

Letter from the Chairman of the Board of Directors



To Our Shareholders

Let me use this opportunity to review the activities, development and the results of the Telefónica O2 Czech Republic Group in 2009. The past year, in particular from the second quarter, marked a significant turnaround for the worse in the macroeconomic environment in the Czech Republic. This negatively translated into a change in the behaviour, and in particular in the greater economizing of our mobile customers, and, by extension, pressed our revenues down. As in the previous years, our activities focused on accommodating – to the maximum extent possible – the wishes of our customers. This strategy proved to be paramount in the recessed economic environment as it helped us to mitigate the effects of the external factors. Our successful market proposition consisting of new and innovated services, which were very positively received by the market, helped us to maintain our rate of growth of our customer base both in the fixed and the mobile segments. Our simple and clear offer has brought us more customers in Slovakia, as well as improved financial performance.

Our services were targeted at responding to the trends in the highly competitive telecommunications market in the Czech Republic. Demand for fixed and mobile services based on broadband internet access, data services, digital television over a fixed line and converged services was among the trends that were still growing strong. At the same time we focused on maintaining our revenues from mobile voice services by means of active migration of customers to post-paid services. In the area of IT and business solutions we completed the integration of our activities in this segment into one organisation unit of business solutions, and the merger of our subsidiaries active in this field of business. As a result we strengthened our position among ICT providers in the Czech marketplace. Thanks to the above-mentioned activities we also confirmed our innovation leadership in the segment of integrated business solutions, and maintained our primacy in the Czech telecommunications market.

In the financial area we concentrated on compensating, to the maximum extent possible, for the negative effects of the economic environment; our continued drive for efficiency helped us maintain operating profitability and deliver on our OIBDA and operating cash flow targets.

And now, allow me to delve deeper into a review of the developments of the past year – our accomplishments – and into our expectations from 2010.

In the fixed access segment we continued to focus on slowing down the rate of decline in this area by means of adding more value to the fixed line. In May we introduced a brand new concept of services for the residential segment. Unlike the previous offer of service bundles affiliated with a voice tariff, the new concept was built on our O₂ Internet and O₂ TV services, without the requirement to pay additional fixed line fees. Customers could choose from a menu of bonus services to complement either of the main two services, or to subscribe to any other fixed or mobile service with a discount. A similar proposition was prepared also for our business and corporate customers. The new service concept began to bear fruit in the second half of the year – by bringing new customers to O₂ Internet and helping to slow down the decline in the number of fixed lines. The number of retail ADSL connections increased by 99 thousand in 2009, which is up 40.1% on the year 2008. The number of cancelled fixed lines fell at the same time to 123 thousand, compared to 176 thousand in the previous year.

For our business customers, whose behaviour showed a shift in preference from traditional fixed voice services to mobile voice and Voice over IP services, we prepared O₂ Neomezené volání, a modern voice solution in the form of a converged voice service. The new service came with unlimited fixed and mobile calls for a flat monthly fee. I am confident that the service will help in countering the trend of declining voice traffic generated from fixed lines and in increasing the penetration of broadband internet.

In the mobile segment we continued to concentrate on migrating customers from the pre-paid service to contracts by means of active promotion and improving the offer of unlimited O₂ NEON tariffs. The new tariff O₂ NEON L+ came with unlimited calls to any number in the O₂ network on weekends and off-peak. We responded to the market demand for having expenditure under full control by offering O₂ ZERO, a new tariff unique on the Czech market, which did not require any commitment or payment of monthly subscription fees. The price for calls, SMS and MMS were a single rate to all networks at any time of day. As a result of these activities, the number of contract customers went up 11.7% in 2009, and their proportion in the total customer base reached 56.9% at the end of the year. The incremental increase of their overall share also helped us in maintaining the growth rate of voice traffic.

During the year 2009, owing in particular to the success of new tariffs O₂ NA!PIŠTE and O₂ NA!HLAS, we significantly slowed down the rate of decline in the number of pre-paid customers. If the customer topped up credit regularly, they could choose from several bonuses including cheaper calls and SMS in our network on weekends and in the evening. Our offer of 100% extra credit NA!VÍC gave new customers who topped up for the first time a bonus of 100% of the value of their top-up. With the aim of stimulating the activity of our pre-paid customers we organised a competition Dobij a vyhrať, followed up by another programme, Odměna za dobití. After each top-up, customers could, depending on the amount of their top-up, claim a prize or get a discount on future O₂ services. As a result, the decline in the number of pre-paid customers in 2009 fell 39.8% year on year.

We responded to the fast-growing demand for internet connectivity in a mobile telephone by accelerating investment in the expansion of our mobile 3G network based on the UMTS/HSDPA technology. During the year we gradually covered all 13 regional capitals with the service, while GPRS, EDGE and HSCSD services were available in other parts of the Czech Republic. At the end of 2009 we had the broadest portfolio of mobile data services, which gave us a significant competitive edge on the other mobile operators in the Czech Republic. The expansion of our 3G network coverage was accompanied by an acquisition offer to new customers who could get O₂ Mobilní Internet for a cut-rate price – either as a standalone service or in combination with other services within our new service concept. In the area of mobile data services we started offering our BlackBerry service to all our customers; it had previously been available only to business customers.

In the area of ICT services we pursued the development of Managed Services: IP Centrex, Managed LAN and WAN. We were also very deeply involved in implementing modern technology in the sectors of government and public administration. We won a tender to implement, in close partnership with Česká pošta, the project for an information system of data boxes, which became a breakthrough project in the area of eGovernment.

The success of our simple and easy to understand tariffs O₂ Fér in Slovakia helped us increase the customer base and improve its quality. During the past year, the number of customers increased by 228 thousand to 553 thousand, and our market share of the Slovak mobile market went up to

almost 10% as a result. Our revenues and financial performance increased, too. We committed to our long-term plans for Slovakia by increasing the registered capital of Telefónica O2 Slovakia by approximately EUR 150 million to EUR 200 million.

As I already mentioned at the beginning, the financial performance in 2009 was negatively affected by the unfavourable macroeconomic climate and also by mobile termination fees which went down. Another factor that impacted on the year-on-year comparison of revenues for 2009 were the Universal Service revenues. Total consolidated revenues reached CZK 59.9 billion in 2009, which is down 7.4% on the previous year. Business revenues fell 7.3% to CZK 59.8 billion. Our operating cost efficiency measures in commercial and non-commercial areas and the effects of booking several one-off items accounted for a 9.7% decline in consolidated operating costs. As a result, the consolidated Operating Income before Depreciation and Amortisation (OIBDA) fell 4.4% to CZK 27.1 billion, which is a slower decline compared to revenues. The result was an OIBDA margin of 45.2%, compared to 43.8% in 2008. This helped us maintain an above-average operating profitability in comparison with other operators in the region of Central and Eastern Europe. The continuing decrease of depreciation of tangible and intangible assets and the lower income tax rate compensated for the lower OIBDA and resulted in an increase of 0.3% of the consolidated net profit for 2009, which reached CZK 11.7 billion. As I already mentioned above, our investment in 2009 was directed at the expansion of the 3G network coverage. We also continued to invest in areas with a potential for growth, which include mainly the development of ADSL and IPTV technologies. We also made investments in information systems and technology, with a view of improving the efficiency of individual processes and, by extension, our operating efficiency. The total capital expenditure fell 19.8% year on year in 2009, down to CZK 6.5 billion.

In 2010 we will keep our focus on satisfying the needs of our customers through offering new products and innovating our existing services. I am confident that we will keep on adding customers at the same rate as in 2009, and stay ahead of the competition in this respect. We will continue to concentrate on active promotion and improvement of our consumer proposition, expanding our portfolio of fixed and mobile bundles with a view to stabilising the downward trend in the area of fixed lines. We will also continue in our active promotion of simple tariffs that bring a lot of value to the customer. Our activities will deliver a growth in the number of customers and raise the bar of our financial performance.

We expect that the challenging environment affected by the economic recession and precarious political situation, in which the consumer behaviour is hard to predict, will last at least for the first half of 2010. Mobile revenues will be under the additional strain of falling mobile termination fees. In addition to the above activities aimed at satisfying the needs of our customers, we will continue to exercise operating cost saving measures in the commercial and non-commercial area, with a view to maximise free cash flow generation, which is among our strategic priorities.



Luis Antonio Malvido
Chairman of the Board of Directors