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Riga Technical University

Case Study

“Lattelecom and LMT: merger?”

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EXECUTIVE SUMMARY

It was a pretty chilly Monday afternoon when the Chairman of the Board of Lattelecom, national provider of telecommunication services, exclaimed: *“Isn’t it time to stop developing two competing enterprises”?* Even though the year 2014 had been successful for Lattelecom, increased competition and continuous technology improvements required large investments. Also the profitability of LMT (Latvijas Mobilais Telefons) was not as brilliant as it could be and turnover had started dropping.

Lattelecom owned 23% of LMT - one of the 3 mobile operators in Latvia. Both companies had similar governance structure and merger could help decrease costs of assets (shared future investments) for both companies and broaden services offered to clients.

European Union countries are experiencing a trend of mergers in the telecommunication industry. The discussion on merging Lattelecom and LMT was heated as many stakeholders would be influenced by the outcomes of the process: shareholders of both companies, current and future clients, society in general, government, Commission for Competition. What could the positions of different stakeholders on this possible merger be?

LATTELECOM

Ltd. Lattelecom is internet and telecommunication provider in Latvia. Company’s offered services vary for different market segments:

- Individual customers are provided with internet, TV, fixed line, data storing and telemetry solutions;
- Corporate clients are offered services in three directions – (1) data transmission, (2) different software solutions, including SAP, CRM, document management systems, (3) data storing and management services.

Lattelecom was founded in 1992 and current market share in several segments is described as leading - around 55% of the market. [1] Company’s consolidated turnover was 180 M EUR and profit around ~ 28 M EUR in 2013, which is about 3 M EUR less than in previous year (2012).

Main shareholders (**Appendix 1**) of the company are Republic of Latvia (51% - controlled by ministry of Economics) and TeliaSonera AB (49%) through entity called “Tilts Communications A/S”. Lattelecom is shareholder in several other companies: 100% owned Lattelecom Technology under which is Baltijas datoru akadēmija, Citrus and Lattelecom BPO. Lattelecom is also shareholder of LMT, currently keeping 23% of shares. Board consists of four members and the chairman of the board is Juris Gulbis operating only in Lattelecom. Council has seven members and the chairman of the council is Gatis Kokins, having minority of shares in other companies not related with Lattelecom.

LMT

LMT (Latvijas Mobilais Telefons) is mobile operator in Latvia founded in 1992. Company’s services are mobile network, mobile internet (4G), e-store for mobile phones and other related accessories.

LMT is market leader comparing turnovers of all three Latvian mobile operators in 2014: LMT 161 M EUR (from LMT Financial statement 2014), Tele2 103 M EUR [2], Bite Latvija ~ 71 M EUR (Bite Latvija has not published their official financial results for 2014). Bite executes an aggressive strategy and both LMT and Tele2 had been losing their client base to this company during the last few years. LMT reported 19 M EUR profit in 2014.

Main shareholders (**Appendix 2**) of LMT are: Privatizācijas Agentūra (5%), Lattelecom (23%), Latvijas valsts radio un televīzijas centrs AS (23%), TeliaSonera (24.5%), Sonera Holding (24.5%). Juris Binde is the Chairman of the Board and Nils Kennet Radne is playing the role of the Council Chairman. Hannu- Mati Makinen is a member of the council both in Lattelecom, both in LMT. According to public information Sonera Holding is subsidiary of TeliaSonera [3].

LATTELECOM AND LMT: FUTURE GOVERNANCE

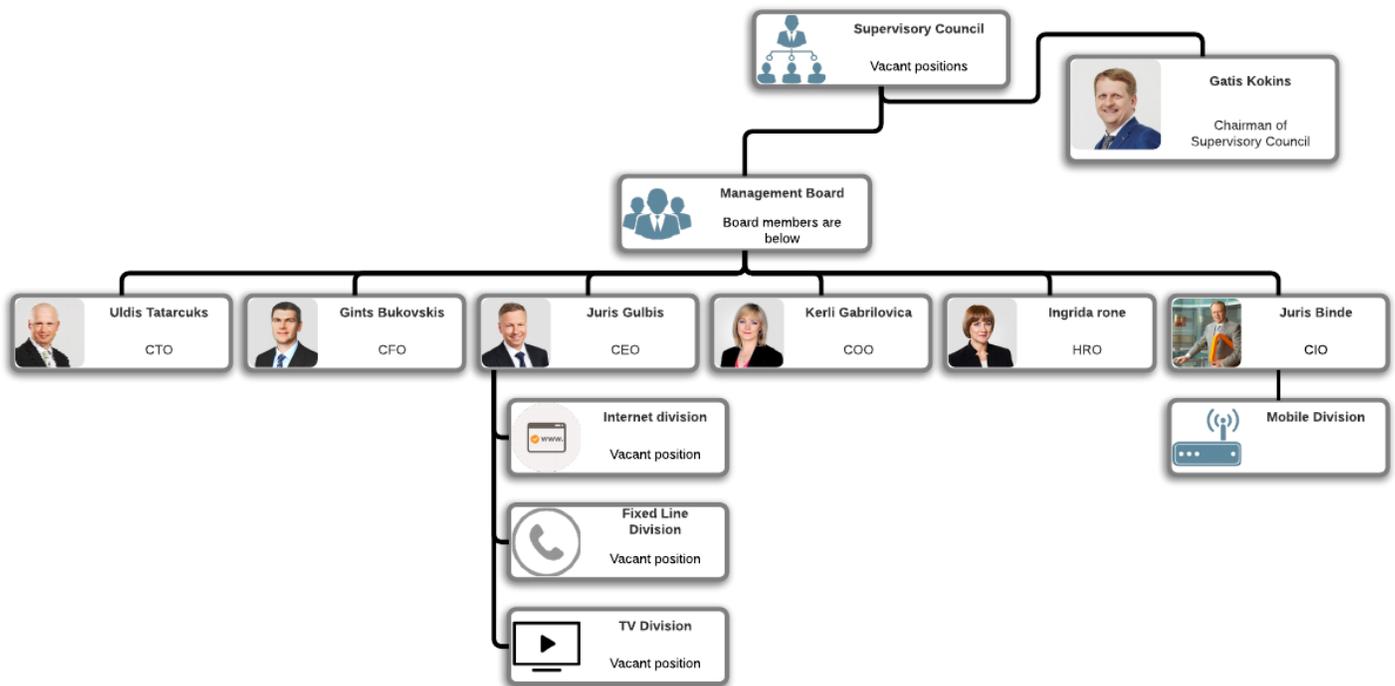
Both Lattelecom and LMT are limited liability companies, although being among the biggest enterprises in Latvia. Both of the companies have similar governance structure featuring management boards and the

supervisory councils. (Appendixes 2, 3, 4). Having that in mind, Mr. Gulbis broke the silence on the Lattelecom board meeting:

“The synergy from this merger will be outstanding. We need quad-play to be at our hand to compete in the long-term. European telecommunication industry as you all know is going through the M&A turmoil. But we have two issues - will the Commission for Competition (Konkurences Padome) accept our proposal and also, how shall the new entity’s structure look like and how it shall be managed?”

The board meeting members and guests from LMT were still silent - everybody understood that this cooperation or possible merger was vital and nobody wanted to be left out of the new enterprise governance model.

G.Kokins approached the flipchart and started drawing, saying: *“Here is what I propose:”*



“I understand some of us will not find our place in the governance structure of the new company. We need 3 leaders from the existing Management Board of Lattelecom to take over 3 divisions of the Quad Play. We will also have vacant positions on the council. As you understand, it will hugely depend on the new shareholder decision. Depending on who it is, Latvia or TeliaSonera, we will know who will stay and who will go. In any case, we are going to cut a lot of fat.”

The new model of the organizational structure should both feature keeping the existing talent and synergies and boost cooperation and integration of LMT into the single enterprise.

One of the LMT senior executives spoke up: *“To make it possible, I suggest creating problem solving teams. Let’s call them integration committees. They will be in charge of ensuring we are uniting resources, resolving conflicts, cutting extra costs in order to create an economy of scale. We might also need to gather a team for quickly managing the finances, to set new KPIs and refurbish budgets.”*

This seemed like a viable plan. Would, however, the two companies go for the merger that had been a hot topic for rumors for at least 5 years or would they keep the status quo?

MERGER OF LATTELECOM AND LMT

Telecommunication industry is developing rapidly all over the world and it’s already competing with traditional media companies in TV content. [4] In recent years there has been serious competition in the European market and it has only been growing; this threatens the position of both companies. Currently, telecommunication companies must be able to follow all the latest trends in the industry such as 4G LTE network development, fiber optic broadband expansion and cloud distribution. This requires significant investments, which is why we are witnessing active convergence in this sector in Europe. There have been a lot of cases showing that the positive synergy in such mergers is essential. [5] For example, in Estonia and Lithuania such process has already concluded and competition from that hasn’t been damaged. [4]

“I must say that in reality such fixed and mobile operators’ convergence has been all over the Europe, in fact Latvia is unique in the sense that only in two countries of the European Union fixed and mobile operators’ haven’t been merged”

- Mikus Janvars, investment banker at UAB “Porta Finance”, March 2015 [6]

At the end of the 90s the Latvian government made a commitment to privatize both telecommunication companies. In October 1998 Lattelecom was assigned for privatization and LMT followed in October 2006. The

argument was that the telecommunication is not a state business. Up till now nothing besides talking hasn't happened. In 2007 management buyout was offered by the former CEO Nils Melngailis, but it was rejected by the Latvian government in the beginning of 2008. Government also rejected the offer from TeliaSonera to buy out all state shares in Lattelecom and LMT for 700 million euros. At the beginning of 2011 TeliaSonera once again confirmed that it wants to privatize state shares of Lattelecom and LMT. Up till this day the Latvian government has formed several government working groups to decide on the future of Lattelecom and LMT. [7]

Over the past few years financial performance and investment policies of both companies are showing some stagnation. If we look at unaudited financial information of 2013 and 2014, dynamics of turnover and EBITDA is negative: LMT -12,40% in 2013 and -19,72% in 2014, but Lattelecom respectively -8,57% and +1,01%. [5]

Both boards of directors - Lattelecom and LMT - agree on the possible positive synergy. Not only the company's shareholders will benefit from the merger, but also consumers - it will keep the prices low in the telecommunications market and maybe can even reduce them, as well as the form new services and develop the existing ones. Boards of directors calculations shows that by improving the structure and model of both companies, the financial benefit would be around 70 million euros. This includes the reduction of employees, opening a share center and providing complementing services for customers. [4]

Merger of Lattelecom and LMT is beneficial for both the customers and the shareholders, including Latvian government. However there are aspects that may create substantial obstacles or at least require a longer discussion. One aspect is related to the ownership and distribution of control between Latvian government and TeliaSonera. Taking into account the latest publicly available information about financial performance and ownership structure, Latvian government may lose the control over the combined enterprise. If the Latvian government and TeliaSonera will hesitate and won't make the decision, the effect on both companies in the upcoming years can be very negative. [5]

The proposal from Latvian government, which is created according to the offer from board managers of Lattelecom in 2013 and which is also supported by the board of directors, is that Lattelecom buys all LMT

shares from existing shareholders, including the state directly and indirectly owned 28%, followed by the merger of both companies. According to the proposal, Latvian government will retain the majority of shares. The privatization of state shares is not considered. This transaction would result in shareholders receiving up to 300 million euros, consisting of income from sales of LMT shares, as well as the combined entity's appreciation. This will be ensured by both companies and their services synergy, as well as by potential for higher growth and the resulting higher value in the eyes of potential investors. [8]

Gatis Kokins, chairman of the board of directors in Lattelecom, believes that without the merger LMT is expecting extinction because foreign competitors will bring it to insolvency. Till this day mobile operator has worked wastefully, ignorant of the fact that in a few years they will no longer be able to pay out dividends and to borrow money for investments. [7]

“Since the telecommunication market opens for more and with the next year the barriers to enter will be minimal, we expect a very strong foreign competition and it's clear that, to withstand it, we have to develop a low-cost structure and we will have to be very powerful.”

-Gatis Kokins, chairman of the board of directors, April 2015[7]

G.Kokins and Kenets Radne, the chairman of the board of directors in LMT, have already agreed that both companies should merge. But Juris Binde, the CEO of LMT, opposes and thinks that LMT doesn't need to merge, he is predicting the growth of LMT without merging with Lattelecom.

Till September 1st, 2015 working group has to report to the Latvian government how Lattelecom and LMT will develop further. [7]

Kenets Rodne, the representative of TeliaSonera, has previously expressed the opinion that the value for both companies will reduce if the decision on merger will be delayed further. K.Rodne also said that in the recent discussions with Latvian government an understanding has been reached that they have to follow the global trend and the market requirements of telecommunication companies' merger. [8]

Swedish shareholder TeliaSonera has clearly stated that first of all the agreement should be made on what portion of shares they will own after the merge of both companies. TeliaSonera wants to own 100% shares in both companies or at least majority of shares, what is completely contrary to the Latvian government proposal.[9]

After the merger, it seems that the new company will be the third biggest company in Latvia, following behind AS Latvenergo and AS Swedbank, and would own 50% of telecommunication market. [10]

CONCLUSION

We believe that merger of Latttelecom and LMT is one of the most promising strategic decisions that are there currently for the two companies on the plate. European Telecommunications industry is witnessing many mergers that are aimed at creating the “quad play” companies and will be expanding to the Eastern Europe as well. Instead of competing against each other, LMT and Latttelecom should think broader, not only considering the Latvian market - we have neighboring countries as potential entry markets. With inner inefficiencies such strategies would be harder to implement. We suppose that the merger is something companies should undergo, with the blessing of the Commission for Competition, of course. Not only will it help cut costs related to overlapping infrastructure and competing services, but will it also increase the shareholder value, which is believed to be the purpose for the company’s existence.

Given that TeliaSonera effectively owns a bit more value cumulatively, we believe that they should possess the majority in the newly formed enterprise. The stakeholders, such as the state and consumers will only benefit from lower cost, better service and potentially more taxable income received on domestic and possibly international markets. The strategic decision to merge would also protect many workplaces and the company from possible entry of bigger international players. The risks of TeliaSonera exercising unfavorable actions for the population of Latvia can be hedged via legislature which the government has power over.

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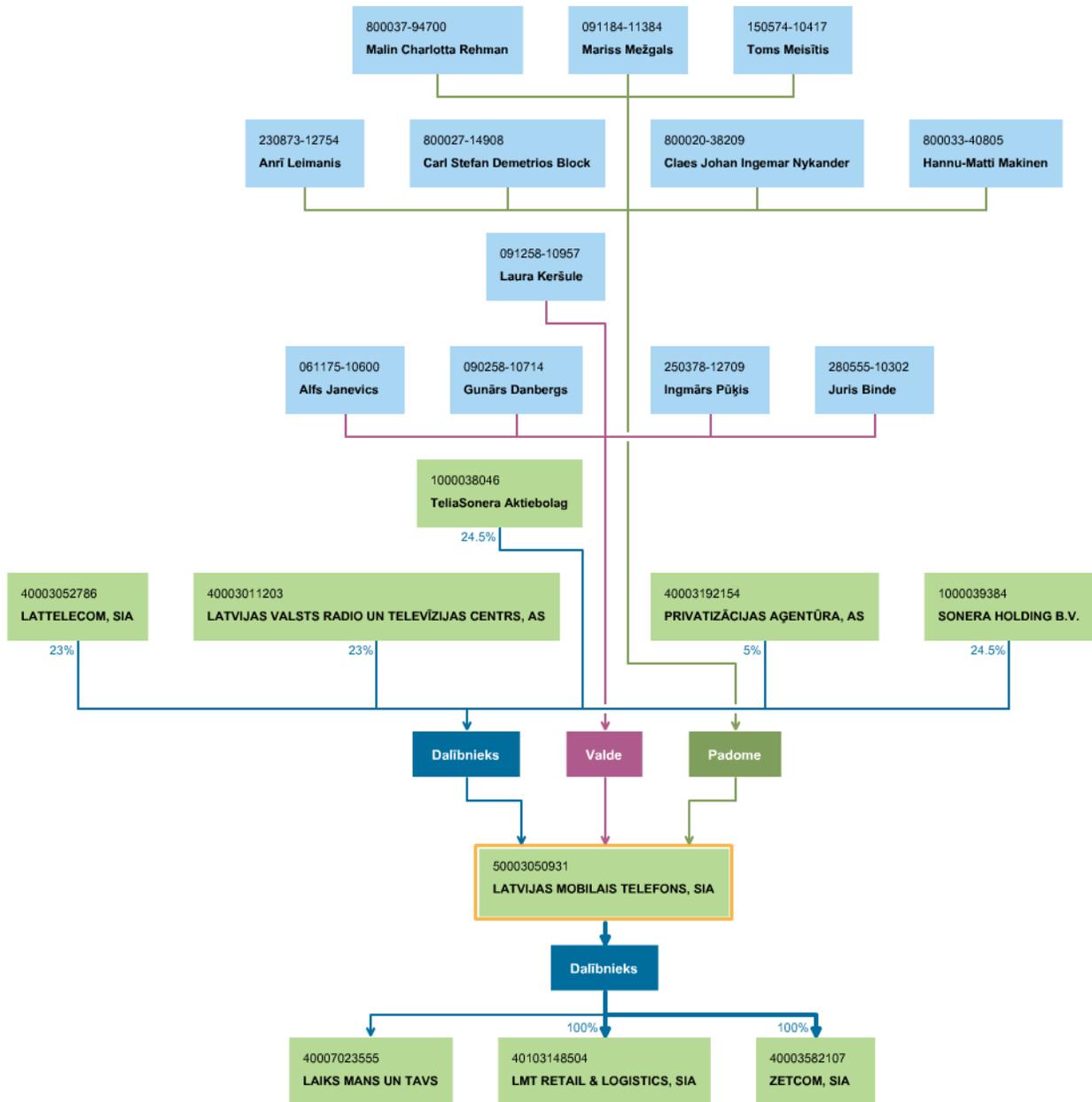
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Appendix 1. "Lattelecom shareholders structure" [8]



Appendix 2. LMT shareholder's structure



Appendix 3. Lattelecom Supervisory Council

LATTELECOM GROUP SUPERVISORY COUNCIL

Gatis Kokins is Chairman of Lattelecom Supervisory Council since 2009. In 2004 he obtained MBA degree at the Stockholm School of Economics in Riga, in 1993 - MSc degree in physics at the University of Latvia. He has also studied macroeconomics at the University of London and carried out research at the Bonn University Synchrotron facility in Germany. In 2014 Gatis Kokins has completed INSEAD Executive Education programme "Leading from the Chair". Mr G. Kokins has worked at the Faculty of Physics and Mathematics of the University of Latvia as a researcher, later he held Vice-president's and a Board member positions at the Deutsche - Lettische bank (after acquisition Hansabanka, now Swedbank). He has also held the Vicepresident's position in Parex bank (now Citadele bank) and has been Chairman of the Supervisory Council of Parex bank (now Citadele bank) in Lithuania.

Ove Lars Alm is a member of Lattelecom Supervisory Council since 3 May, 2007 and Deputy Chairman of Lattelecom Supervisory Council since 6 February, 2013. Mr O. Alm holds the positions of CEO of TeliaSonera Skanova Access AB within the TeliaSonera AB Business Area Broadband Services and is a member of the board and CEO of Tilts Communications AS. Mr O. Alm has worked within TeliaSonera Group since 1988.

Jānis Grēviņš is a member of Lattelecom Supervisory Council since 10 December, 2004. Previously, since July 2002, he served as a member of SIA Lattelecom Board of Directors. Since April 2003, Mr J. Grēviņš is the Director of Riga Business School at Riga Technical University. He is teaching and conducting research on the contemporary information technologies and the effects of modern communication means in project management. From 1998 till 2003, Mr J. Grēviņš studied for his PhD and worked as a project coordinator at the School of Management of the University at Buffalo, State University of New York, USA.

Jānis Brazovskis is a member of Lattelecom Supervisory Council since 25 January, 2013. From 2000 till October 2012, Mr J. Brazovskis has served as Deputy Chairman of the Financial and Capital Market

Commission of the Republic of Latvia. From 1996 till 2000, Mr J. Brazovskis served as Deputy Director in the field of legislation and licensing of Credit Institutions Supervision Department of the Bank of Latvia. In 1993, Mr J. Brazovskis graduated the Faculty of Law of the University of Latvia. Justin Wesley Bancroft is a member of Lattelecom Supervisory Council since 25 January 2013. He is a Certified Public Accountant and Certified Internal Auditor, and a former partner with Deloitte, an international “Big-4” professional services firm. From 2012, he has been an independent consultant in the areas of finance and corporate governance, and a guest lecturer or adjunct faculty at the Stockholm School of Economics in Riga and Riga Business School.

Dan Olov Strömberg is a member of Lattelecom Supervisory Council since 6 March, 2013. Mr D. Strömberg holds the position of CEO within the UAB Omnitel. UAB Omnitel is part of TeliaSonera AB Group. Mr D. Strömberg has worked within TeliaSonera Group since 1990.

Hannu-Matti Mäkinen is a member of Lattelecom Supervisory Council since 14 May 2014. Mr. H. Mäkinen occupies position of General Counsel for Region Europe at TeliaSonera AB. He has held various legal positions within TeliaSonera Group companies starting from 2001. Hannu-Matti Mäkinen is a member of the board of Omnitel UAB, TeliaSonera Norge AS, Eesti Telekom AS, TeliaSonera Finland Oyj and Valve Branding Oy and a member of Latvijas Mobilais Telefons SIA Supervisory Council.

Appendix 4. Lattelecom Management Board

Juris Gulbis is Chairman of Lattelecom Management Board and Chief Executive Officer since 8 May 2008. Since 1 January 2007 he was Chief Financial Officer and Deputy Chairman of the Management Board. Before joining Lattelecom Mr J. Gulbis was Executive Director of the S.P.I. Group SA in Geneva, Switzerland - a company specialising in production and distribution of alcoholic drinks. Previously he held Executive Director's position at S.P.I. Spirits (Cyprus) Limited as well as the position of Chairman of the Board of the largest Baltic alcohol bottling and distribution company Latvijas Balzams. From 1994 till 1997 Mr J. Gulbis worked as an audit manager at Coopers&Lybrand in Riga and London. Mr J. Gulbis holds an engineering degree in the fields of managing production and constructing roads and bridges from the Riga Technical University. He has attended various professional courses, including ones focused on international bookkeeping standards, the specifics of banking and capital markets, as well as personnel management. He has also completed INSEAD (Institut Européen d'Administration des Affaires) Executive Education Advanced Management Programme in France, Singapore and London Business School. He is a member of the Council of Employers' Confederation of Latvia, a member of the Board of Latvian Information and Communications Technology Association and a member of the Counsellors' Convention of Latvian Chamber of Commerce and Industry and a member of the Advisors' Board at Riga Technical University. In 2014 he received Sweden's King Carl XVI Gustaf award – the Order of the Polar Star. He also has been awarded the “RTU Honorary graduate 2013” title.

Gints Bukovskis is Deputy Chairman of the Management Board from 5 June 2009 and a member of Lattelecom Management Board since 21 July 2008. He also holds the position of Chief Financial Officer. Earlier Mr G. Bukovskis was an Associated Director of Business Consulting Services at financial consulting company SIA KPMG Baltics. He has also been a member of the board and the Finance director in several large enterprises, listed in NASDAQ OMX Riga. He started his career in finance sector as Audit Manager at SIA PricewaterhouseCoopers. Mr G. Bukovskis has a bachelor's degree in accounting and analysis of economic

activities from the University of Latvia. Since 2014 he holds an EMBA (Executive Master of Business Administration) degree from Stockholm School of Economics in Riga. He is also a member of the largest international association of accountants ACCA (Association of Chartered Certified Accountants).

Uldis Tatarčuks is a member of Lattelecom Management Board from 12 March 2011. He also holds the position of Chief Technology Officer. Prior to this, with effect from March 2009 he fulfilled the duties of Chairman of SIA Citrus Solutions Management Board, but before that U. Tatarčuks was the Member of SIA Citrus Solutions Management Board and Commercial Director of SIA Citrus Solutions. Before joining Lattelecom Group he fulfilled the duties of Regional Business Manager of SIA Bite Latvija. Mr U. Tatarčuks has also been Chairman of AS Falck Apsargs Board, filling also other management positions within this company. Mr U. Tatarčuks graduated the Latvia Academy of Sports Education with a bachelor's degree in sports pedagogy. He has also studied at the University of Latvia, Faculty of Law. He holds MBA degree from Riga Business School. Since March 2013 he is a member of the Council of the Federation of Security and Defense Industries of Latvia and since May 2014 he is also a member of the Council of European telecommunications community ETIS (Electronic Telecommunications Information Services).

Kerli Gabriloviča is a member of Lattelecom Management Board since 11 September 2009. She also holds the position of Commercial Director. Ms K. Gabriloviča joined Lattelecom in 2004. She was Marketing and Brand Manager as well as Director of Customer Service and Retail. Previously she was Head of Marketing Department at AS Rīgas Miesnieks, as well as Management Consultant at SIA Ernst & Young Baltic and Regional Representative at Hoiubank Investments. Ms K. Gabriloviča has specialised in business administration and economics at the Stockholm School of Economics in Riga. She holds an MSc degree in business administration and economics specialising in Product Management and CRM from Karlstad University (Sweden). Since 2013 she holds two Global executive MBA degrees - London Business School and Columbia Business School. Ingrīda Rone is a member of Lattelecom Management Board since 10 December 2004. She holds the position of Director of Personnel Management.

Ms I. Rone is a board member of the Latvian Association of Personnel Management and foundation Mission Possible. She holds a bachelor's degree in psychological science and a master's degree in business administration from the Riga International School of Economics and Business Administration. Previously, she has worked as Personnel Manager at AS Laima and AS Staburadze, as well as SIA Pepsi Cola General Bottlers Latvia.

Appendix 5. Excerpts from the interview with Lattelecom member of the Council J.W. Bancroft

Question 1: Please mention biggest advantage from Lattelecom & LMT merger?

It would save a lot of costs because we're competing for the same customers and are duplicating investments. We'd also eliminate a lot of managers - cut extra fat. More money to the shareholders.

Question 2: Please mention biggest disadvantage for Lattelecom & LMT merger?

From the shareholders point of view, there's a problem in who is going to control the new enterprise. Government against TeliaSonera. How to combine the shareholding structure.

Question 3: Do You think there is possibility that TeliaSonera agrees not to have majority of shares?

I have no idea what TeliaSonera thinks. The government does have majority in Lattelecom. There's another company created for cable and wireless... the problem is with the umbrella agreement with the clause that if there's no consensus, the shareholders should decide. It eliminates the role of the board. If you can't reach consensus, it stops the progress.

Question 4: Do You think that other cooperation forms exist instead of merger?

There could be theoretically a strategic cooperation. Over time it hasn't happened. We already have agreements but it hasn't happened. I don't know why. LMT is making the investments to duplicate what we have.

Question 5: What do You think will happen with both companies in future if they do not merge?

Basically we could continue stagnating, profit margin of LMT is much lower than Lattelecom's

When it takes business, it grows the revenue, but decreases the shareholder value. Either it stays as it is, either there's a divorce. Shareholders will split two companies. If lattelecom is owned by the state, it can go for 4G.

Question 6: Is Quad play important?

Yes, there is a lot of convergence tendencies in the industry in other European countries.

Question 7: Is there a strategic benefit in a merger?

Yes, things could be different.

Question 8:What external markets would you be looking at?

If TeliaSonera is there with no majority, there wouldn't be any sense. We are going in there with our subsidiaries already but just for some services. If TeliaSonera had control, there might have been a pan-baltic merger.

Appendix 6. Proposal for the governance structure of the new company

