leverage reduction achieved upfront due to the theoretical sale of Eplus.

Exhibit 17

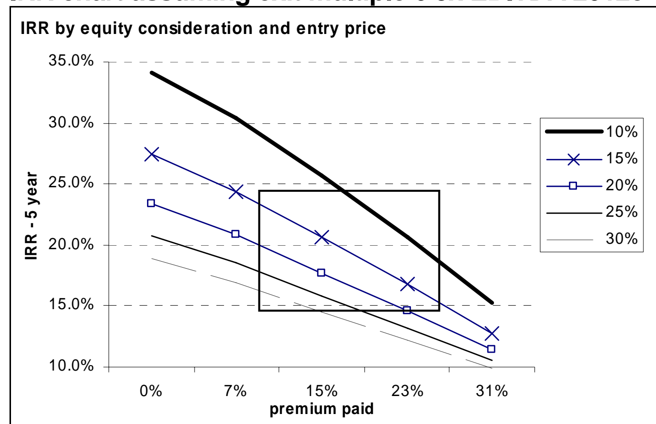
Scenario 2:
IRR assuming exit multiple 6.5x EBITDA 2012e

		IRR for equity consideration of:				
Premium	Share price	10%	15%	20%	25%	30%
0%	12.2	34.1%	27.4%	23.4%	20.8%	18.9%
7%	13	30.4%	24.4%	20.9%	18.6%	16.9%
15%	14	25.7%	20.6%	17.7%	15.8%	14.5%
23%	15	20.7%	16.7%	14.6%	13.2%	12.2%
31%	16	15.3%	12.8%	11.4%	10.5%	9.9%

Source: Morgan Stanley Research estimates

Exhibit 18

Scenario 2:
IRR chart assuming exit multiple 6.5x EBITDA 2012e



Source: Morgan Stanley Research estimates

Exhibit 19

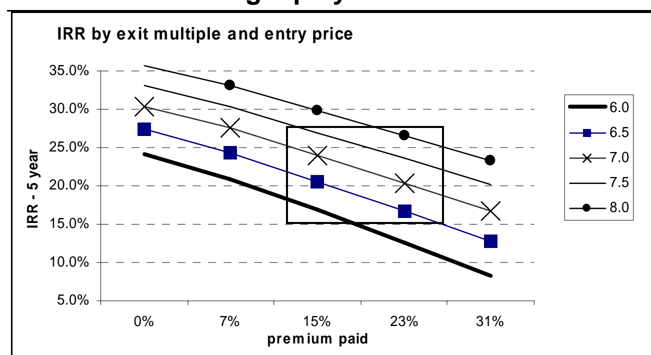
Scenario 2:
IRR assuming equity consideration of 15%

		Exit multiple				
Premium	Share price	6.0	6.5	7.0	7.5	8.0
0%	12.2	24.1%	27.4%	30.4%	33.1%	35.7%
7%	13	20.9%	24.4%	27.5%	30.4%	33.0%
15%	14	16.8%	20.6%	24.0%	27.0%	29.7%
23%	15	12.6%	16.7%	20.3%	23.6%	26.5%
31%	16	8.2%	12.8%	16.7%	20.1%	23.2%

Source: Morgan Stanley Research estimates

Exhibit 20

Scenario 2:
IRR chart assuming equity consideration of 15%



Source: Morgan Stanley Research estimates

Exhibit 21

LBO example assuming no immediate disposals (€14/share acquisition price and 15% equity financed: IRR 15.4%

Acquisition Date	31-Dec-07
Prospective EBITDA (2008)	5,022
Prospective Trading EBITDA Multiple (2008)	6.2
Premium on EV/EBITDA multiple	11%
Acquisition EBITDA Multiple (2008)	6.9
Acquisition EV	34,506
Net Debt 07e	8,850
Acquisition Equity Price	25,656
Acquisition Share Price	14.00

Acquisition Financing					
Bank Debt	43%	14,665			
Non-Investment Grade	43%	14,665			
Equity	15%	5,176			
Total Consideration+Refinancing	100%	34,506			
Bank Debt Interest Expense (%)		*5.0*	*5.0*	*5.0*	*5.0*
Non-Investment Debt Interest Expense (%)		*10.0*	*10.0*	*10.0*	*10.0*
Net Debt to EBITDA		5.8	5.4	4.9	4.8
EBITDA to Interest Charges		2.2	2.4	2.6	2.7

Summarised P&L	2006e	2007e	2008e	2009e	2010e
Revenues	12,057	12,084	12,186	12,431	12,686
EBITDA	4,837	4,843	5,022	5,234	5,148
EBIT	2,230	2,433	2,599	2,770	2,649
Bank Debt Interest Charges	520	719	692	662	633
Non-Inv Debt Interest Charges		1,438	1,384	1,324	1,265
EBT	1,710	275	522	784	751
Tax	120	69	130	196	188
Net Income	1,590	207	391	588	564

Summarised Cash Flow	2006e	2007e	2008e	2009e	2010e
Net Income	1,590	207	391	588	564
D&A	2,607	2,410	2,424	2,463	2,499
NWC Requirements	(106)	(104)	(85)	(84)	(85)
Capex	(1,650)	(1,727)	(1,781)	(1,778)	(1,683)
Cash taxes Savings/(extra payment)	127	198	(285)	(300)	(321)
Other	100	150	350	500	0
Debt Repayment Capacity	2,668	1,133	1,014	1,389	973

Net Debt Calculator	2006e	2007e	2008e	2009e	2010e
Bank Debt BOP		14,665	14,098	13,591	12,897
Non-Inv. Debt BOP		14,665	14,098	13,591	12,897
Total Debt BOP		29,330	28,197	27,182	25,793
Total Debt Repayment		1,133	1,014	1,389	973
Bank Debt EOP	8,850	14,098	13,591	12,897	12,410
Non-Inv. Debt EOP		14,098	13,591	12,897	12,410
Debt EOP		28,197	27,182	25,793	24,820

Selling Date	31-Dec-08	31-Dec-09	31-Dec-10	31-Dec-11	31-Dec-12
Prospective EBITDA	5,234	5,148	5,148	5,148	5,148
Prospective EBITDA Multiple			6.5		6.5
Selling EV			33,464		33,464
Net Debt			24,820		22,875
Selling Equity Price			8,644		10,589
Return on Invested Equity					15.4%

Source: Morgan Stanley Research estimates

Exhibit 22

LBO example assuming Eplus disposal, €14 per share acquisition price and 15% equity financed: IRR 20.6%

Acquisition Date		**31-Dec-07**					
Prospective EBITDA (2008)		3,904					
Acquisition EV		34,506					
Net Debt 07e		8,850					
Acquisition Equity Price		25,656					
Acquisition Share Price		14.00					
Acquisition Financing							
Bank Debt	43%	14,665					
Non-Investment Grade	43%	14,665					
Equity	15%	5,176					
Total Consideration+Refinancing	100%	34,506					
Bank Debt Interest Expense (%)		*5.0*	*5.0*	*5.0*	*5.0*		
Non-Investment Debt Interest Expense (%)		*10.0*	*10.0*	*10.0*	*10.0*		
Net Debt to EBITDA		6.1	4.6	4.1	3.9		
EBITDA to Interest Charges		2.2	3.8	4.3	4.6		
Summarised P&L	**2006e**	**2007e**	**2008e**	**2009e**	**2010e**		
Revenues	12,057	12,084	9,024	9,110	9,184		
EBITDA	4,837	4,843	3,904	4,057	3,890		
Margin (%)	*40.1*	*40.1*	*43.3*	*44.5*	*42.4*		
EBIT	2,230	2,433	2,175	2,341	2,189		
Bank Debt Interest Charges	520	719	690	655	624		
Non-Inv Debt Interest Charges		1,438	349	281	217		
EBT	1,710	275	1,137	1,406	1,349		
Tax	120	69	284	351	337		
Net Income	1,590	207	852	1,054	1,011		
Operating cash flow		3,011	2,489	2,595	2,529		
Summarised Cash Flow	**2006e**	**2007e**	**2008e**	**2009e**	**2010e**		
Net Income	1,590	207	852	1,054	1,011		
D&A	2,607	2,410	1,729	1,716	1,701		
NWC Requirements	(106)	(104)	(85)	(84)	(85)		
Capex	(1,650)	(1,727)	(1,331)	(1,378)	(1,276)		
Cash taxes Savings/(extra payment)	127	198	(285)	(300)	(321)		
Restructuring costs	0	0	0	0	0		
Other	100	150	350	500	0		
Debt Repayment Capacity	2,668	1,133	1,231	1,508	1,030		
Net Debt Calculator	**2006e**	**2007e**	**2008e**	**2009e**	**2010e**		
Bank Debt BOP		14,665	14,098	13,483	12,729		
Non-Inv. Debt BOP		14,665	3,799	3,183	2,429		
Total Debt BOP		29,330	17,897	16,666	15,158		
Total Debt Repayment		1,133	1,231	1,508	1,030		
Bank Debt EOP	8,850	14,098	13,483	12,729	12,214		
Non-Inv. Debt EOP		14,098	3,183	2,429	1,914		
Debt EOP		28,197	16,666	15,158	14,128		
Selling Date			**31-Dec-08**	**31-Dec-09**	**31-Dec-10**	**31-Dec-11**	**31-Dec-12**
Prospective EBITDA			4,057	3,890	3,890	3,890	3,890
Prospective EBITDA Multiple					6.5	6.5	6.5
Selling EV					25,286	25,286	25,286
Net Debt					14,128	13,098	12,067
Selling Equity Price					11,159	12,189	13,219
Return on Invested Equity (%)					*29.2*	*23.9*	*20.6*

Source: Morgan Stanley Research estimates

Potential M&A Is the Main Risk to Our Upgrade

We believe that the main risk to our call is that the company, which has declared its intention to investigate investment opportunities, goes for expensive or dilutive acquisitions and puts shareholder returns at risk. However, we believe that a transaction is unlikely to happen in the short term and we also note KPN's conservative approach in the past. We also believe that, contrary to other companies in the sector, investors would tend to give KPN the benefit of the doubt if it were to invest abroad due to its excellent track record so far.

Declared interest in One in Austria and Bouygues Telecom in France
The company has repeatedly declared that is looking for options abroad in terms of both an asset light approach (MVNO, reseller) and/or a network operator. Among the latter, the company has stated its interest in One, the mobile operator in Austria, and has also declared that if Bouygues Telecom was for sale in the future it would look at it.

France Telecom seems the most plausible buyer of One …
E.On has requested offers for One to be filed by 18 June 2007, Wirtschaftsblatt reported on June 11. The report quoted the value of One at around €1.3 billion. Eon owns a 50.1% stake, with the remaining shares more or less evenly split between Telenor, TDC and Orange (FT subsidiary). However, France Telecom has a pre-emptive right for One, and the article claimed that FT has teamed up with a private equity consortium consisting of PAI Partners, Mid-Europa Partners and Cinven, although this has not been confirmed by these companies. Reportedly, TDC and Telenor have already agreed to let France Telecom buy them out of One, the report continued, although again this is not confirmed. Therefore, we think that KPN would encounter many impediments if it attempted to buy One.

… and Bouygues Telecom is not for sale now
Bouygues Telecom is not officially for sale now although a few companies such as KPN or Orascom have declared their interest if eventually it was for sale. Our sum or the parts for Bouygues values 100% of the equity at €8.2 billion, implying 6.2x EBITDA 07e. If we assume a 20% acquisition premium, consistent with recent industry transactions, we get to around €10 billion. However, KPN has declared that a few private equity firms have approach it to offer to take part in a theoretical consortium if Bouygues was for sale. This could reduce the theoretical cash outflow to as low as c. €5 billion while still leaving KPN in control, on our estimates.

KPN believes that even if Bouygues comes up for sale and even if it receives help from private equity firms, this acquisition would be a difficult one to complete as other potential acquirers would probably have more financial flexibility. Anyway, given the circumstances, we do not expect any activity on this front in the foreseeable future.

Although not expected, both would be financially achievable transactions …
KPN is now at 1.8x debt to EBITDA 08e while the target is to be between 2-2.5x. Moving to the higher end of the range would provide an additional €3.5 billion, which would theoretically allow KPN to acquire One without putting at risk its shareholder remuneration policy.

In the case of Bouygues Telecom, if we were to use a €5 billion cash outflow for KPN as a base case, this would take KPN to 2.3x debt to EBITDA 08e (proportionate), which looks close to the current target range and not very aggressive in our view (or 2.9x debt to EBITDA 08e if acquiring 100%, still feasible in our view). This is assuming that both dividends and buy-backs remain.

If we assumed that the buy-back was cancelled, then the metric would come down to 2.5x in 2008 assuming 100% acquisition or 1.9x if assuming 50% acquisition (both proportionate). We therefore believe that financing this theoretical deal would not present much difficulty.

… but KPN would have to improve Bouygues Telecom's margins to make it attractive, in our view
Although we believe that financing this deal could be feasible without substantially jeopardising KPN's credit ratings, we believe that KPN would have to convince the market of its ability to improve this asset's profitability to make the deal look attractive. On our numbers and using our current forecasts for Bouygues Telecom, the deal would be 4-7% net income dilutive for KPN in 2008 and 2-4% dilutive in 2009 if acquiring 50% and 100% respectively.
We estimate EBITDA margins for Bouygues Telecom to be stable at around 27-28% for the period 2007-2009. If we were to assume that KPN could manage to take these margins to the 35% level that we forecast for Eplus in 2007, then a hypothetical deal could be up to 9% net income accretive if 100% acquired or 4-5% if only 50% acquired.
We do not make a similar analysis for One as we do not have estimates for this asset but, being a much smaller theoretical deal, the impact would be much less relevant, we believe.

Earnings Forecasts and Cash Flow Statement

Exhibit 23
KPN consolidated earnings forecasts (€ millions)

	2006	2007E	2008E	2009E	2010E
Mobile	6,496	6,890	7,115	7,403	7,698
Fixed (inc other and intragroup)	5,561	5,194	5,072	5,029	4,988
Total operating revenues	12,057	12,084	12,186	12,431	12,686
Mobile (%)	*10.9*	*6.1*	*3.3*	*4.0*	*4.0*
Fixed (inc other and intragroup) (%)		*-6.6*	*-2.4*	*-0.8*	*-0.8*
Total revenue growth (%)	*1.0*	*0.2*	*0.8*	*2.0*	*2.1*
Mobile business	2,261	2,579	2,705	2,840	2,993
Fixed (inc other and intragroup)	2,576	2,263	2,317	2,393	2,155
Total EBITDA	4,837	4,843	5,022	5,234	5,148
Growth as reported (%)	*2%*	*0.1%*	*3.7%*	*4.2%*	*-1.6%*
EBITDA Margins (%)					
Fixed (inc other and intragroup)	*46.3*	*43.6*	*45.7*	*47.6*	*43.2*
Mobile business	*34.8*	*37.4*	*38.0*	*38.4*	*38.9*
Total EBITDA margin	*40.1*	*40.1*	*41.2*	*42.1*	*40.6*
Depreciation					
Fixed	(1,072)	(1,074)	(1,042)	(1,013)	(976)
Mobile business	(753)	(736)	(781)	(851)	(923)
Total Depreciation	(1,825)	(1,810)	(1,824)	(1,863)	(1,899)
Amortisation					
Fixed	(100)	(100)	(100)	(100)	(100)
Mobile business	(677)	(500)	(500)	(500)	(500)
Total Amortisation	(782)	(600)	(600)	(600)	(600)
EBIT					
Fixed	1,404	1,089	1,175	1,281	1,079
Mobile business	831	1,343	1,424	1,489	1,570
EBIT	2,230	2,433	2,599	2,770	2,649
Growth (%)	*-5*	*9*	*7*	*7*	*-4*
Interest expense	(520)	(478)	(477)	(476)	(476)
Profit before taxes	1,710	1,955	2,122	2,294	2,173
Taxes	(127)	(498)	(541)	(585)	(554)
Affiliates	7	-	-	-	-
Net income	1,590	1,456	1,581	1,709	1,619

Source: Company data, Morgan Stanley Research
e = Morgan Stanley Research estimates

Exhibit 24

KPN consolidated cash flow statement (€ millions)

	2006	2007e	2008e	2009e	2010e
Cash flow statement					
Net Income	1,590	1,456	1,581	1,709	1,619
Depreciation	1,825	1,810	1,824	1,863	1,899
Amortization	782	600	600	600	600
Affiliates	(7)	0	0	0	0
Non cash financial expenses	59	62	65	68	71
Net Cash Flow	4,249	3,928	4,069	4,240	4,189
Movement in WC	(106)	(104)	(85)	(84)	(85)
Cash taxes Savings/(extra payment)	127	198	(285)	(300)	(321)
New Equity/(Share buy backs)	(1,560)	(1,000)	(1,000)	(1,209)	(923)
Capex	(1,650)	(1,727)	(1,781)	(1,778)	(1,683)
Acquisitions	(250)	(255)	0	0	0
Disposals	100	150	350	500	0
Dividend	(941)	(964)	(1,008)	(1,002)	(1,105)
Less book gains already captured in EBITDA		(100)	(200)	(300)	0
Net debt reduction/(increase)	(31)	126	61	68	71
FCFE analysis					
EBITDA	4,837	4,843	5,022	5,234	5,148
Capex	(1,650)	(1,727)	(1,781)	(1,778)	(1,683)
Working capital	(106)	(104)	(85)	(84)	(85)
Interests	(520)	(478)	(477)	(476)	(476)
Taxes-current	-	(300)	(826)	(885)	(875)
Other	(150)	(105)	350	500	-
Less book gains included in the EBITDA		(100)	(200)	(300)	-
FCFE as reported	2,411	2,028	2,004	2,210	2,028
Net Debt Estimates					
Net debt	8,976	8,850	8,789	8,721	8,651
Net debt to EBITDA (clean)	1.9	1.83	1.75	1.67	1.68
EBITDA interest cover (clean)	9.30	10.13	10.53	10.99	10.81

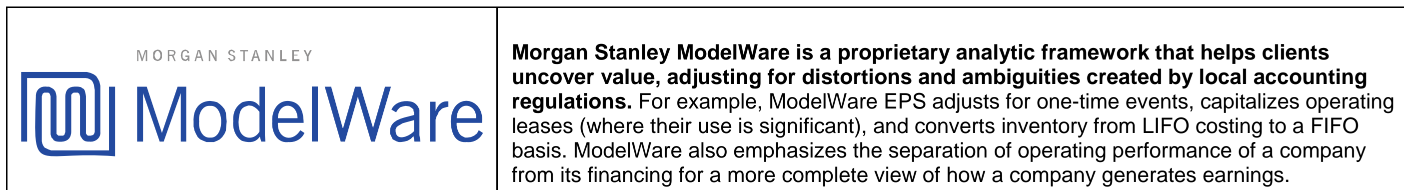
Source: Company data, Morgan Stanley Research
e = Morgan Stanley Research estimates

Exhibit 25

Consolidated balance sheet (€millions)

	2006	2007e	2008e	2009e	2010e
Assets					
Goodwill	4,571	4,571	4,571	4,571	4,571
Gross Intangible assets	11,290	11,463	11,641	11,819	11,987
Accumulated amortization	(7,164)	(7,857)	(8,558)	(9,266)	(9,980)
Net intangible assets	4,126	3,606	3,083	2,553	2,007
Gross Tangible assets	21,924	23,329	24,582	25,682	27,197
Accumulated amortization	(13,939)	(15,656)	(17,379)	(19,134)	(20,919)
Net tangible assets	7,985	7,673	7,203	6,548	6,279
Associates	33	33	33	33	33
Derivative financial instruments	17	17	17	17	17
Deferred Tax Asset	1,221	1,223	1,508	1,808	2,128
trade and other receivables	299	554	554	554	554
LT investments	1,570	1,827	2,112	2,412	2,732
Inventories	126	122	119	115	112
Accounts receivable	2,201	2,223	2,228	2,234	2,245
Available for sale financial assets	5	5	5	5	5
Cash and ST investments	282	363	366	373	381
Total current assets	2,614	2,713	2,717	2,727	2,742
no current assets held for sale	176	176	176	176	176
Total Assets	21,042	20,565	19,862	18,987	18,507
Liabilities					
Capital Stock	478	455	434	411	395
Paid in Capital	12,596	11,619	10,640	9,454	8,547
Other reserves	(787)	(587)	(587)	(587)	(587)
Retained earnings	(8,122)	(7,730)	(7,357)	(6,950)	(6,436)
Shareholders funds ex minorities	4,165	3,757	3,130	2,329	1,919
Minority interest	28	28	28	28	28
Shareholders funds	4,193	3,785	3,158	2,357	1,947
LT interest bearing debt	6,518	6,472	6,415	6,354	6,291
derivative financial instruments	716	716	716	716	716
Deferred tax liabilities	2,229	2,229	2,229	2,229	2,229
provisions for retirement benefit obligations	1,379	1,441	1,506	1,574	1,645
provisions for other liabilities	396	396	396	396	396
Other payables and deferred income	292	292	292	292	292
Total non-current liabilities	11,530	11,547	11,554	11,561	11,569
Trade accounts payable	2,862	2,777	2,693	2,612	2,534
ST interest bearing debt	2,020	2,020	2,020	2,020	2,020
Derivative financial instruments	7	7	7	7	7
Curent tax liability	261	261	261	261	261
Provisions for other liabilities	77	77	77	77	77
Total current liabilities	5,227	5,142	5,058	4,977	4,899
Accruals	-	-	-	-	-
Liabilities held for sale	91	91	91	91	91
Total Equity and Liabilities	21,042	20,565	19,862	18,987	18,507

Source: Company data, Morgan Stanley Research
e = Morgan Stanley Research estimates



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(as of May 31, 2007)

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Underweight/Sell	**363**	**16%**	**99**	**14%**	**27%**
Total	**2,250**		**693**		

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Industry Coverage:Telecommunications Services

Company (Ticker)	Rating (as of)	Price (06/13/2007)
Frederic Boulan, CFA		
Fastweb (FWB.MI)	E-V (03/20/2007)	€39.47
France Telecom (FTE.PA)	E (01/12/2006)	€21.31
Iliad (ILD.PA)	O-V (10/27/2006)	€72.47
Neuf Cegetel (NEUF.PA)	O-V (04/17/2007)	€28.6
Swisscom (SCMN.VX)	E (10/10/2006)	SFr416.75
Nick Delfas		
BT Group plc (BT.L)	E (07/06/2006)	324p
Deutsche Telekom (DTEGn.DE)	E (03/01/2007)	€13.64
Inmarsat (ISAT.L)	O-V (11/28/2006)	392p
Telecom Italia (TLIT.MI)	U (05/02/2007)	€2.05
Telecom Italia (TLITn.MI)	U (05/03/2007)	€1.66
Vodafone Group (VOD.L)	O (11/19/2003)	158p
Christopher Fremantle, CFA		
COLT Telecom Group S.A. (COLT.L)	E-V (10/05/2006)	153p
Cable & Wireless (CW.L)	O-V (11/01/2006)	200p
Telekom Austria (TELA.VI)	E (10/02/2006)	€19.22
Luis Prota		
Belgacom (BCOM.BR)	E (04/05/2006)	€33.39
Cosmote (COSr.AT)	E (02/03/2005)	€22.5
KPN (KPN.AS)	O (06/15/2007)	€12.23
OTE (Hellenic Telecoms.) (OTEr.AT)	O (05/24/2007)	€22.92
Portugal Telecom (PTC.LS)	NA (02/10/2006)	€10.25
Telefonica (TEF.MC)	O (01/19/2006)	€16.3
Saroop Purewal		
Bouygues (BOUY.PA)	E (04/16/2007)	€63
Tele2 (TEL2b.ST)	O (05/21/2007)	SKr116.25
Telefonica O2 Czech Republic (SPTT.PR)	O (02/05/2007)	CZK590
Telenor (TEL.OL)	O (04/20/2005)	NKr111.5
TeliaSonera (TLSN.ST)	E (05/11/2005)	SKr51.5

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