MICROPAC INDUSTRIES INC
Form 10-K
February 17, 2010

United States Securities and Exchange Commission

WASHINGTON, D.C. 20549

FORM 10-K

(Mark One)

x **Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the fiscal year ended November 30, 2009

or

o Transition Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the transition period from ___________to ___________

Commission file number 000-5109

Micropac Industries, Inc.

(Exact name of registrant as specified in charter)

Delaware (State or other jurisdiction of incorporation or organization)		**75-1225149** (I.R.S. Employer Identification No.)
905 E. Walnut Street, Garland, TX (Address of principal executive offices)	**75040** (Zip Code)	**972/272-3571** (Telephone No.)

Securities Registered Pursuant to Section 12(b) of the Act:

Title of each class	**Name of each exchange on which registered**
None	N/A

Securities Registered Pursuant to Section 12(g) of the Act:
Common stock, par value $0.10 per share
(Title of class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yeso No o

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No o

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes o No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes o No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o
Non-accelerated filer o
Accelerated filer o
Smaller reporting company x

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes o No x

The aggregate market value of the voting and non-voting common equity held by non-affiliates of the registrant as of May 29, 2009, representing the last business day of the registrant's most recently completed second fiscal quarter was approximately $3,372,000, The number of shares of the registrant's common stock, $0.10 par value, outstanding as of February 15, 2010 was 2,578,315.

DOCUMENTS INCORPORATED BY REFERENCE

The definitive proxy statement relating to the registrant's Annual Meeting of Shareowners, to be held March 12, 2010, is incorporated by reference in Part III to the extent described therein.

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PART I

Item 1. Business

INTRODUCTION

Micropac Industries, Inc. (the Company), a Delaware corporation, manufactures and distributes various types of hybrid microelectronic circuits, solid state relays, power operational amplifiers, and optoelectronic components and assemblies. The Company's products are used as components in a broad range of military, space and industrial systems, including aircraft instrumentation and navigation systems, power supplies, electronic controls, computers, medical devices, and high-temperature (200° C) products.

The Company's facilities are certified and qualified by Defense Supply Center Columbus (DSCC) to MIL-PRF-38534 (class K-space level); MIL-PRF-19500 JANS (space level), MIL-PRF-28750 (class K- space level), and is certified to ISO 9001-2002. Micropac is a National Aeronautics and Space Administration (NASA) core supplier, and is registered to AS9100-Aerospace Industry standard for supplier certification.

The business was started in 1963 as a sole proprietorship. On March 3, 1969, the Company was incorporated under the name of "Micropac Industries, Inc." in the state of Delaware. The stock was publicly held by approximately 500 shareholders on November 30, 2009, of which some cannot be located.

PRODUCTS AND TECHNOLOGIES

The Company's products are either custom (being application-specific circuits designed and manufactured to meet the particular requirements of a single customer) or standard, proprietary components such as catalog items. Custom-designed components accounted for approximately 21% of the Company's sales for the fiscal year ended November 30, 2009, and were 27% for fiscal 2008. Standard components accounted for approximately 79% of the Company's sales for the fiscal year ended November 30, 2009, and were 73% for fiscal 2008.

The Company provides microelectronic and optoelectronic components and assemblies along with contract electronic manufacturing services and offers a wide range of products sold to the industrial, medical, military, aerospace and space markets.

The microcircuits product line, including custom microcircuits, solid state relays, power operational amplifiers, and regulators accounted for 55% of the Company's business in 2009, and the optoelectronics product line accounted for 45% of the Company's business in 2009, compared to 44% and 56% in 2008, respectively. . The major decreases in sales were to international customers associated with the economic downturn in 2009 and optoelectronic products sold through the distribution channels due to stock level reductions at the distributors.

The Company's core technology is the packaging and interconnects of miniature electronic components, utilizing thick film and thin film substrates, forming microelectronics circuits. Other technologies include light emitting and light sensitive materials and products, including light emitting diodes and silicon phototransistors used in the Company's optoelectronic components, and assemblies. The Company's basic products and technologies include:

Custom design hybrid microelectronic circuits
Solid state relays and power controllers
Custom optoelectronic assemblies and components
Optocouplers
Light-emitting diodes
Hall-Effect devices
Displays
Power operational amplifiers

Fiber optic components and assemblies
High temperature (200º C) products

Micropac’s products are primarily sold to original equipment manufacturers (OEM’s) who serve the following major markets:

Military/Aerospace – aircraft instrumentation, guidance and navigations systems, control circuitry, power supplies, laser positioning
Space – control circuitry, power monitoring and sensing
Industrial – power control equipment, robotics

The Company has no patents, licenses, franchises, concessions, royalty agreements or labor contracts. The Company's trademark "Mii" is registered with the U.S. Patent and Trademark Office.

Sales of our products internationally are subject to government regulations, including export control regulations of the U.S. Department of State and Department of Commerce. Violation of these regulations by the Company could result in monetary penalties and denial of export privileges. We are not aware of any violations of export control regulations.

Five of the Company's principal product families require government approval. Further, a significant portion of our business is military and is dependent on maintaining our facility certifications to MIL-PRF-38534, MIL-PRF-19500 and MIL-PRF-28750. We expect to maintain these certifications and qualifications; however, the loss of any of these certifications would have a significant impact on our business.

Government regulations impose certain controls on chemicals used in electronics and semiconductor manufacturing. Micropac has obtained all the necessary environmental permits, and routinely monitors and reports the wastewater stream results to the local governing agency. Micropac is classified as a small generator of hazardous waste, and the annual cost of complying with the regulations is minimal.

In 2009, the Company's investment in technology through research and development, which was expensed, totals approximately $639,000 ($530,000 in 2008). The Company's research and development expenditures were directed primarily toward long-term specific customer requirements, some of which have future potential as Micropac proprietary products, and product development and improvement associated with the Company's space level and other high reliability programs.

In addition to the Company's investment in research and development, various customers paid the Company approximately $205,000 in non-recurring engineering costs associated with the development of custom products for specific applications.

The Company provides a one year warranty from the date of shipment to the original purchaser. The Company is obligated under this warranty to either replace or repair defective goods or refund the purchase price paid by the buyer.

CUSTOMERS

The Company's products are marketed throughout the United States and in Western Europe, through a direct technical sales staff, independent representatives and independent stocking distributors. Approximately 21% of the sales for fiscal year 2009 (23% in 2008) were to international customers. Sales to Western European customers are made by independent representatives under the coordination of the Company's office in Bremen, Germany.

Sales through the Company's distribution channels were $2,800,000 in 2009 compared to $4,008,000 in 2008 or 16% and 20% of sales, respectively.

The Company's major customers include contractors to the United States government. Sales to these customers for Department of Defense (DOD) and NASA contracts accounted for approximately 71% of the Company's revenues in 2009 compared to 68% in 2008.

The Company's major customers are Lockheed Martin, Northrop Grumman, Boeing, Rockwell Int'l, and NASA.

At any time a single customer may have a disproportionate and material impact on the company's operations and profit and loss.

BACKLOG

At November 30, 2009, the Company had a backlog of unfilled orders totaling approximately $14,102,000 compared to approximately $9,723,000 at November 30, 2008. The Company expects to complete and ship most of its November 30, 2009 backlog during fiscal 2010.

EMPLOYEES

At November 30, 2009, the Company had 133 full-time employees (compared to 138 at November 30, 2008), of which 30 were executive and managerial employees, 32 were engineers and quality-control personnel, 15 were clerical and administrative employees, and 56 were production personnel. None of the Company's employees were covered by collective bargaining agreements.

The Company is an Equal Opportunity Employer. It is the Company's policy to recruit, hire, train and promote personnel in all job classifications, without regard to race, religion, color, national origin, sex or age. Above and beyond non-discrimination, we are committed to an Affirmative Action Program, dedicated to the hiring, training, and advancement within the Company of minority group members, women, veterans, and handicapped individuals.

COMPETITION

The Company competes with two or more companies with respect to each of its major products, including custom hybrid microcircuits, solid state relays and power controllers, optocouplers, light-emitting diodes, light sensitive silicon phototransistors and diodes, hall-effect devices, displays, power operational amplifier, custom optoelectronic components and assemblies. These products and technologies are sold into various markets, including military/aerospace, space, industrial and medical. Some of these competitors are larger and have greater capital resources than the Company. Management believes the Company's competitive position is favorable with regard to our product reliability and integrity, past performance, customer service and responsiveness, timely delivery and pricing; however, no assurance can be given that the Company can compete successfully in the future.

There are approximately 38 independent hybrid microcircuit manufacturing companies who are certified to supply microcircuits to MIL-PRF-38534, in addition to OEM's, who manufacture hybrid microcircuits for their internal needs. Micropac may compete with all of these for hybrid microcircuit business. Some of the Company's primary competitors are Teledyne Industries, Inc., Advanced Photonix, Honeywell, Avago, and International Rectifier.

SUPPLY CHAIN

The parts and raw materials for the Company's products are generally available from more than one source. Except for certain optoelectronic products, the Company does not manufacture the basic parts or materials used in production of its products. From time to time, the Company has experienced difficulty in obtaining certain materials when needed. The Company's inability to secure materials for any reason could have adverse effects on the Company's ability to deliver products on a timely basis and could result in loss of customers or sales. The Company uses capacitors, active semiconductor devices (primarily in chip form), hermetic packages, ceramic substrates, resistor inks, conductor pastes, precious metals and other materials in its manufacturing operations. However, the Company has not been materially affected by such shortages. The Company's delivery commitments to customers allow for adequate lead times for production of the products including lead time for order and receipt from the supply chain.

Some of the Company's primary suppliers are International Rectifier, NTK Technologies, Electrovac, Schott Glass, Micross Components, Kyocera, Microsemi, and Aborn Electronics.

Item 1A. Risk Factors

This Form 10K contains forward-looking statements that are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Actual results could differ materially. Investors are warned that forward-looking statements involve risks and unknown factors including, but not limited to, customer cancellation or rescheduling of orders, problems affecting delivery of vendor-supplied raw materials and components, unanticipated manufacturing problems and availability of direct labor resources.

Such risks and uncertainties include, but are not limited to historical volatility and cyclicality of the semiconductor and semiconductor capital equipment markets that are subject to significant and often rapid increases and decreases in demand. In addition, the Company produces silicon phototransistors and light emitting diode die for use in certain military, standard and custom products. Fabrication efforts sometimes may not result in successful results, limiting the availability of these components. Competitors offer commercial level alternatives and our customers may purchase our competitors' products if the Company is not able to manufacture the products using these technologies to meet the customer demands.

The Company disclaims any responsibility to update the forward-looking statements contained herein, except as may be required by law.

Majority shareholder ability to control the election of the Board of Directors

The Company's majority shareholder, Mr. Heinz-Werner Hempel, established a partnership organized under the laws of Germany which owns 1,952,577 shares or 75.7% of the outstanding voting shares. Mr. Hempel through the partnership has the ability to control the election of the Company's Board of Directors and elect individuals who may be more sympathetic to such majority shareholders' desires and not necessarily sympathetic to the desires of minority shareholders as to the policies and directions of the Company. However, the ability to control the election of the Board of Directors does not modify the fiduciary duties of the Board of Directors to represent the interests of all shareholders.

Availability of public share for purchase and sale

A small number of shares are available for public purchase and sale. As a result, the company's reported share price may be subject to extreme fluctuations due in part to the small number of shares traded at any time.

Pricing pressures from customers for reduction in selling prices

The Company continues to experience pricing pressures from some of its OEM customers. In some cases, the Company's customers request the review of pricing for possible reduction in selling price on future orders. This requires the Company to improve its productivity and to request similar price reductions from its supplier chain. If one or both of the approaches by the Company does not succeed, the Company could be required to reduce the selling price on future orders reducing the product gross margins and affecting the Company's net earnings in order to receive future orders from the customer. However, the Company has no agreement that requires a reduction in the selling price on any current customer order. All contracts are firm fixed pricing.

Insurance coverage and exposure to substantial claims or liabilities

The Company operates manufacturing facilities in Garland, Texas and subcontracts portions of the Company's manufacturing to a contract manufacturer in Juarez, Mexico. These facilities use industrial machines and chemicals that could provide risks of personal injury and/or property damage. There is no assurance that accidents will not occur. If accidents do occur, the Company could be exposed to substantial liability. The Company maintains worker's compensation insurance and general liability insurance for protection of its employees and for protection of the Company's assets in Garland, Texas and for equipment and inventory located at the contract manufacturer in Juarez, Mexico. In addition to the basic policies mentioned, the Company maintains an umbrella insurance policy. The Company reviews all insurance coverage on an annual basis, and makes any necessary adjustments based on risk assessment and changes in its business. In the opinion of the Company's management, and its' insurance advisors, the Company is adequately insured; however, the Company's financial position could be materially affected by claims not covered or exceeding coverage currently carried by the Company.

The Company is subject to numerous environmental regulations or changes in government policy

The Company is subject to governmental regulations pertaining to the use, storage, handling and disposal of hazardous substances used in connection with its manufacturing activities. Failure of the Company to control all activities dealing with hazardous chemicals could subject the Company to significant liabilities or could cause the Company to cease its manufacturing activities.

The Company could be adversely affected by changes in laws and regulations made by U.S. and non U.S. governments and agencies dealing with foreign shipments. Changes by regulatory agencies dealing with environmental issues could affect the cost of the Company's products and make it hard for a small company to be competitive with larger companies.

Product liability claims

The use of the Company's products in commercial or government applications may subject the Company to product liability claims. Although the Company has not experienced any product liability claims, the sale of any product may provide risk of such claims. Product liability claims brought against the Company could have a material adverse effect on the Company's operating results and financial condition.

Component shortages or obsolescence from suppliers could affect ability to manufacture products or delay shipments to customers

The Company relies on suppliers to deliver quality raw materials in a timely and cost effective manner. Most of the materials and components are generally available from multiple sources; however, from time to time vendors do not deliver the product as needed due to manufacturing problems or possibly a decision not to furnish that product in the future. Such interruption of supply or price increases could have a material adverse effect on the Company's operations; however, the Company is not currently impacted by materials shortages.

The ability to develop new products and technologies used in the military, space or aerospace markets

The Company's base products and technologies generally have long life cycles. The Company's products are primarily used in military, space or aerospace applications, which also have long life cycles. There can be no assurance that the Company will be able to define, develop and market new products and technologies on a timely and cost effective basis. Failure to respond to customer's requirements and to competitors' progress in technological changes could have a material adverse effect on the Company's business.

General economic downturn or the current credit crisis

The Company cannot assure you that our business will not be adversely affected as a result of an industry or general economic downturn, or the current credit crisis. If the Company's supply chain is adversely affected by the current credit crisis or economic downturn, this could result in the Company's inability to secure materials and could have adverse effects on the Company's ability to deliver products on a timely basis.

Item 1B. Unresolved Staff Comments

None

Item 2. Properties

The Company occupies approximately 36,000 square feet of manufacturing, engineering and office space in Garland, Texas. The Company owns 31,200 square feet of that space and leases an additional 4,800 square feet. The Company considers its facilities adequate for its current level of operations.

The Company also subcontracts some manufacturing to Inmobiliaria San Jose De Ciuddad Juarez S.A. DE C.V, a maquila contract manufacturer in Juarez, Mexico. The Company owns all equipment and inventory with temporary importation into Mexico under the maquila rules of Mexico. The Company does not lease or own any real property in Mexico.

The Company employs an International Sales Manager in Bremen, Germany who coordinates sales to Western European customers made by independent representatives. The sales manager maintains an office in a private residence. The Company does not lease or own any real property in Germany, or any other foreign country.

Item 3. Legal Proceedings

The Company is not involved in any material current or pending legal proceedings.

Item 4. Submission of Matters to a Vote of Security Holders

No matters were submitted to vote of the Company's security holders through the solicitation of proxies by the Company during the fourth quarter of the fiscal year ended November 30, 2009.

PART II

Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

On November 30, 2009, there were approximately 500 shareholders of record of the Company's common stock. The stock of the Company is closely held; and, therefore, certain shareholders have the ability to significantly influence decisions. Our common stock is quoted on the OTC Bulletin Board under the symbol "MPAD.OB". The following sets forth the high and low bid prices for each quarter during the last two fiscal years:

	High	Low
Fiscal Year Ended November 30, 2009		
Fourth Quarter	$ 5.30	$ 3.51
Third Quarter	$ 5.10	$ 1.19
Second Quarter	$ 5.10	$ 2.00
First Quarter	$ 5.20	$ 2.00
Fiscal Year Ended November 30, 2008		
Fourth Quarter	$ 7.30	$ 2.25
Third Quarter	$ 8.00	$ 5.66
Second Quarter	$ 7.05	$ 5.66
First Quarter	$ 7.30	$ 6.30

During the three month period ended November 30, 2009, approximately 20,240 shares of the Company's common stock were traded in the over-the-counter market at a price range of $3.51 to $5.30 per share. For the two year period ending November 30, 2009, approximately 105,889 shares of the Company's common stock were traded in the over-the-counter market at prices ranging from a low of $1.20 to a high of $7.30. Due to this average monthly volume of approximately 4,412 shares of common stock being publicly bought and sold during this two year period, the Company does not believe this share trading volume represents the market value of the Company's common stock held by non-affiliates.

Our stock prices quoted on the OTC Bulletin Board represent over-the-counter market quotations and reflect inter-dealer prices, without retail mark-up, mark-down or commission and may not represent actual transactions.

On December 19, 2007, the Board of Directors of Micropac Industries, Inc. approved the payment of a $.10 per share dividend to all shareholders of record on January 25, 2008. The dividend payment was paid to shareholders on February 8, 2008.

On January 12, 2009 the Board of Directors of Micropac Industries, Inc. approved the payment of a special dividend of $0.10 per share for shareholders of record as of January 26, 2009. The dividend payment was paid to shareholders on February 9, 2009.

On January 11, 2010, the Board of Directors of Micropac Industries, Inc. approved the payment of a special dividend of $0.10 per share for shareholders of record as of January 25, 2010. It is anticipated that this dividend will be paid to the Company's shareholders on or about February 17, 2010.

There are no plans to make the dividend permanent.

Item 6. Selected Financial Data

Not applicable

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

	Twelve Months Ended	
	11/30/09	11/30/08
Net Sales	100.0%	100.0%
Cost of sales	70.2%	66.6%
R & D	3.6%	2.6%
S, G, & A	19.4%	17.0%
Total Cost & Expenses	93.2%	86.2%
Operating Income	6.8%	13.8%
Other and Interest Income	.4%	.9%
Income Before Income Taxes	7.2%	14.7%
Provision for taxes	2.6%	5.1%
Net Income	4.6%	9.6%

Micropac Industries, Inc. (the Company), a Delaware corporation, manufactures and distributes various types of hybrid microelectronic circuits, solid state relays, power operational amplifiers, and optoelectronic components and assemblies. The Company's products are used as components in a broad range of military, space and industrial systems, including aircraft instrumentation and navigation systems, power supplies, electronic controls, computers, medical devices, and high-temperature (200º C) products.

The Company's products are either custom (being application-specific circuits designed and manufactured to meet the particular requirements of a single customer) or standard, proprietary components such as catalog items. Custom-designed components accounted for approximately 21% of the Company's sales for the fiscal year ended November 30, 2009, and were 27% for fiscal 2008. Standard components accounted for approximately 79% of the Company's sales for the fiscal year ended November 30, 2009, and were 73% for fiscal 2008.

The Company provides microelectronic and optoelectronic components and assemblies along with contract electronic manufacturing services and offers a wide range of products sold to the industrial, medical, military, aerospace and space markets.

Sales in 2009 were approximately $17,571,000, a decrease of 12.4% or ($2,489,000) compared to 2008 sales. The major decreases in sales were to international customers associated with the economic downturn in 2009 and optoelectronic products sold through the distribution channels due to stock level reductions at the distributors.

The Company's management expects sales and profits to be stable in 2010, based on the current backlog of optoelectronics products, certain space product contracts, and requirements for microcircuits.

New orders for fiscal year 2009 totaled $22,176,000 compared to $21,857,000 for fiscal 2008. Approximately $8,409,000 of the new orders received in 2009 was delivered to customers in 2009, along with approximately $9,359,000 of the Company's $9,723,000 backlog of orders at November 30, 2008.

The Company's backlog as of November 30, 2009, was approximately $14,102,000, compared to approximately $9,723,000 on November 30, 2008.

Custom-designed components are estimated to account for approximately 21% of the Company’s sales for the fiscal year ended November 30, 2009, and 27% in fiscal 2008; standard components are estimated to account for approximately 79% of the Company’s sales for the fiscal year ended November 30, 2009, and 73% for fiscal 2008.

Sales through the Company’s distribution channels were $2,800,000 in 2009 compared to $4,008,000 in 2008 or 16% and 20% of sales, respectively.

Approximately 21% of the sales for fiscal year 2009 (23% in 2008) were to international customers.

The Company’s major customers include contractors to the United States government with fixed price contracts. Sales to these customers for Department of Defense (DOD) and National Aeronautics and Space Administration (NASA) contracts accounted for approximately 71% of the Company’s fiscal net sales in 2009 compared to 68% in 2008.

Cost of sales, as a percentage of net sales, was 70.2% in 2009 compared to 66.6% in 2008. The increase of 3.6% is attributable to changes in product mix with lower sales volume of standard optoelectronic products sold through the distributions channels and space level sales to international customers. With the decrease in sales volume, the Company’s cost of manufacturing overhead was higher as a percentage of sales. In actual dollars, cost of sales decreased $1,026,000 for 2009 versus 2008.

In 2009, the Company’s investment in technology through research and development, which was expensed, totals approximately $639,000 ($530,000 in 2008). The Company’s research and development expenditures were directed primarily toward long-term specific customer requirements, some of which have future potential as Micropac proprietary products, and product development and improvement associated with the Company’s space level and other high reliability programs

Selling, general, and administrative expenses total 19.4% of net sales in 2009, compared to 17.0% in 2008, based on lower sales. In dollars expensed, selling, general and administrative expenses totaled $3,416,000 in 2009 compared to $3,410,000 in 2008, an increase of $6,000.

Interest and other income for fiscal 2009 totaled $78,000 compared to $182,000 for fiscal 2008. The decrease is related to lower interest rates on the Company’s investments and cash and cash equivalents.

Income before taxes for fiscal 2009 was approximately $1,266,000 or 7.2% of net sales, compared to $2,948,000 or 14.7% of net sales in fiscal 2008.

Provisions for income tax for fiscal 2009 total $449,000 compared to $1,030,000 for fiscal 2008. The Company’s effective income tax rate is 36% for the year ended November 30, 2009, compared to 35% for the year ended November 30, 2008. Management believes it will meet its future tax payments through the use of cash derived from operations and/or usage of the Company’s cash and cash equivalents.

Net income after taxes totaled approximately $817,000 or $.32 per share in 2009 versus 2008 net income of $1,918,000 or $.74 per share. Net income after taxes decreased $1,101,000 in 2009 compared to 2008.

Liquidity and Capital Resources

The Company currently has an existing line of credit with a Texas banking institution. The line of credit agreement provides the Company with up to $3,000,000 for normal operation of the Company. The interest rate on any borrowings against this credit agreement is equal to the prime rate less ¼%. The line of credit requires the Company to maintain certain financial ratios, including quick ratio of at least 1:1, maintain a tangible net worth of $10,000,000 and maintain a total liabilities-to-tangible-net-worth of less than 1.25:1. The Company is in compliance with these covenants. To date, the Company has not used any of the available line of credit. The Company expects to continue to generate adequate amounts of cash to meet its liquidity needs from the sale of products and services and the collection thereof.

The Company realized $1,727,000 net in cash flows from operations in 2009. Cash influx came primarily from the combination of net income totaling $817,000, and changes in working capital including advance payments from customers for materials recorded as deferred revenue.

The Company used $189,000 in cash for investment in additional manufacturing equipment, computers and facility improvements in 2009 compared to $419,000 in 2008.

The Company issued a dividend payment of $.10 per share dividend to all shareholders of record for the last two years. The total dividend payment was $258,000 per year.

As of November 30, 2009, the Company had $6,802,000 in cash and cash equivalents compared to $6,522,000 in cash and cash equivalents on November 30, 2008. The Company held $1,000,000 in short term investments at November 30, 2009.

The Company continues on-going investigations for the use of cumulative cash for business expansion and improvements, such as operational improvements, new product expansion, facility upgrades, and acquisition opportunities.

Company management believes it will meet its 2010 capital requirements through the use of cash derived from operations for the year and/or usage of the Company's cash and cash equivalents. There were no significant outstanding commitments for equipment purchases or improvements at November 30, 2009.

Critical Accounting Policies

Revenue Recognition

Revenues are recorded as deliveries are made based upon contract prices. Any losses anticipated on fixed price contracts are provided for currently. Sales are recorded net of sales returns, allowances and discounts.

The Company recognizes revenue in accordance with SEC Staff Accounting Bulletin No. 104, *Revenue Recognition in Financial Statements* (SAB 104), as codified. SAB 104 requires that four basic criteria must be met before revenues can be recognized: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred or services have been rendered; (3) the fee is fixed and determinable; and (4) collectibility is reasonably assured.

Inventories

Inventories are stated at lower of cost or market value and include material, labor and manufacturing overhead. All inventories are valued using the FIFO (first-in, first-out) method of inventory valuation. The Company provides an allowance for obsolete and overstocked inventory. The allowance is based on the usage of inventory over a three year period.

Income Taxes

The Company accounts for income taxes using the asset and liability method. Under this method the Company records deferred income taxes for the temporary differences between the financial reporting basis and the tax basis of assets and liabilities at enacted tax rates expected to be in effect when such amounts are realized or settled. The resulting deferred tax liabilities and assets are adjusted to reflect changes in tax law or rates in the period that includes the enactment date.

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income, and tax-planning strategies in making this assessment. Based upon the level of historical taxable income and projections for future taxable income over the periods in which the deferred tax assets are deductible, management believes it is more likely than not that the Company will realize the benefits of these deductible differences.

New Accounting Standards

In September 2009, the Financial Accounting Standards Board (FASB) issued ASC 605-25, *Revenue Recognition - Multiple-Deliverable Revenue Arrangements.* This guidance addresses how to separate deliverables and how to measure and allocate consideration to one or more units of accounting. Specifically, the guidance requires that consideration be allocated among multiple deliverables based on relative selling prices. The guidance establishes a selling price hierarchy of (1) vendor-specific objective evidence, (2) third-party evidence and (3) estimated selling price. This guidance is effective for annual periods beginning after December 15, 2009 but may be early adopted as of the beginning of an annual period. The Company is currently evaluating the effect that this guidance will have on its financial position and results of operations.

In June 2009, the FASB issued SFAS No. 168, *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles – a replacement of FASB Statement No. 162,* now referred to as ASC 105-10, *Generally Accepted Accounting Principles*. The FASB Accounting Standards Codification (Codification) has become the source of authoritative U.S. generally accepted accounting principles (GAAP) recognized by FASB to be applied by nongovernmental entities. Rules and interpretive releases of the Securities and Exchange Commission (SEC) under authority of federal securities laws are also sources of authoritative GAAP for SEC registrants. On the effective date of this statement, the Codification will supersede all then-existing non-SEC accounting and reporting standards. All other non-grandfathered non-SEC accounting literature not included in the Codification will become non-authoritative. This statement is effective for financial statements issued for interim and annual periods ending after September 30, 2009. The adoption of this statement did not have a material effect on the Company's financial statements.

In June 2009, the FASB issued SFAS No. 165, later codified in ASC 855-10, *Subsequent Events*. ASC 855-10 establishes general standards for the evaluation, recognition and disclosure of events and transactions that occur after the balance sheet date. Although there is new terminology, the standard is based on the same principles as those that currently exist in the auditing standards. The standard, which includes a new required disclosure of the date through which an entity has evaluated subsequent events, is effective for interim or annual periods ending after June 15, 2009. The adoption of ASC 855-10 did not have a material effect on the Company's financial statements.

In April 2009, the FASB issued FASB Staff Position No. 107-1 and APB Opinion No. 28-1 (FSP 107-1 and APB 28-1), later codified in ASC 825-10-65-1, *Interim Disclosures about Fair Value of Financial Instruments*. FSP 107-1 and APB 28-1 require fair value disclosures in both interim, as well as annual, financial statements in order to provide more timely information about the effects of current market conditions on financial instruments. FSP 107-1 and APB 28-1 and their adoption did not have a material impact on the Company's financial statements.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

Not applicable

Item8. Financial Statements and Supplementary Data

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11	Report of Independent Registered Public Accounting Firm
12	Balance Sheets as of November 30, 2009 and 2008
13	Statements of Income for the years ended November 30, 2009 and 2008
14	Statements of Shareholders' Equity for the years ended November 30, 2009 and 2008
15	Statements of Cash Flows for the years ended November 30, 2009 and 2008
16-21	Notes to Financial Statements for the years ended November 30, 2009 and 2008

The Board of Directors and Shareholders

Micropac Industries, Inc.:

We have audited the accompanying balance sheets of Micropac Industries, Inc. as of November 30, 2009 and 2008, and the related statements of income, shareholders' equity, and cash flows for each of the years in the two-year period ended November 30, 2009. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform an audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Micropac Industries, Inc. as of November 30, 2009 and 2008, and the results of its operations and its cash flows for each of the years in the two-year period ended November 30, 2009, in conformity with U.S. generally accepted accounting principles.

KPMG LLP

Dallas, TX
February 16, 2010

MICROPAC INDUSTRIES, INC.
BALANCE SHEETS
NOVEMBER 30, 2009 AND 2008

(Dollars in thousands except share data)

ASSETS	2009	2008
CURRENT ASSETS:		
Cash and cash equivalents	$ 6,802	$ 6,522
Short-term investments	1,000	--
Receivables, net of allowance for doubtful accounts of $0 for 2009 and $89 for 2008, respectively	2,364	3,243
Inventories		
Raw materials and supplies	2,785	2,368
Work-in-process	2,728	2,696
Total inventories	5,513	5,064
Deferred income taxes	1,069	632
Prepaid expenses and other assets	130	123
Total current assets	16,878	15,584
PROPERTY, PLANT, AND EQUIPMENT, at cost:		
Land	80	80
Buildings	498	498
Facility improvements	882	796
Machinery and equipment	6,571	6,488
Furniture and fixtures	623	603
Total property, plant, and equipment	8,654	8,465
Less- accumulated depreciation	(7,324)	(7,069)
Net property, plant, and equipment	1,330	1,396
Total assets	$ 18,208	$ 16,980
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$ 713	$ 1,169
Accrued compensation	481	631
Accrued professional fees	25	42
Income taxes payable	45	94
Property taxes	75	77
Commissions payable	52	68
Deferred revenue	1,524	204
Other accrued liabilities	41	123
Total current liabilities	2,956	2,408
DEFERRED INCOME TAXES	218	97
SHAREHOLDERS' EQUITY:		
Common stock, $.10 par value, authorized 10,000,000 shares 3,078,315 issued 2,578,315 outstanding at November 30, 2009 and November 30, 2008	308	308
Paid-in capital	885	885
Treasury stock, at cost, 500,000 shares	(1,250)	(1,250)
Retained earnings	15,091	14,532
Total shareholders' equity	15,034	14,475
Total liabilities and shareholders' equity	$ 18,208	$ 16,980

See accompanying notes to financial statements.

MICROPAC INDUSTRIES, INC.

STATEMENTS OF INCOME
FOR THE YEARS ENDED NOVEMBER 30, 2009 AND 2008

(Dollars in thousands except share data)

	2009	2008
NET SALES	$ 17,571	$ 20,060
COSTS AND EXPENSES:		
Cost of sales	12,328	13,354
Research and development	639	530
Selling, general, and administrative expenses	3,416	3,410
Total costs and expenses	16,383	17,294
OPERATING INCOME	1,188	2,766
Other income	58	37
Interest income	20	145
INCOME BEFORE INCOME TAXES	1,266	2,948
PROVISION (BENEFIT) FOR INCOME TAXES:		
Current	765	1,022
Deferred	(316)	8
Total provision for income taxes	449	1,030
NET INCOME	$ 817	$ 1,918
BASIC AND DILUTED EARNINGS PER SHARE	$ 0.32	$ 0.74
WEIGHTED AVERAGE NUMBER OF SHARES, basic and diluted	2,578,315	2,578,315

See accompanying notes to financial statements.

MICROPAC INDUSTRIES, INC.
STATEMENTS OF SHAREHOLDERS' EQUITY
FOR THE YEARS ENDED NOVEMBER 30, 2009 AND 2008

(Dollars in thousands)

	Common Stock	Paid-in Capital	Treasury Stock	Retained Earnings	Total
BALANCE, November 30, 2007	308	885	(1,250)	12,872	12,815
Dividend	--	--	--	(258)	(258)
Net income	--	--	--	1,918	1,918
BALANCE, November 30, 2008	$ 308	$ 885	$ (1,250)	$ 14,532	$ 14,475
Dividend	--	--	--	(258)	(258)
Net income	--	--	--	817	817
BALANCE, November 30, 2009	$ 308	$ 885	$ (1,250)	$ 15,091	$ 15,034

See accompanying notes to financial statements.

MICROPAC INDUSTRIES, INC.
STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED NOVEMBER 30, 2009 AND 2008

(Dollars in thousands)

	2009	2008
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 817	$ 1,918
Adjustments to reconcile net income to		
net cash provided by operating activities-		
Depreciation and amortization	255	251
Deferred tax expense (benefit)	(316)	8
Gain on sale of equipment	--	(3)
Changes in certain current assets and liabilities-		
(Increase) decrease in receivables, net	879	(828)
Increase in inventories	(449)	(1,021)
Increase in prepaid expenses and other assets	(7)	(54)
Increase (decrease) in accounts payable	(456)	561
Increase (decrease) in accrued compensation	(150)	87
Decrease in income taxes payable	(49)	(141)
(Decrease) increase in all other accrued liabilities	1,203	(3)
Net cash provided by operating activities	1,727	775
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase and maturity of short term investment, net	(1,000)	2,021
Proceeds from sale of equipment	--	9
Additions to property, plant, and equipment	(189)	(419)
Net cash provided by (used in) in investing activities	(1,189)	1,611
CASH FLOWS FROM FINANCING ACTIVITIES:		
Dividends paid	(258)	(258)
Net cash used in financing activities	(258)	(258)
NET INCREASE IN CASH AND CASH EQUIVALENTS	280	2,128
CASH AND CASH EQUIVALENTS, beginning of year	6,522	4,394
CASH AND CASH EQUIVALENTS, end of year	$ 6,802	$ 6,522
SUPPLEMENTAL CASH FLOW DISCLOSURES:		
Cash paid for income taxes, net of refunds received	$ 745	$ 1,232

See accompanying notes to financial statements.

MICROPAC INDUSTRIES, INC.
NOTES TO FINANCIAL STATEMENTS
NOVEMBER 30, 2009 AND 2008

1. BUSINESS DESCRIPTION:

Micropac Industries, Inc. (the Company), a Delaware corporation, manufactures and distributes various types of hybrid microelectronic circuits, solid state relays, power operational amplifiers, and optoelectronic components and assemblies. The Company's products are used as components in a broad range of military, space and industrial systems, including aircraft instrumentation and navigation systems, power supplies, electronic controls, computers, medical devices, and high-temperature (200° C) products.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:

Revenue Recognition

Revenues are recorded as deliveries are made based upon contract prices. Any losses anticipated on fixed price contracts are provided for currently. Sales are recorded net of sales returns, allowances and discounts.

Deferred Revenue represents prepayments from customers and will be recognized as revenue when the products are shipped.

Short-Term Investments

The Company has $1,000,000 in short term investments at November 30, 2009. Short-term investments historically include certificates of deposits with maturities greater than 90 days. These investments are reported at historical cost, which approximates fair value. All highly liquid investments with maturities of 90 days or less are classified as cash equivalents. All short-term investments are securities which the Company has the ability and intent to hold to maturity. All held-to maturity securities mature within one year.

Inventories

Inventories are stated at lower of cost or market value and include material, labor and manufacturing overhead. All inventories are valued using the FIFO (first-in, first-out) method of inventory valuation. The Company provides an allowance for obsolete and overstocked inventory. The allowance is based on the usage of inventory over a three year period.

Income Taxes

The Company accounts for income taxes using the asset and liability method. Under this method the Company records deferred income taxes for the temporary differences between the financial reporting basis and the tax basis of assets and liabilities at enacted tax rates expected to be in effect when such amounts are realized or settled. The resulting deferred tax liabilities and assets are adjusted to reflect changes in tax law or rates in the period that includes the enactment date.

Property, Plant, and Equipment

Property, plant, and equipment are carried at cost, and depreciation is provided using the straight-line method at rates based upon the following estimated useful lives (in years) of the assets:

Buildings	15
Facility improvements	8-15
Machinery and equipment	5-10
Furniture and fixtures	5-8

The Company assesses long-lived assets for impairment under ASC 360-10-35, *Property, Plant and Equipment – Subsequent Measurement*, formerly known as SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. When events or circumstances indicate that an asset may be impaired, an assessment is performed. The estimated future undiscounted cash flows associated with the asset are compared to the asset's net book value to determine if a write down to market value less cost to sell is required.

Repairs and maintenance are charged against income when incurred. Improvements, which extend the useful life of property, plant, and equipment, are capitalized.

Research and Development Costs

Costs for the design and development of new products are expensed as incurred.

Comprehensive Income

Comprehensive income includes net income and other comprehensive income which is generally comprised of changes in the fair value of available-for-sale marketable securities, foreign currency translation adjustments and adjustments to recognize additional minimum pension liabilities. For each period presented in the accompanying statement of income, comprehensive income and net income are the same amount.

Basic and Diluted Earnings Per Share

Basic and diluted earnings per share are computed based upon the weighted average number of shares outstanding during the year. Diluted earnings per share give effect to all dilutive potential common shares. During 2009 and 2008, the Company had no dilutive potential common stock.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

3. NOTES PAYABLE TO BANKS:

The Company currently has an existing line of credit with a Texas banking institution. The line of credit agreement provides the Company with up to $3,000,000 for normal operation of the Company. The interest rate on any borrowings against this credit agreement is equal to the prime rate less ¼%. The line of credit requires the Company to maintain certain financial ratios, including quick ratio of at least 1:1, maintain a tangible net worth of $10,000,000 and maintain a total liabilities-to-tangible-net-worth of less than 1.25:1. The Company is in compliance with these covenants. The Company has not, to date, used any of the available line of credit.

4. RELATED PARTIES:

The Company leases a building from the Company’s former Chairman of the Board of Directors. Since 1980, the Company has leased a 4,800 square-foot building from Mr. Nadolsky which is used primarily for manufacturing. The lease originally provided for a monthly rental of $1,900 (an amount based upon a January 1984, independent appraisal of the building’s value) and was to have expired on January 1, 1987. Since 1987, the Company has extended the term of this lease from time to time. The rental paid to Mr. Nadolsky pursuant to this lease was $45,000 for the fiscal year ended November 30, 2009 and $44,000 in 2008. The lease was renewed for three (3) years, July 2007 to June 2010 at the same rental rate provided for in the previous lease subject to increase based upon increases in the Consumer Price Index.

Glast, Phillips & Murray, P.C. serves as the Company’s legal counsel. Mr. James K. Murphey, a director and member of the Company’s audit committee, is a member of Glast, Phillips & Murray, P.C. Glast, Phillips & Murray, P.C. were paid $17,800 in 2009 and $8,300 in 2008.

Mr. Eugene Robinson, a director and member of the Company’s audit committee, provides advisory services to the Company and was paid $6,100 in 2009 and $6,500 in 2008.

Effective May 13, 2003, the Company's Board of Directors approved the formation of an audit committee composed of the members of the Board. It is possible that the members of the audit committee may resign from the committee if future Securities and Exchange Commission rules establish the criteria that such individuals must be independent, due to their relationships with the Company. The Board of Directors held five (5) board meetings during the year ended November 30, 2009. Directors (excluding Mark King) received a fee of $1,500 for each meeting. The Audit Committee held four (4) meetings during the year ended November 30, 2009. Members of the Audit Committee (excluding Mark King) received a fee of $750 for each meeting.

5. PRODUCT WARRANTIES:

In general, the Company warrants that the products, when delivered, will be free from defects in material workmanship under normal use and service. The obligations are limited to replacing, repairing or giving credit for, at the option of the Company, any products that are returned within one year after the date of shipment. Because the Company does not have extended warranties, the exposure is limited to product returns for defective products.

The Company reserves for potential warranty expense based on historical warranty experience claims. While management considers the process to be adequate to effectively quantify its exposure to warranty claims based on historical performance, changes in warranty claims on a specific or cumulative basis may require management to adjust its reserve for potential warranty costs.

Warranty expense to repair or replace products in 2009 and 2008, was $87,300 and $62,700, respectively.

6. LEASE COMMITMENTS:

Rent expense for the years ended November 30, 2009 and 2008, was $45,000 and $44,000, respectively.

The Company's future minimum lease payments under non-cancellable operating leases (including the related party lease described in note 4) for office and manufacturing space with remaining terms in excess of one year are:

2010	$ 46,000
2011	$ 27,000

7. EMPLOYEE BENEFITS:

The Company sponsors an Employees' Profit Sharing Plan and Trust (the Plan). Pursuant to section 401(k) of the Internal Revenue Code, the Plan is available to substantially all employees of the Company. Employee contributions to the Plan are matched by the Company at amounts up to 6% of the participant's salary. Contributions made by the Company and expensed were approximately $219,000 in 2009 and $210,000 in 2008. Employees become vested in Company contributions at 20% after two years, 40% after three years, 60% after four years, 80% after five years and 100% after six years. If the employee leaves the Company prior to being fully vested, the unvested portion of the Company contributions are forfeited and such forfeitures are used to lower future Company contributions. The Company does not offer other post retirement benefits to its employees at this time.

8. NEW ACCOUNTING STANDARDS

In September 2009, the Financial Accounting Standards Board (FASB) issued ASC 605-25, *Revenue Recognition - Multiple-Deliverable Revenue Arrangements.* This guidance addresses how to separate deliverables and how to measure and allocate consideration to one or more units of accounting. Specifically, the guidance requires that consideration be allocated among multiple deliverables based on relative selling prices. The guidance establishes a selling price hierarchy of (1) vendor-specific objective evidence, (2) third-party evidence and (3) estimated selling price. This guidance is effective for annual periods beginning after December 15, 2009 but may be early adopted as of the beginning of an annual period. The Company is currently evaluating the effect that this guidance will have on its financial position and results of operations.

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In April 2009, the FASB issued FASB Staff Position No. 107-1 and APB Opinion No. 28-1 (FSP 107-1 and APB 28-1), later codified in ASC 825-10-65-1, *Interim Disclosures about Fair Value of Financial Instruments*. FSP 107-1 and APB 28-1 require fair value disclosures in both interim, as well as annual, financial statements in order to provide more timely information about the effects of current market conditions on financial instruments. FSP 107-1 and APB 28-1 and their adoption did not have a material impact on the Company's financial statements.

9. INCOME TAXES:

The income tax provision consisted of the following for the years ended November 30:

	2009	2008
Current Provision:		
Federal	$ 685,000	$ 950,000
State	80,000	72,000
	765,000	1,022,000
Deferred federal tax expense	(316,000)	8,000
Total	$ 449,000	$ 1,030,000

The provision for income taxes differs from that computed at the federal statutory corporate tax rate as follows:

	2009	2008
Tax at 34% statutory rate	$ 430,000	$ 1,002,000
State income taxes, net of federal benefit	53,000	47,000
Section 199 Adjustment	(50,000)	(60,000)
Deferred tax impact of effective tax rate change	--	47,000
Permanent differences and other	16,000	(6,000)
Income tax provision	$ 449,000	$ 1,030,000

The components of deferred tax assets and liabilities were as follows:

	November 30, 2009	November 30, 2008
Current Deferred Taxes -		
Allowance for doubtful accounts	$ --	$ 30,000
Inventory	486,000	441,000
Deferred revenue	532,000	111,000
Other accrued liabilities	51,000	49,000
Net current deferred tax asset	1,069,000	632,000
Non-current Deferred Taxes Liability		
Depreciation	(218,000)	(97,000)
Net deferred taxes	$ 851,000	$ 535,000

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income, and tax-planning strategies in making this assessment. Based upon the level of historical taxable income and projections for future taxable income over the periods in which the deferred tax assets are deductible, management believes it is more likely than not that the Company will realize the benefits of these deductible differences.

10. SIGNIFICANT CUSTOMER INFORMATION:

The Company’s primary line of business relates to the design, manufacture, and sale of hybrid microcircuits and optoelectronic components and assemblies. Sales to primary contractors for defense and space related contracts accounted for 71% of total sales in 2009 and 68% of total sales in 2008. One customer accounted for 13% of the Company’s sales during 2009 and no customer accounted for 10% of the Company’s sales during 2008.

11. SHAREHOLDERS’ EQUITY:

On November 30, 2009, there were approximately 500 shareholders of record of the Company’s common stock, of which some cannot be located. The Company’s majority shareholder, Mr. Heinz-Werner Hempel, established a partnership organized under the laws of Germany which owns 1,952,577 shares or 75.7% of the outstanding voting shares. Mr. Hempel through the partnership has the ability to control the election of the Company’s Board of Directors and elect individuals who may be more sympathetic to such majority shareholders’ desires and not necessarily sympathetic to the desires of minority shareholders as to the policies and directions of the Company. However, the ability to control the election of the Board of Directors does not modify the fiduciary duties of the Board of Directors to represent the interests of all shareholders

On December 19, 2007, the Board of Directors of Micropac Industries, Inc. approved the payment of a $.10 per share dividend to all shareholders of record on January 25, 2008. The dividend payment was paid to shareholders on February 8, 2008.

On January 12, 2009 the Board of Directors of Micropac Industries, Inc. approved the payment of a special dividend of $0.10 per share for shareholders of record as of January 26, 2009. The dividend payment was paid to shareholders on February 9, 2009.

On March 1, 2001, the Company’s shareholders approved the 2001 Employee Stock Option Plan (the Stock Plan). As of November 30, 2009, there were 500,000 options available to be granted; however, no options had been granted at year-end.

12. SUBSEQUENT EVENTS

On January 11, 2010, the Board of Directors of Micropac Industries, Inc. approved the payment of a special dividend of $0.10 per share for shareholders of record as of January 25, 2010. It is anticipated that this dividend will be paid to the Company’s shareholders on or about February 17, 2010.

Management has evaluated subsequent events after the balance sheet date, through the issuance of the financial statements, for appropriate accounting and disclosure through February 16, 2010.

Item 9. Changes in and Disagreements With Accountants on Accounting and Financial Disclosure

None

Item 9A(T). Controls and Procedures

Our Chief Executive Officer and Chief Financial Officer (the Certifying Officers) are responsible for establishing and maintaining disclosure controls and procedures for the Company. The Certifying Officers have designed such disclosure controls and procedures to ensure that material information is made known to them, particularly during the period in which this report was prepared. The Certifying Officers have evaluated the effectiveness of the Company's disclosure controls and procedures (as such term is defined in Exchange Act Rules 13a-15(e) and 15d-15(e) (the

Rules) under the Securities Exchange Act of 1934 (or Exchange Act)) as of the end of the period covered by this Annual Report and believe that the Company's disclosure controls and procedures are effective based on the required evaluation.

Management of Micropac Industries, Inc. (the Company) is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in the Securities Exchange Act Rule 13a-15(f). Under the supervision and with the participation of the Company's management, including the Chief Executive Officer (principal executive officer) and the Chief Financial Officer (principal financial officer), the Company's management conducted an evaluation of the effectiveness of its internal control over financial reporting as of November 30. 2009 as required by the Securities Exchange Act of 1934 Rule 13a-15(c). In making this assessment, the Company's management used the criteria set forth in the framework in "Internal Control – Integrated Framework" issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on the evaluation conducted under the framework in "Internal Control – Integrated Framework," the Company's management concluded that the Company's internal control over financial reporting was effective as of November 30. 2009.

This report does not include an attestation report of the Company's registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the Company's registered public accounting firm pursuant to temporary rules of the SEC that permit the Company to provide only management's report in this Annual Report on Form 10-K.

During our most recent fiscal quarter, there has not occurred any change in our internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Item 9B. Other Information

None

PART III

In accordance with General Instruction G(3) of Form 10-K, the information required by this Part III is incorporated by reference to Micropac Industries, Inc.'s definitive proxy statement relating to its 2010 Annual Meeting of Stockholders, as set forth below. The 2010 Proxy Statement will be filed with the Securities and Exchange Commission on or about February 17, 2010.

Item 10. Directors, Executive Officers and Corporate Governance

The information set forth in the 2010 Proxy Statement under the headings "Election of Directors", and "Principal Stockholders and Stockholdings of Management", is incorporated herein by reference.

Name	Age	Position(s) With the Company	Director Since
Patrick S. Cefalu	52	CFO, Executive Vice President	
H. Kent Hearn	73	Director and Member of Audit Committee	February 1983
Heinz-Werner Hempel	81	Director and Member of Audit Committee	February 1997
Mark King	55	CEO, President and Member of Audit Committee and Chairman of the Board	November 2005
James K. Murphey	67	Member of Audit Committee and Board of Directors and Secretary	March 1990
Eugene Robinson	70	Director, and Member of Audit Committee	October 2008
Connie Wood	70	Director, and Member of Audit Committee	February 2002

Mr. Hearn is retired. Mr. Hearn was formerly employed as a stockbroker by Milkie/Ferguson Investments, Inc.

Mr. Hempel is the Chief Operating Officer of Hanseatische Waren-Gesellschaft MBH & Co, KG, Bremen, Germany.

Mr. King is the current President and Chief Executive of the Company. Prior to November 2002, Mr. King was the President and Chief Operating Officer of Lucas Benning Power Electronics. Mr. King joined the Company in November of 2002, and was elected Chief Executive Officer, President and Director in October 2005.

Mr. Murphey is an attorney and member of the law firm Glast, Phillips & Murray, P.C. in Dallas, Texas. Glast, Phillips & Murray, P.C. serves as legal counsel to the Company.

Mr. Robinson has 35 years of experience in the electronics industry, including 26 years with Texas Instruments, Inc. and later Raytheon through acquisition. During the past 10 years, Mr. Robinson has been actively engaged consulting with numerous high technology organizations. He has served on several advisory boards for high technology companies and universities.

Ms. Wood served as the Company’s Chief Executive Officer and President of the Company until her retirement in January 2006.

The Board of Directors held five (5) board meetings during the year ended November 2009. Directors received a fee of $1,500.00 other than Mr. King for each meeting attended during the year ended November 2009. Beginning on December 1, 2005, the Board agreed to pay an annual retainer of $10,000 to Mr. Hearn, Mr. Robinson and Ms. Wood. Ms. Wood, Mr. Hearn, Mr. Robinson and Mr. Murphey attended all of the meetings. Mr. Hempel attended two (2) of the meetings.

The Audit Committee held four (4) meetings during the year ended November 30, 2009. Members of the Audit Committee received a fee of $750.00 for each meeting attended during the year ended November 2009. Mr. King did not receive any payments for attending meetings of the Audit Committee. Mrs. Wood and Messrs Murphey, Robinson, and Hearn attended all of the meetings. Mr. Hempel attended one (1) of the meetings.

With the exception of Mr. Hearn and Mr. Robinson, members of the Audit Committee are not considered independent members under applicable United States statutes.

The Board of Directors does not have nominating or compensation committee or committees performing similar functions. The Board of Directors formed an audit committee on May 13, 2002. The members of the Audit Committee operate pursuant to a charter developed by the Board of Directors.

The Audit Committee has discussed with management and the independent auditors the quality and adequacy of the Company's internal controls. The Audit Committee has considered and reviewed with the independent auditors their audit plans, the scope of the audit, and the identification of audit risks. The Audit Committee has reviewed and discussed the audited financial statements with management and has discussed such financial statements with the independent auditors.

The Audit Committee has received the written disclosures and the report from the independent accountants required by the applicable requirements of the Public Company Accounting Oversight Board regarding the independent accountants’ communications with the Audit Committee concerning independence and has discussed with the independent accountant the independent accounts’ independence. Based upon the review and discussions referred to above, the Audit Committee recommended to the Board of Directors that the audited financial statements be included in the Company’s annual report on Form 10-K for the fiscal year ended November 30, 2009, for filing with the Securities and Exchange Commission.

Management has the responsibility for the preparation and integrity of the Company's financial statements and the independent auditors have the responsibility for the examination of those statements. It is not the duty of the Audit Committee to conduct audits to determine that the Company’s financial statements are complete and accurate and are in accordance with accounting principles generally accepted in the United States. Those responsibilities belong to management of the Company. In giving its recommendations, the Audit Committee considered (a) management's representation that such financial statements have been prepared with integrity and objectivity and in conformity with accounting principles generally accepted in the United States, and (b) the report of the Company’s independent auditors with respect to such financial statements.

The Company has adopted a code of ethics that applies to the Company's chief executive officer and principal financial officer.

Item 11. Executive Compensation

The information set forth in the 2010 Proxy Statement under the heading "Management Remuneration and Transactions", is incorporated herein by reference.

The following table shows as of November 30, 2009, all cash compensation paid to, or accrued and vested for the account of Mr. Mark King, President and Chief Executive Officer and Mr. Patrick Cefalu, Vice President and Chief Financial Officer. Mr. King and Mr. Cefalu received no non-cash compensation during 2009.

On January 15, 2001, the Board of Directors adopted the Micropac Industries, Inc. 2001 Employee Stock Option Plan. To date, no options have been granted under the Plan.

Annual Compensation

Name and Principal Position	Year	Annual Salary	Bonus	Other Annual Compensation	All Other Compensation (a)
Mark King,	2009	$ 246,716	$ 25,200	-0-	$ 21,626
President and	2008	$ 239,250	$ 21,800	-0-	$ 15,031
Chief Executive Officer (1)	2007	$ 232,641	$ 20,000	-0-	$ 25,452
Patrick Cefalu,	2009	$ 144,133	$ 25,200	-0-	$ 8,907
Vice President and	2008	$ 133,208	$ 21,800	-0-	$ 6,118
Chief Financial Officer	2007	$ 123,161	$ 20,000	-0-	$ 11,978

(a) Reflects amounts contributed by Micropac Industries, Inc., under Micropac's 401(k) profit sharing plan; unused vacation pay; and reimbursement for medical expenses under Micropac's Family Medical Reimbursement Plan.

(1) Effective November 2005, Mr. King's existing employment agreement was revised to provide that Mr. King would serve as the Company's President and Chief Executive Officer, and a member on the Board of Directors and Audit Committee at a base salary of $186,400 for a term of three (3) years. In December 2005, the Company and Mr. King amended his employment agreement to increase his annual base salary to $225,000. In June 2009, the Company and Mr. King amended his employment agreement to increase his annual base salary to $247,104 for a term of three (3) years with annual increases to be determined by the Board of Directors. The June 2009 amendment also provides under certain events, either the Company or Mr. King can terminate the agreement upon a payment to Mr. King of 18 or 36 month's salary as severance payments.

Amount included in all other compensation relating to employee benefit plans

The Company maintains a Family Medical Reimbursement Plan for the benefit of its executive officers and their dependents. The Plan is funded through a group insurance policy issued by an independent carrier and provides for reimbursement of 100% of all bona fide medical and dental expenses that are not covered by other medical insurance plans. During the fiscal year ended November 30, 2009, Mr. King received $7,826.17 and Mr. Cefalu received $8,907.29 which amounts are included in the "All Other Compensation" column shown in the preceding remuneration table.

In July 1984, the Company adopted a Salary Reduction Plan pursuant to Section 401(k) of the Internal Revenue Code. The Plan's benefits are available to all Company employees who are at least 18 years of age and have completed at least six months of service to the Company as of the beginning of a Plan year. Plan participants may elect to defer up to 15% of their total compensation as their contributions, subject to the maximum allowed by the Internal Revenue code 401(k), and the Company matches their contributions up to a maximum of 6% of their total compensation. A participant's benefits vest to the extent of 20% after two years of eligible service and become fully vested at the end of six years. During the fiscal year ended November 30, 2009, the Company made contributions to the Plan for Mr. King in the amount of $13,800.02 which amounts are included in the "All Other Compensation" column shown in the preceding remuneration table.

Employment agreements of the Company’s officers provide that they may elect to carry over any unused vacation time to subsequent periods or elect to be paid for such unused vacation time. In 2009, Mr. King and Mr. Cefalu did not receive any unused vacation which is included in the “All Other Compensation” column shown in the preceding remuneration table

On January 15 2001, the Board of Directors adopted the Micropac Industries, Inc. 2001 Employee Stock Option Plan. To date, no options have been granted under the Plan.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

The information set forth in the 2010 Proxy Statement under the heading "Principal Stockholders and Stockholdings of Management" is incorporated herein by reference.

The following table shows the number and percentage of shares of the Company's common stock beneficially owned (a) by each person known by the Company to own 5% or more of the outstanding common stock, (b) by each director and nominee, and (c) by all present officers and directors as a group.

Name and Address of Beneficial Owner	Number of Shares Beneficially Owned	Percent of Class(1)
Patrick Cefalu 8706 Arborside Rowlett, Texas 75089	0	0%
Heinz-Werner Hempel (2) (3) (4) Hanseatische Waren-Gesellschaft MBH & Co., KG Am Wall 127 28195 Bremen 1 Germany	1,952,577	75.7%
H. Kent Hearn (3) 1409 Briar Hollow Garland, Texas 75043	3,500	Less than .2%
Mark King (3) 2905 Wyndham Ln. Richardson, TX 75082	4,200	Less than .2%
James K. Murphey (3) 2290 One Galleria Tower 13355 Noel Road, L.B.75 Dallas, Texas 75240	0	0%
Eugene Robinson (3) 1200 Lake Pointe Circle McKinney, Texas 75070	0	0%
Connie Wood (3) 877 FM 2948 Como, Texas 75431	6,000	Less than .2%
All officers and directors as a group (7 Persons)	1,966,277	76.3%

[1] Calculated on the basis of the 2,578,315 outstanding shares. There are no options, warrants, or convertible securities outstanding.

[2] The Company and Mr. Heinz-Werner Hempel are parties to an Ancillary Agreement entered into in March 1987. The Ancillary Agreement primarily obligates the Company to register Mr. Hempel's stock and allows Mr. Hempel to participate in any sale of stock by the Company.

[3] A director of the Company. Each incumbent director has been nominated for reelection at the Annual Meeting.

[4] Effective October 10, 2007, Mr. Hempel transferred all of the shares of the Company’s common stock owned by him and consisting of 1,952,577 shares, to a partnership organized under the laws of Germany. This partnership is composed of Mr. Hempel, his son, and his daughter. As the consideration for this transfer, Mr. Hempel received a 99.98% share in this partnership and received the sole voting and management control. His son and daughter each own a 0.01% ownership interest in this partnership.

Item 13. Certain Relationships and Related Transactions, and Director Independence

The information set forth in the 2010 Proxy Statement under the heading "Management Remuneration and Transactions" is incorporated herein by reference.

The Company leases a building from the Company's former Chairman of the Board of Directors. Since 1980, the Company has leased a 4,800 square-foot building from Mr. Nadolsky which is used primarily for manufacturing. The lease originally provided for a monthly rental of $1,900 (an amount based upon a January 1984, independent appraisal of the building's value) and was to have expired on January 1, 1987. Since 1987, the Company has extended the term of this lease from time to time. The rental paid to Mr. Nadolsky pursuant to this lease was $45,000 for the fiscal year ended November 30, 2009. The lease was renewed for three (3) years, July 2007 to June 2010, at the same rental rate provided for in the previous lease subject to increase based upon increases in the Consumer Price Index.

Mr. Eugene Robinson, a director and member of the Company's audit committee, provides advisory services to the Company and was paid $6,100 in 2009.

Item 14. Principal Accounting Fees and Services

The information set forth in the 2010 Proxy Statement under the heading "Independent Public Accountants" and "Audit Fees" is incorporated herein by reference.

KPMG LLP was selected as the independent accountants in 2002 and has been responsible for the Company's financial audit for the fiscal years ended November 30, 2002 through November 30, 2009.

Management anticipates that a representative from KPMG LLP will be present at the Annual Meeting and will be given the opportunity to make a statement if he or she desires to do so. It is also anticipated that such representative will be available to respond to appropriate questions from stockholders.

AUDIT FEES

KPMG LLP fees for professional services for the audit of the Company's financial statements for 2009 and the review of the interim financial statements included in the Quarterly Reports was $115,000 and for the audit of the Company's financial statements for 2008 and the review of the interim financial statements included in the Quarterly Reports was $108,500.

TAX FEES

In addition to the audit fees, KPMG LLP fees for tax advisory and 2008 tax return preparation services were $29,000 and 2007 tax return preparation services were $32,500.

ALL OTHER FEES

KPMG LLP did not provide any other services.

The Audit Committee requests that KPMG LLP provide the committee with the anticipated charges of all accounting and tax related services to be performed by KPMG LLP in advance of performing such services. The Audit

Committee approves all KPMG LLP tax return preparation in advance of the performance of such services.

Part IV

Item 15. Exhibits, Financial Statement Schedules

(a) Exhibits

31.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes- Oxley Act of 2002

31.2 Certification of Chief Accounting Officer pursuant to Section 302 of the Sarbanes- Oxley Act of 2002

32.1 Certification of Chief Executive Officer pursuant to 18 U.S.C. section 1350**,**

as adopted pursuant to section 906 of the Sarbanes-Oxley act of 2002.

32.2 Certification of Chief Accounting Officer pursuant to 18 U. S. C. section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley act of 2002.

(b) Form 8K –

Effective October 10, 2007, the Company's majority shareholder, Mr. Heinz-Werner Hempel, transferred all of the shares of the Company's common stock, $.10 par value and consisting of 1,952,577 shares to Micropac Industries, Inc. Vermoegensverwaltungsgesellschaft buergerlichen Rechts. This Partnership is composed of Mr. Hempel, his son, and his daughter. As the consideration for this transfer, Mr. Hempel received a 99.98% share in this partnership and retains the sole voting and management control. His son and daughter each own 0.01% in this Partnership. On December 19, 2007, the Board of Directors of Micropac Industries, Inc. approved the payment of a $.10 per share dividend to all shareholders of record on January 25, 2008. The dividend payment was paid to shareholders on February 8, 2008.

On January 23, 2008, Mr. Nadolsky announced his plan not to run for re-election as a Director and Chairman of the Board of Micropac Industries, Inc. (the Company) due to health reasons. Mr. Nadolsky continued to serve in such positions until the Company's Annual Shareholder Meeting held on March 7, 2008.

On October 15, 2008, the Board of Directors elected Mr. Eugene A. Robinson, 69, as a director to the board.

On January 12, 2009 the Board of Directors of Micropac Industries, Inc. approved the payment of a special dividend of $0.10 per share for shareholders of record as of January 26, 2009. The dividend payment was paid to shareholders on February 9, 2009.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

MICROPAC INDUSTRIES, INC.

By: /s/ Mark King
Mark King, President
and Chief Executive Officer
(Principal Executive Officer)

By: /s/ Patrick Cefalu
Patrick Cefalu, CFO and
Principal Accounting Officer

Dated: 02/17/2010

Pursuant to the requirements of the Securities and Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated on 02/17/2010.

/s/ Connie Wood
Connie Wood, Director

/s/ J. K. Murphey
James K. Murphey, Director

/s/ Eugene Robinson
Eugene Robinson, Director

/s/ H. K. Hearn
H. Kent Hearn, Director

/s/ Heinz-Werner Hempel
Heinz-Werner Hempel, Director

/s/ Mark W. King
Mark King, Director

DIRECTORS AND OFFICERS

NOVEMBER 30, 2009

MARK KING
Chief Executive Officer
Chairman of the Board
Micropac Industries, Inc

CONNIE WOOD
Retired Chief Executive Officer
Micropac Industries, Inc.

HEINZ-WERNER HEMPEL
Chief Operating Officer
Hanseatishe Waren Handelsgesellschaft MBH & Co. KG, Bremen, Germany

H. KENT HEARN
Retired Stockbroker
Milkie-Ferguson, Dallas, Texas

JAMES K. MURPHEY
Corporate Attorney
Glast, Phillips and Murray, Dallas, Texas

EUGENE ROBINSON
Retired

PATRICK CEFALU
Chief Financial Officer
Micropac Industries, Inc.

as a % of net revenue	*19.8%*	*21.6%*											
Add. info:													
Operating results	326	383	307	566	830	1,042	1,184	1,364	1,565	1,738	1,845	1,955	2,020
Amortization/depreciation	63	84	73	76	79	83	84	85	83	87	91	92	95
EBITDA	**389**	**467**	**381**	**643**	**909**	**1,125**	**1,268**	**1,449**	**1,649**	**1,825**	**1,936**	**2,046**	**2,114**

as a % of net revenue	*23.1%*	*26.0%*	*16.7%*	*20.6%*	*22.8%*	*23.5%*	*22.5%*	*22.8%*	*23.3%*	*23.5%*	*23.3%*	*23.5%*	*23.5%*

The segment "Germany" includes for the most part T-Online International AG and the German divisions of the Scout24 group acquired in 2004. Due to the purchase of the Scout24 group in 2004, only a restricted comparison of the financial year 2004 figureswith the previous year's figures is possible.

Adjustments

In an effort to improve comparisons with previous years, the operating results in 2003 and 2004 were adjusted to account for goodwill amortization. The adjustments involved EUR 7 million in a last-time scheduled amortization of goodwill in 2003; in 2004, the full value of goodwill in daybyday media GmbH (EUR 4 million) was written off.

Net revenue

On the basis of the combined business model, T-Online generated net revenue both from fees for Internet access (access business) and from additional services such as email, online banking, instant messaging, calendar/address book management, web hosting, online communities and international roaming (non-access business). In T-Online's combined business model, access services are offered in combination with portal-based content data and services. The access and non-access services are, accordingly, combined into an integrated package. The combination benefits both areas.

In the revenue streams generated by the customers under the combined business model, a distinction is generally made between "subscription fees" (*i.e.*, fees from fixed basic charges), on the one hand, and "usage fees", (*i.e.*, usage-related fees), on the other hand. Revenue is also generated from online advertising and corporate customer (B2B) business.

These services represent T-Online's current core business. Consistent with current market trends, it is assumed that greater focus will be directed to broadband Internet services during the projection years. Accordingly, beginning in 2005, T-Online took over handling the DSL full package marketing (*DSL-Komplettvermarktung*) and is thereby able to offer both the line and Internet access from the same source. Starting from the existing package, T-Online is planning to expand the entertainment services area.

From 2003 to 2004, T-Online's net revenue rose by EUR 111 million, from EUR 1,683 million to EUR 1,794 million. This rise resulted from the continuing customer growth and improvements in average revenues per user (ARPU). Even more than in previous years, in 2004 the Company was able to convert new and existing customers to subscription models such as the DSL volume-based tariffs. These tariffs provide for a fixed quantity of transactions in the subscription fee. The duration of the Internet session is irrelevant to the fees made. A contribution to this trend was, *inter alia*, the broadband marketing initiative launched in mid-2004, which made it easier for customers to try out the broadband Internet since T-Online agreed to refund the initial activation fee charged by Deutsche Telekom for new DSL lines. As a result of this campaign, the number of DSL customers rose by 1.1 million (49.4%) to 3.23 million in 2004. In the previous year, the company reported 454,000 new DSL customers. T-Online is expecting to increase, by the year 2014, its own customer base in the broadband business to approximately 15.2 million DSL customers.

On 31 January 2005, T-Online launched the **DSL full package marketing campaign**. This offer includes the sale of DSL access components with integrated DSL tariffs, whereby the potential revenue per end customer is to be increased and the relationship with the customer improved. Through using this package, customers will enjoy greater comfort because all services, from ordering to account settlement, are provided under one roof. Significant revenue increases are expected from the access fees collected. As a result of the continued rise in subscription models, the subscription revenue, as a percentage of total revenue, is expected to increase from currently 60% to over 80% in 2014 and the percentage of non-usage-related (*i.e.*, less volatile) net revenues would therefore rise.

In 2005, T-Online is planning to launch a "**Voice over IP**" package in Germany. This technology permits Internet users to place telephone calls over the Internet.

The existing combined business model and portfolio is expected to be expanded with the launch of **entertainment services**, which would include, for example, music, gaming and videos. In addition to Video on Demand for individual use or in the form of a subscription to various program packages, functions, such as changing the times of television viewings and the provision of electronic program guide, should be offered. It is planned to offer various types of service packages consisting of DSL lines and tariffs for Internet usage, as well as special terminal devices for the reception, selection and, if desired, the recording of television programs, films and videos. The customer should be offered access to a broad selection of films and videos contained in a large database. The offer of available music titles in musicload is to be further extended, also in respect of types of music, including individual usage and subscription services.

Cost of sales

The cost of sales consists primarily of the costs of purchasing network capacity from Deutsche Telekom. The decrease in 2004 in cost of sales by EUR 88 million to EUR 808 million, despite the increase in revenue, was caused mainly by the amount of purchased capacity remaining constant.

Whereas wholesale costs in the narrowband area are charged on the basis of the maximum number of parallel Internet connections, the maximum used transmission capacity is the basis for charging in the broadband area. By spreading usage evenly, the maximum usage and the related costs can be reduced. Moreover, wholesale costs were reduced further with effect from 1 April 2004 by executing a wholesale costs contract.

The company expects that cost of sales will increase during the projection period primarily as a result of expenses for access components relating to DSL full package marketing, the subsidizing of the terminal devices and the purchase of premium content data in the entertainment services area. Accordingly, gross profit margins during the projection period will fall from 55% in 2004 to 36.4% in 2014, despite a projected increase in business volume to approximately EUR 8,716 million.

Selling costs

The selling costs include primarily the expenses that are necessary to solicit new customers and maintain the existing customer base. These expenses relate primarily to sales commissions, which are charged *via* the existing distribution channels when new customers are successfully solicited, and to advertising funds.

The broadband marketing initiative commenced in 2004 led to a EUR 76 million increase (17.1%) compared to the previous year in selling costs, which now total EUR 520 million. This increase was cushioned in part by the change in reporting of reversed provisions and accruals as required under IFRS. Unlike in 2003, the reversals in 2004 were no longer reported under other operating income, but netted against the corresponding expenses.

Beyond the projection period, the company expects selling costs to continually decline as a percentage of revenue. One reason for this expectation is the declining growth in new customers and the lower subscriber acquisition costs resulting therefrom. Another reason is that the combined business model is expected to increase customer loyalty and therefore produce lower rates of fluctuation (the so-called "churn rate").

General and administrative costs

In the segment "Germany", administrative costs rose in 2004 by EUR 20 million (27.4%) compared to the previous year to EUR 93 million. As a percentage of revenue, these costs increased by approximately one percentage point to 5.2%. The increase related primarily to the special factors resulting from expanding the group of consolidated companies as a result of acquiring the Scout24 group and internal strategic projects, such as integrating the Scout24 group into the conglomerate.

A decrease in administrative costs in relation to revenue through economies of scale is planned.

Other operating income/expenses

The other operating income/expenses result consists mostly of other operating income and expenses netted against each other. Between 2003 and 2004, this result fell by EUR 48 million to EUR 9 million. In contrast to 2003, income relating to other accounting periods which resulted from reversing provisions and accruals, is no longer shown in these positions in 2004, but netted against the expense, under which the provision and accruals had originally been recognized. This reporting change affected primarily the amount of the selling costs. This decline may also be explained through the favorable one-time effect from the sale of t-info GmbH in the amount of EUR 24 million in 2003.

Other operating expenses include, among other things, losses from disposals of assets and currency translation.

Amortization/depreciation

Amortization/depreciation consists, almost equally, of amortization of intangible assets and the depreciation of property, plant and equipment. The depreciation of property, plant and equipment consists almost exclusively of depreciation of operating office equipment. Among intangible assets, the amortization applies to proprietary software as well as software licenses and other licenses and rights.

The EUR 24 million increase (42.9%) in amortization and depreciation (excluding the amortization of goodwill) to EUR 80 million in 2004 resulted from the one-time effect of a nonscheduled write-down of IT systems, the market value of which had fallen below the carrying amount, and from the amortization of proprietary software development completed at the end of 2003. In addition, tenant improvements at the new headquarters building at T-Online in Darmstadt as well as newly purchased office and operating equipment were capitalized and then depreciated on a scheduled basis for the first time in 2004.

Since no significant capital expenditures will be required in Germany for expanding T-Online's business, depreciation is projected to be constant throughout the projection period.

Sustainable earnings (2015 and thereafter)

The assumptions about the sustainable earnings for the period beginning in 2015 are based primarily on the projected results of operations at the individual domestic companies in 2014. The projected earnings were rolled forward on the basis of the growth rates assumed for T-Online.

In determing the 2015 and thereafter result, it was assumed that the portal and shopping contract with Deutsche Telekom, which expires on 31 December 2014, will be replaced. T-Online expects sustainable value of portal sites to increase in the coming years. Consequently, it is assumed that, on termination of the portal contract with Deutsche Telekom, the media services volume becoming available from 2015 onwards will be marketable without giving rise to a loss.

Instead of the amortization and depreciation projected in 2014, the sustainable earnings must factor in the reinvestments, which are required in the long-term in order to maintain business operations. The requisite investment needs were calculated on the basis of the capital expenditures forecasted for the projection period and the amortization of intangible assets and depreciation of property, plant and equipment, and were applied as the re-investment rate (*Reinvestitionsrate*).

4.1.2 Segment "Rest of Europe"

The budget projections of the Rest of Europe segment for the financial years 2005 through 2015 *et seq.* (including comparisons with 2003 and 2004) are set forth in the following table:

	Actual		Medium-term planning			Long-term planning							Sustainable
Segment "Rest of Europe"	**2003 EUR m**	**2004 EUR m**	**2005 EUR m**	**2006 EUR m**	**2007 EUR m**	**2008 EUR m**	**2009 EUR m**	**2010 EUR m**	**2011 EUR m**	**2012 EUR m**	**2013 EUR m**	**2014 EUR m**	**2015 ff. EUR m**
Net revenue	171	230	244	374	587	821	1,027	1,169	1,296	1,412	1,515	1,598	1,669
Cost of sales	141	151	200	311	434	531	637	717	779	846	906	909	950
Gross profit	**30**	**79**	**45**	**63**	**153**	**290**	**389**	**452**	**518**	**567**	**609**	**688**	**719**
as a % of net revenue	*17.6%*	*34.4%*	*18.2%*	*16.9%*	*26.1%*	*35.3%*	*37.9%*	*38.6%*	*39.9%*	*40.1%*	*40.2%*	*43.1%*	*43.1%*
Selling costs	82	86	136	190	216	247	259	282	300	318	334	347	363
General and admin. costs	14	16	13	14	15	16	17	18	19	19	20	21	22
Other op. inc./exp., net	-343	8	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1
Operating results	**-410**	**-16**	**-105**	**-143**	**-80**	**26**	**112**	**150**	**198**	**228**	**253**	**319**	**334**
as a % of net revenue	-240.0%	-6.8%	-43.1%	-38.1%	-13.6%	3.1%	10.9%	12.9%	15.3%	16.2%	16.7%	20.0%	20.0%
Adjustments	347	0											
Operating results (adjusted)	**-62**	**-16**											
as a % of net revenue	*-36.6%*	*-6.8%*											
Add. info:													
Operating results	-410	-16	-105	-143	-80	26	112	150	198	228	253	319	334
Non-income taxes	0	2	0	0	0	0	0	0	0	0	0	0	0
Amortization/depreciation	364	23	38	79	106	88	92	106	108	118	125	83	87
EBITDA	**-45**	**9**	**-67**	**-63**	**26**	**114**	**204**	**257**	**306**	**346**	**378**	**403**	**421**
as a % of net revenue	*-26.6%*	*4.1%*	*-27.4%*	*-16.9%*	*4.4%*	*13.9%*	*19.9%*	*22.0%*	*23.6%*	*24.5%*	*25.0%*	*25.2%*	*25.2%*

T-Online has non-domestic subsidiaries in the core markets of France and Spain. These two countries are the main regions making up the segment "Rest of Europe". With the purchase of the Scout24 group in 2004, T-Online has entered the online market relating to automobiles, finance, real estate and job advertising. The focus of these business activities is in Switzerland, France, Italy, Spain, The Netherlands and Belgium but chiefly in Switzerland, which is the original country of the Scout24 group. Due to the purchase of the Scout24 group in 2004, only a restricted comparison of the financial year 2004 figures with the previous year's figures is possible.

Adjustments

In an effort to improve comparisons with previous years, the operating results in 2003 were adjusted to account for goodwill amortization. The adjustments involved EUR 347 million in a last-time scheduled amortization of goodwill.

Net revenue

The key factor contributing to the favorable business development in the segment "Rest of Europe" in 2003 and 2004 was the dramatic EUR 59 million increase (34.5%) in revenue to EUR 230 million in 2004. The catalyst for this increase was the strong growth mainly in the promising broadband market, which was reflected in the considerable increase (36%) in the DSL customer base. Another factor was the favorable impact on revenue, which the foreign companies within the Scout24 group had. This group was purchased in 2004.

The customer growth in the **access business** was not achieved by incurring high marketing expenditures or charging lower prices, but was instead the consequence of expanding broadband use in France and the continuing development of the narrowband market and the gradual introduction of broadband in Spain. This strategy will be modified in the future as the company plans an aggressive marketing campaign in both core markets to expand its existing market share.

Strong competition in the French broadband market led to a price level which makes it very attractive for customers to try DSL. Accordingly, at the end of 2004, 6.1 million customers already had a broadband Internet access. The company expects this growth to continue and anticipates that approximately 10.9 million customers will have a DSL line as early as 2007. T-Online plans to expand its market share to 15-20% by pricing aggressively and adding interesting packages based on high-speed Internet access, high quality communication services (particularly Voice over IP) and downloadable entertainment services.

The broadband market in Spain is still in its early stages, and broadband prices for consumers are still among the highest in Europe. In the 3rd quarter of 2004, approximately 2.2 million customers had a broadband line. Given the oligopolistic market structure in Spain, a significant decline in access fees is also not expected in the future. Based on the 2004 figures, the average annual growth rate of the broadband market in Spain is projected to be approximately 24% through 2007 (*i.e.*, roughly 5.4 million broadband customers are expected in 2007). By virtue of its early market entry and its attractive pricing offers, T-Online expects to capture and maintain *vis-à-vis* competitors a long-term market share of 15-20%.

Starting with a broadband customer base (totaling 360,000 DSL customers) as of the end of 2004, the segment "Rest of Europe" is seeking to acquire 3.8 million new DSL customers by 2014.

The Spanish subsidiary is not only engaged in the access business, but also operates in e-commerce, primarily through the leading travel portal Viajar.com. The e-commerce business is expected to grow during the projection period. The launch of a new shopping portal in 2004 was an early step in this direction.

The continuously increasing broadband penetration in Europe raises the expectation that the Scout24 group will enjoy additional growth in markets beyond its current country-specific market.

As a whole, the aforementioned courses of action in the segment "Rest of Europe" should produce an average annual growth rate of approximately 21.4% starting in 2004 and should increase revenue in absolute terms from EUR 230 million in 2004 to EUR 1,598 million in 2014.

Cost of sales

Both in France and in Spain, long-term contracts regarding network capacities have been concluded with alternative carriers which lead to lowered wholesale costs. These contracts should allow the companies to gain additional market shares by offering lower prices and to improve profitability as a result of wholesale costs, which are proportionately lower than revenue growth. The effects resulting therefrom should be significantly noticeable beginning 2008.

Furthermore, in France, additional capital expenditures in proprietary net components are required not only to prepare the necessary technical infrastructure for triple play packages but also to create the potential for cost savings in the wholesale services. These additional investments should initially lead to increased depreciation and therefore a higher cost of sales but, given their fixed cost features, they should produce economies of scale and lead to a long-term continuing improvement in gross earnings with an increasing number of customers.

The exploitation of economies of scale should produce an expansion of business among the foreign Scout24 subsidiaries since there are an adequate number of technical platforms available. The planned revenue growth is sustainable even though cost of sales would remain virtually unchanged.

Since cost of sales should increase proportionately less than net revenue, the gross margin should improve over time based on the previously described components (increasing from 17.6% in 2003 to 43.1% in 2014).

Selling costs

As described above, the companies' strategic focus during the years under comparison was on profitable growth. An increase in the market share through the use of large advertising budgets has not been sought. Indeed, selling costs were only EUR 82 million in 2003 and EUR 86 million in 2004. The T-Online foreign companies will face increasing marketing and selling costs during the projection period because they are seeking to increase their market share to 15-20%. Thus, a significant increase in costs (totaling approximately EUR 136 million) is already expected in 2005, and these costs will continually increase in absolute terms until the end of the projection period. On the other hand, selling costs as a percentage of revenue should continually decline.

General and administrative costs

The administrative costs in the segment "Rest of Europe" remained almost constant in prior years and are not expected to increase significantly in the future. Economies of scale are expected to decrease the administrative costs as a percentage of revenue.

Other operating income/expenses, net

Other operating income/expenses, include EUR 347 million in scheduled amortization of goodwill for 2003. Beginning in financial year 2004, no more scheduled amortization of goodwill will be recorded (as mentioned above).

Amortization/depreciation

The amortization/depreciation (excluding the amortization of goodwill) in 2003 and 2004 relates to intangible assets and to property, plant and equipment. The EUR 6 million increase (35.3%) in this item to EUR 23 million in 2004 is attributable, among other things, to the addition of the Scout24 group.

As a result of the planned capital expenditures in the proprietary network infrastructure in France, depreciation beginning in 2005 is expected to increase through 2013.

Sustainable earnings (2015 and thereafter)

The assumptions about the sustainable earnings for the period beginning in 2015 are based primarily on the projected results of operations at the individual foreign companies in 2014. The projected earnings were rolled forward on the basis of the growth rates assumed for T-Online.

Instead of the amortization and depreciation projected in 2014, the sustainable earnings must factor in the reinvestments, which are required in the long term in order to maintain business operations. The requisite investment needs were calculated on the basis of the capital expenditures forecasted for the projection period and the amortization of intangible assets and depreciation of property, plant and equipment, and were applied as the re-investment rate.

4.1.3 T-Online business plans

The consolidated business plans of T-Online (including comparisons with 2003 and 2004) are set forth in the following table:

	Actual		**Medium-term planning**			**Long-term planning**							**Sustainabl**
T-Online	**2003 EUR m**	**2004 EUR m**	**2005 EUR m**	**2006 EUR m**	**2007 EUR m**	**2008 EUR m**	**2009 EUR m**	**2010 EUR m**	**2011 EUR m**	**2012 EUR m**	**2013 EUR m**	**2014 EUR m**	**2015 ff. EUR m**
Net revenue	1,851	2,012	2,517	3,474	4,551	5,595	6,638	7,506	8,358	9,174	9,793	10,292	10,65
Cost of sales	1,034	956	1,468	2,043	2,752	3,292	3,971	4,551	5,045	5,634	6,125	6,437	6,66
Gross profit	**817**	**1,056**	**1,049**	**1,431**	**1,799**	**2,304**	**2,667**	**2,955**	**3,313**	**3,540**	**3,668**	**3,855**	**3,99**
as a % of net revenue	*44.1%*	*52.5%*	*41.7%*	*41.2%*	*39.5%*	*41.2%*	*40.2%*	*39.4%*	*39.6%*	*38.6%*	*37.5%*	*37.5%*	*37.*
Selling costs	526	598	734	883	922	1,090	1,207	1,260	1,352	1,361	1,346	1,347	1,39
General and admin. costs	87	109	107	117	120	138	157	173	189	204	216	225	23
Other op. inc./exp., net	-287	8	-6	-7	-7	-7	-8	-8	-8	-9	-9	-9	-
Operating results	**-83**	**357**	**202**	**424**	**751**	**1,068**	**1,295**	**1,514**	**1,764**	**1,966**	**2,097**	**2,274**	**2,35**
as a % of net revenue	*-4.5%*	*17.8%*	*8.0%*	*12.2%*	*16.5%*	*19.1%*	*19.5%*	*20.2%*	*21.1%*	*21.4%*	*21.4%*	*22.1%*	*22.*
Financial expense, net *	140	123	7	28	77	114	114	111	115	118	121	122	12
Income taxes	97	180	82	177	320	452	536	618	713	792	842	907	93
Income after taxes	**-40**	**301**	**127**	**275**	**508**	**730**	**874**	**1,008**	**1,165**	**1,293**	**1,377**	**1,489**	**1,54**
Inc. appl. to minority shareh.	3	-1	-2	-4	-5	-6	-6	-7	-7	-7	-8	-9	-
Net income *	**-38**	**300**	**125**	**271**	**503**	**724**	**867**	**1,001**	**1,158**	**1,286**	**1,369**	**1,480**	**1,53**
as a % of net revenue	-2.0%	14.9%	5.0%	7.8%	11.0%	12.9%	13.1%	13.3%	13.9%	14.0%	14.0%	14.4%	14.
Add. info:													
Operating results	-83	357	202	424	751	1,068	1,295	1,514	1,764	1,966	2,097	2,274	2,35
Non-income taxes	0	3	0	0	0	0	0	0	0	0	0	0	
Amortization/depreciation	427	107	112	156	184	172	176	191	191	205	217	175	18
EBITDA	**344**	**467**	**314**	**580**	**935**	**1,239**	**1,472**	**1,706**	**1,955**	**2,171**	**2,314**	**2,449**	**2,53**

	Actual		Medium-term planning			Long-term planning							Sustainabl
as a % of net revenue	*18.6%*	*23.2%*	*12.5%*	*16.7%*	*20.5%*	*22.1%*	*22.2%*	*22.7%*	*23.4%*	*23.7%*	*23.6%*	*23.8%*	*23.*

* Separate valuation of non-operating cash and cash-equivalents in comparision to IFRS-consolidated financial statements results in lower financial income and thus lower group net income 2005 et. seq.

A reconciliation of the segment's net revenue and operating result with the Group figures is set forth in the table below:

	Medium-term planning			**Long-term planning**							**Sustainable**
T-Online	**2005 EUR m**	**2006 EUR m**	**2007 EUR m**	**2008 EUR m**	**2009 EUR m**	**2010 EUR m**	**2011 EUR m**	**2012 EUR m**	**2013 EUR m**	**2014 EUR m**	**2015 ff. EUR m**
Net revenue											
Segment "Germany"	2,285	3,112	3,979	4,790	5,629	6,355	7,081	7,782	8,299	8,716	9,006
Segment "Rest of Europe"	244	374	587	821	1,027	1,169	1,296	1,412	1,515	1,598	1,669
Subtotal	**2,529**	**3,486**	**4,566**	**5,611**	**6,656**	**7,524**	**8,377**	**9,194**	**9,814**	**10,313**	**10,676**
Intra-division revenue	12	13	14	16	17	18	19	20	21	22	24
Consolidated net revenue	**2,517**	**3,474**	**4,551**	**5,595**	**6,638**	**7,506**	**8,358**	**9,174**	**9,793**	**10,292**	**10,652**
Operating results											
Segment "Germany"	307	566	830	1,042	1,184	1,364	1,565	1,738	1,845	1,955	2,020
Segment "Rest of Europe"	-105	-105	-80	26	112	150	198	228	253	319	334
Consolidated operating results	**202**	**424**	**751**	**1,068**	**1,295**	**1,514**	**1,764**	**1,966**	**2,097**	**2,274**	**2,353**

The business plans were made by the individual segments; these ultimately yielded the projected operating result item, which was supplemented at the group level by the additional entries "financial result, net" and "taxes on income" which were calculated as follows:

The **financial result, net** consists of the net interest and the income/expenses related to associated and related companies. The net interest and net income/expenses related to associated and related companies amounted in 2004 to EUR 113 million and EUR 11 million respectively.

The net interest was integrated on the basis of the projected financial statements from which the projected cash flow statements were then prepared. Non-operating cash and cash equivalents existing on 31 December 2004 and amounting to EUR 3,900 million were valued separately (see 4.2) and are accordingly, not included in the projection period in the computation of net interest. The remaining cash and cash equivalents were calculated factoring in the expected investment interest. This approach is the principal reason for the significant change in net interest between 2004 and 2005.

In addition, the computation of net interest took into account the assumed dividend policy. T-Online has assumed that, for the years 2005 through 2007, the dividend payments will amount to the dividend planned in respect of 2004. The remaining balances of the annual net income have been treated as retained earnings, adjusted by the discount rate before taxes on income at company level and, consequently, have a positive impact on net interest. A part transfer to retained earnings was also assumed in respect of amounts available in the long-term period (see 4.4). Since the factoring in of a discount rate before taxes on income at company level in respect of amounts available can be reflected at the same value by a fictitious direct transfer of the retained earnings to the shareholders, the retained earnings from 2008 onwards were, for simplification purposes, treated as net income received by the shareholders and thus, no longer accounted for in the computation of interest.

The **taxes on income** charge for the T-Online Group was calculated on the basis of the group tax charge expected; movements in deferred tax assets and liabilities were included in this group tax charge.

T-Online is subject to trade tax on income at an average effective rate of approximately 17%. The corporation tax rate assumed is 25% (plus a solidarity surcharge of 5.5%). Available unutilized tax losses, after allowing for the minimum tax charge payable, were taken into account. The same applies to deductions and additions to be made in determining the amount on which corporation tax is based.

Deferred taxes reflect temporary differences arising between the impact of taxes on the annual accounts for tax reporting purposes and those used for the projections in which group transactions and available tax losses, insofar as they can be regarded as utilizable, are taken into consideration. Deferred taxes have been calculated in accordance with IAS 12 at the tax rates expected to be applicable in the individual countries at the time the tax losses are utilized, based on the regulations valid on the effective date of the valuation. Deferred taxes have been determined, based on the tax rates applicable to the individual countries.

The **minority shares** relate mainly to third party interests in the AutoScout24 group and in Scout24 Schweiz AG.

4.1.4 Calculation of the discounted earnings value

On the basis of the consolidated net income of T-Online and upon applying the period-specific discount rate explained above, the discounted earnings value of T-Online's operating assets as of 1 January 2005 is set forth as follows:

	Medium-term planning			**Long-term planning**							**Sustainable**
T-Online	**2005 EUR m**	**2006 EUR m**	**2007 EUR m**	**2008 EUR m**	**2009 EUR m**	**2010 EUR m**	**2011 EUR m**	**2012 EUR m**	**2013 EUR m**	**2014 EUR m**	**2015 ff. EUR m**
Net income*	**125**	**271**	**503**	**724**	**867**	**1,001**	**1,158**	**1,286**	**1,369**	**1,480**	**1,531**
Retention	76	222	454	0	0	0	0	0	0	0	90
Value impact of retention	0	0	0	625	715	787	865	910	916	933	874
Value impact of distribution	49	49	49	99	152	214	293	376	453	548	566
Typified shareholder income tax on distribution	-9	-9	-9	-17	-27	-38	-51	-66	-79	-96	-99
Net earnings received	**40**	**40**	**40**	**706**	**841**	**964**	**1,107**	**1,220**	**1,289**	**1,384**	**1,341**
Net earnings received	40	40	40	706	841	964	1,107	1,220	1,289	1,384	1,341
Present value as of 12/31	14,576	15,900	17,346	18,274	19,141	19,976	20,743	21,465	22,185	22,877	
Capitalization subtotal	14,616	15,941	17,386	18,980	19,982	20,940	21,850	22,685	23,474	24,262	1,341
Discount rate	9.36%	9.36%	9.35%	9.42%	9.35%	9.40%	9.38%	9.36%	9.36%	9.36%	5.86%
Present value factor applicable to the year	0.9144	0.9144	0.9145	0.9139	0.9145	0.9141	0.9143	0.9144	0.9144	0.9144	17.0558
Applicable present value as of 01/01	13,365	14,576	15,900	17,346	18,274	19,141	19,976	20,743	21,465	22,185	22,877
Discounted earnings value as of 01/01/2005	**13,365**										

	Medium-term planning			**Long-term planning**							**Sustainable**
T-Online	**2005 EUR m**	**2006 EUR m**	**2007 EUR m**	**2008 EUR m**	**2009 EUR m**	**2010 EUR m**	**2011 EUR m**	**2012 EUR m**	**2013 EUR m**	**2014 EUR m**	**2015 ff. EUR m**
Risk-free interest rate before typified shareholder income tax	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%
Typified shareholder income tax	-1.75%	-1.75%	-1.75%	-1.75%	-1.75%	-1.75%	-1.75%	-1.75%	-1.75%	-1.75%	-1.75%
Risk-free interest rate after typified shareholder income tax	3.25%	3.25%	3.25%	3.25%	3.25%	3.25%	3.25%	3.25%	3.25%	3.25%	3.25%
Market risk premium after typified shareholder income tax	5.50%	5.50%	5.50%	5.50%	5.50%	5.50%	5.50%	5.50%	5.50%	5.50%	5.50%
Beta factor unlevered	1.10	1.10	1.10	1.10	1.10	1.10	1.10	1.10	1.10	1.10	1.10
Applicable present value as of 01/01	*13,365*	*14,576*	*15,900*	*17,346*	*18,274*	*19,141*	*19,976*	*20,743*	*21,465*	*22,185*	*22,877*

	Medium-term planning			Long-term planning							Sustainable
Interest-bearing debt as of 01/01	*140*	*153*	*156*	*309*	*168*	*298*	*251*	*212*	*222*	*232*	*241*
Debt to equity ratio	0.01	0.01	0.01	0.02	0.01	0.02	0.01	0.01	0.01	0.01	0.01
Beta factor levered	1.11	1.11	1.11	1.12	1.11	1.12	1.11	1.11	1.11	1.11	1.11
Risk premium	6.11%	6.11%	6.10%	6.17%	6.10%	6.15%	6.13%	6.11%	6.11%	6.11%	6.11%
Growth rate	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	3.50%
Discount rate	**9.36%**	**9.36%**	**9.35%**	**9.42%**	**9.35%**	**9.40%**	**9.38%**	**9.36%**	**9.36%**	**9.36%**	**5.86%**

* Separate valuation of non-operating cash and cash-equivalents in comparison to IFRS-consolidated financial statements results in lower financial income and thus lower group net income 2005 et seq.

It has been assumed that the dividends payable in the years 2005 through 2007 will be the same as the amount expected to be payable in respect of 2004. The amounts transferred to retained earnings have a favorable impact on interest.

To reach the dividend payout ratio of 37% expected for comparative Internet companies in the long run, a straight-line increase in the dividend payout ratio has been assumed for the years 2008 to 2014. Since the factoring in of a discount rate before company level-taxes on income in respect of amounts available can be reflected at the same value by a fictitious direct transfer of the retained earnings to the shareholders, the retained earnings from 2008 onwards were, for simplification purposes, treated as net income received by the shareholders.

The dividends are subject to a typified shareholder income tax charge of 17.5% (half credit method).

The total of the values representing net earnings received, attributed to retained earnings and dividends (less typified shareholder income tax), has been capitalized at the period-specific discount rate, which was calculated based on the unlevered beta factor taking into account the debt to equity ratio applicable to each year.

4.2 Special items

Available cash and cash equivalents

T-Online has non-operating cash and cash equivalents totaling EUR 3,900 million. For purposes of defining cash and cash equivalents, the fact that the planned investments and dividend payments remain funded and a reasonable cash reserve remains available for managing the operating business was taken into account. In this connection, an analysis regarding the cash needs throughout the year was conducted. The amount of non-operating cash and cash equivalents as of the technical reporting date (1 January 2005) was calculated on an iterative basis: T-Online's balance sheets were projected through to the last projected year. Then, as of the reporting date, an amount of cash and cash equivalents was withdrawn such that there would be no cash or cash equivalents or only minimum petty cash available at the end of the projection period.

Participating interests

The participation in comdirect bank AG has been valued separately. The valuation of the participating shares held by T-Online was based on the average stock exchange price determined by the German Federal Finance Supervisory Office (*Bundesaufsicht für Finanzwesen*) as of 31 January 2005 (EUR 211 million). Other participations held by T-Online which have not been included in the planning have been stated at their actual carrying amount (EUR 4 million).

Stock options

In connection with its stock options plans, T-Online granted its employees options to purchase shares in T-Online. If the options are exercised, the equity value per share must be reduced as part of the company valuation, to the extent that the calculated per share price is higher than the exercise price for the option prior to the exercise of such option (dilution effect).

For purposes of calculating the negative special value caused by the stock options, a simplified assumption was made that all outstanding options, which had not yet been exercised as of 31 December 2004 and for which the exercise price was lower than the projected stock price (to be matched with the calculated equity value per share), will be fully exercised on the day of the annual shareholders' meeting. With respect to T-Online, only the options under the 2001 stock option plan (which were issued in two tranches) had to be taken into account.

Thus, the dilution effect from the T-Online stock options is calculated as follows:

Dilution effect of T-Online stock options

Preliminary equity value (discounted earnings value plus aforementioned special items) as of 01/01/2005	EUR m	17,480
Number of shares outstanding	Number	1,223,890,578
Preliminary value per share	EUR	14.28
Outstanding options	Number	3,868,195
Exercise price	EUR	10.31
Incoming cash flow	EUR m	39.86
Value of equity after exercise of options	EUR m	17,520
Number of shares after exercise of options	Number	1,227,758,773
Value per share after dilution	EUR	14.27
Dilution effect per share	EUR	0.01
Dilution effect as of 01/01/2005	**EUR m**	**15**

4.3 Equity value

Thus, the equity value of T-Online is presented as follows:

Derivation of T-Online equity value	**EUR m**
Discounted earnings value	13,365
Special items	
Free cash and cash equivalents	3,900
Participating interests	215
Stock options program	-15
Equity value as of 01/01/2005	17,465
Accumulation factor	1.030523
Equity value as of 04/29/2005	**17,998**

In order to calculate the Merger Exchange Ratio, the equity value calculated as of 1 January 2005 amounting to EUR 17,465 million must be adjusted upwards to reflect interest up to 29 April 2005. The equity value of T-Online as of the effective date of the valuation amounts to EUR 17,998 million.

The value per share of T-Online stock derived from the calculated equity value and the relevant number of shares is as follows:

Derivation of T-Online value per share

Equity value as of 04/29/2005 in EUR m	17,998
Number of shares	1,223,890,578
Value per share in EUR	**14.71**

T-Online had 1,223,890,578 registered par value shares available as of 31 December 2004. As a result of the exercise of options, this number may change marginally in the period up to the effective date of the valuation. As this would not have any significant impact on the value per share, the calculation of the value per share has been based, for simplification reasons, applying the number of shares as of 31 December 2004.

5. Valuation of Deutsche Telekom

5.1 Discounted earnings value

The discounted earnings value of Deutsche Telekom was calculated on the basis of the consolidated business plans for the years 2005 through 2014. The basis for the consolidated financial planning is the business plans of T-Com, T-Mobile, T-Systems and GHS as well as the T-Online business plans described and explained above.

5.1.1 T-Com

The projected income statements of T-Com for the financial years 2005 through 2015 et seq. (including comparisons with 2003 and 2004) are set forth below:

	Actual		**Medium-term planning**			**Long-term planning**							**Sustainable**
T-Com	**2003 EUR m**	**2004 EUR m**	**2005 EUR m**	**2006 EUR m**	**2007 EUR m**	**2008 EUR m**	**2009 EUR m**	**2010 EUR m**	**2011 EUR m**	**2012 EUR m**	**2013 EUR m**	**2014 EUR m**	**2015 ff. EUR m**
Net revenue	27,884	26,253	26,254	25,854	25,505	23,925	23,729	23,535	23,404	23,264	23,382	23,507	23,507
Cost of sales	16,062	14,610	14,278	14,123	14,001	13,532	13,590	13,340	13,215	12,564	12,137	12,158	12,408
Gross profit	**11,822**	**11,643**	**11,976**	**11,731**	**11,504**	**10,393**	**10,139**	**10,195**	**10,188**	**10,700**	**11,245**	**11,348**	**11,098**
as a % of net revenue	*42.4%*	*44.4%*	*45.6%*	*45.4%*	*45.1%*	*43.4%*	*42.7%*	*43.3%*	*43.5%*	*46.0%*	*48.1%*	*48.3%*	*47.2%*
Selling costs	5,399	4,937	4,719	4,585	4,491	4,307	4,251	4,137	4,005	3,991	3,874	3,885	3,885
General and admin. costs	1,653	1,535	1,593	1,595	1,547	1,533	1,562	1,531	1,440	1,369	1,348	1,344	1,344
Other op. inc./exp., net	387	63	207	230	244	228	208	207	197	197	176	195	195
Operating results	**5,158**	**5,234**	**5,870**	**5,781**	**5,711**	**4,780**	**4,534**	**4,734**	**4,940**	**5,536**	**6,198**	**6,314**	**6,064**
as a % of net revenue	*18.5%*	*19.9%*	*22.4%*	*22.4%*	*22.4%*	*20.0%*	*19.1%*	*20.1%*	*21.1%*	*23.8%*	*26.5%*	*26.9%*	*25.8%*
Adjustments	130	389											
Operating results (adjusted)	5,288	5,623											
as a % of net revenue	*19.0%*	*21.4%*											
Add. info:													
Operating results	5,158	5,234	5,870	5,781	5,711	4,780	4,534	4,734	4,940	5,536	6,198	6,314	6,064
Amortization/depreciation	4,662	4,304	3,800	3,560	3,305	3,065	3,080	2,906	3,083	2,879	2,515	2,485	2,735
EBITDA	**9,820**	**9,538**	**9,670**	**9,341**	**9,015**	**7,845**	**7,614**	**7,640**	**8,024**	**8,415**	**8,714**	**8,799**	**8,799**
as a % of net revenue	*35.2%*	*36.3%*	*36.8%*	*36.1%*	*35.3%*	*32.8%*	*32.1%*	*32.5%*	*34.3%*	*36.2%*	*37.3%*	*37.4%*	*37.4%*

Adjustments

The adjustments in 2003 amounting to approximately EUR 281 million relate to one-time expenses from setting up accruals for staff reductions (redundancy payments) in Germany and Croatia as well as a one-time payment to the Group's own personnel placement agency, Vivento. In addition, an adjustment (EUR 73 million) was made for the nonscheduled write-down of Matáv and an adjustment

(EUR 224 million) for the income generated from the sale of cable companies. In 2004, expenses incurred in reorganizing the T-Com companies (EUR 186 million) and the amortization of the Slovak Telekom goodwill (EUR 150 million) were adjusted.

Net revenue

The revenue performance reflects T-Com's evolution from a traditional telephone company (the sale and installation of traditional voice telephony lines and voice telephony calls) into a provider of broadband telecommunication services. Given its position as the former monopolist telephone company, many of T-Com's business activities are subject to regulation by the European Union (EU) or by the relevant national government institutions.

This transformation is heading to a decline in net revenue, from EUR 26.3 billion in 2004 to EUR 23.5 billion by the end of the projection period in 2014. Net revenue in the individual areas is expected to develop as follows:

	Actual		**Medium-term planning**			**Long-term planning**						
T-Com	**2003 EUR m**	**2004 EUR m**	**2005 EUR m**	**2006 EUR m**	**2007 EUR m**	**2008 EUR m**	**2009 EUR m**	**2010 EUR m**	**2011 EUR m**	**2012 EUR m**	**2013 EUR m**	**2014 EUR m**
Network communication	14,997	14,608	13,838	12,597	11,200	9,128	8,366	7,747	7,196	6,769	6,487	6,231
Data communication	1,761	1,862	2,402	2,777	3,211	3,247	3,297	3,361	3,442	3,545	3,672	3,823
Carrier services	4,707	4,185	4,464	4,854	5,405	5,819	6,305	6,605	6,869	6,968	7,149	7,286
Miscellaneous	3,765	3,034	3,084	3,240	3,380	3,440	3,501	3,564	3,629	3,698	3,766	3,837
Net revenue "Germany"	**25,230**	**23,689**	**23,788**	**23,468**	**23,196**	**21,634**	**21,470**	**21,277**	**21,137**	**20,980**	**21,073**	**21,177**
as a % of net revenue T-Com	*90.5%*	*90.2%*	*90.6%*	*90.8%*	*90.9%*	*90.4%*	*90.5%*	*90.4%*	*90.3%*	*90.2%*	*90.1%*	*90.1%*
Net revenue "Eastern Europe"	**2,655**	**2,564**	**2,466**	**2,386**	**2,309**	**2,291**	**2,259**	**2,258**	**2,267**	**2,284**	**2,309**	**2,330**
as a % of net revenue T-Com	*9.5%*	*9.8%*	*9.4%*	*9.2%*	*9.1%*	*9.6%*	*9.5%*	*9.6%*	*9.7%*	*9.8%*	*9.9%*	*9.9%*
Net revenue "Division T-Com"	**27,884**	**26,253**	**26,254**	**25,854**	**25,505**	**23,925**	**23,729**	**23,535**	**23,404**	**23,264**	**23,382**	**23,507**

Compared to 2003, revenues declined in almost all segments in 2004. This trend may be attributed especially to regulatory effects above all, the call-by-call and preselection in the local network in 2003 and increasing competition, the sale of shares in cable companies in 2003 as well as the change in the business models. For T-Com's financial planning purposes, an assumption was made that past trends would continue during the projection period. It is expected, however, that individual effects will weaken in the medium- and long-term and that at the end of the projection period a slight growth in sales may materialize as a result of the currently evolving markets in broadband applications as well as integrated information technology and data communication.

In 2004, net revenues from **Network Communication** fell by EUR 0.4 billion to EUR 14.6 billion because, for the first time that year, the significant loss of market share, particularly in the call business as a result of the local network liberalization in 2003 (launch of call-by-call and preselection options), affected the entire financial year. Furthermore losses in the call market share also occurred. In order to improve its position vis-à-vis the other competitors and to promote customer loyalty, T-Com introduced a series of option tariffs. In return for a reasonable monthly base fee, which is itemized under the access charges, customers receive discounts on calls, can make calls free of charge at certain times or receive a free calling-minutes package. As a consequence, the calculated average price per call and corresponding net revenue have fallen.

In the coming years, T-Com continues to expect significant declines in revenue in the voice telephony product area (accesses and calls). The cause of this development is the anticipated change in customer behavior concerning Internet telephony, the emergence of mobile communication as an alternative to the traditional fixed network lines and calls, competition and price effects. The fixed network market for voice telephony lines will continue to decline as a result of the increased mobile phone alternatives triggered by the UMTS roll-out, and the greater access to Internet telephony, which was still in its early stages in the year 2004 in the German consumer market. T-Com cannot escape this market trend and will thereby lose market share in terms of lines. At the same time, the increased competitive pressure specifically from local carriers is expected to cut into T-Com's market share, lowering it from over 90% in 2004 to 73% in 2014. It is assumed that for the years 2005 to 2007 the average revenue per line will slightly increase as a result of a shift from call revenue to access revenue brought on by the use of the option tariffs. T-Com is projecting declining average revenue per line beginning in 2008. This trend may be attributed to an anticipated drop in access prices which, on the one hand, should reposition today's premium product ISDN specifically to meet the competition from Internet telephony and, on the other hand, should lead to market share stabilization.

T-Com expects that during the projection period there will be a significant decline in call revenue caused, *inter alia,* by a shift from call revenue to access revenue resulting from the increased availability of option tariff packages. Moreover, losses on lines translate directly into losses on any calls generated through such lines. Thus, the aforementioned T-Com access losses will have an adverse effect on the call business. Lower call minutes are also expected as a result of the additional market share loss to T-Com competitors.

As a result of an increase in the existing numbers from 4 million to 5.6 million in Germany, the revenue generated by broadband DSL data lines has risen significantly in 2004 compared to 2003. The significant growth in existing lines was supported by pricing campaigns initiated in the first half of 2004. The strong demand for greater bandwidth provided by DSL lines has also translated into greater revenue. While in the past competitors in Germany were able to supply DSL lines only through local subscriber lines of Deutsche Telekom, line-sharing with Deutsche Telekom, or by creating their own infrastructure, T-Online launched a voluntary DSL Resale Package on the market in mid-2004. Sales of DSL Resale were reported under Carrier Services since this package was being offered to competitors. The financial planning takes into consideration that T-Online has launched DSL lines in the way of full package marketing since the beginning of 2005, on the basis of the upstream service provided by T-Com. In addition, it is expected that the non-group Internet service providers will service their new customers mostly on the basis of resale and that in connection with the turnover, their current DSL customers with DSL lines to T-Com will migrate to these resale packages. This means that T-Com will lose a considerable market share of the consumer market.

Net revenue from **Carrier Services** declined in 2004 by approximately EUR 0.5 billion to EUR 4.2 billion. For regulatory reasons, T-Com's interconnection charges fell by an average of 9.5% at the end of 2003. Despite the increase in volume based on successful market share gains made by competitors at the expense of T-Com's call business net revenue did not increase in this area since there were significant price drops. The direct network interconnection between T-Mobile and T-Systems and between the mobile phone networks themselves and with other fixed network carriers also led to a significant decline in revenue from the interconnection business at T-Com, whose networks had previously been used to carry the relevant traffic. This magnitude of revenue loss is not expected to continue in the future since the transit service between competitors and mobile phone networks is no longer expected to generate significant revenues. Other factors contributing to the decline in revenue in 2004 included lower wholesale prices charged to Internet service providers, which could not be offset by any growth in volume, and price declines in other product areas.

A significant increase in Carrier Services revenue has been assumed for the projection period. Net sales of EUR 4.2 billion in 2004 should increase to EUR 7.3 billion in 2014, representing a total increase of approximately 74.1%. The initial strong rise in the volume of interconnection calls due to the competitors' increasing share of the market, will probably be compensated by the continuing fall in prices. The introduction of online flat rate wholesale prices will, in this connection, lead to a further fall in net revenue. The declining market volume of the fixed network telephony, the anticipated falling market share of T-Com and the competition's creation of its own infrastructure will have long-term negative effects on net revenue. The increase in net revenue is expected to come from the growing business of outside network carriers and from the dynamic growth of the broadband market. Based on the anticipated dynamic growth of the broadband market from approximately 6 million lines today to 30 million lines expected in 2014, Internet service providers such as T-Online will increase their orders for DSL resale lines and the corresponding IP wholesale services or for infrastructure services to create their own networks on the basis of local subscriber lines. As a result, revenue will shift from what is today the access business (network communication) to the Carrier Services business. The main cause for this growth in the broadband business is the roll-out of innovative broadband products, which integrate voice, online and entertainment services (such as "T-Home") into a single package ("triple-play"). T-Online's new services will trigger not only an expansion in the broadband market based on higher subscriber numbers, but will also produce increased Internet traffic. Since in the future T-Com will also construct the infrastructure for T-Online, the growth in T-Online's broadband online services will directly affect T-Com. Furthermore, T-Com's revenue will increase through its DSL resale packages and ISP wholesale services to T-Online competitors.

While almost all major Internet service providers relied on T-Com's infrastructure in 2004, the expansion of the competitors' own infrastructure will likely reduce T-Com's market share in the coming years. Since the competitors are building their own infrastructure and T-Com is losing its market share in the access business, the local subscriber line business is expecting a considerable drop in sales. The launch of flat rate online wholesale products will precipitate an additional decline in revenue. With respect to all other products in the Carrier Services business, the assumption is that revenue will decline and that, above all, fewer wholesale products will be supplied to T-Systems given the prices and volumes.

In the **Data Communication** area, net revenue is expected to increase from EUR 1.9 billion in 2004 to EUR 3.8 billion in 2014. The main growth engines here are expected to be web-based IT services, solutions to optimize operating processes (IT Solutions) and Internet-Protocol based products (IP Products), together with the solutions business. In the solutions business, special telecommunications and IT services are designed and operated for individual customers. T-Com is expected to participate in the expansion of this market by offering innovative products and by conducting joint marketing efforts with T-Systems. It is also assumed that this joint marketing effort with T-Systems will regain much of the market share that was lost in recent years. Any competition-related price reductions should be more than offset by increases in volume. The price levels in the data communication business have been falling continually. As a result of the migration to modern IP Products, the importance of the traditional leased line business, on the other hand, is expected to be decline significantly.

The **"Other"** area includes, above all, income from value added services, the sale of terminal devices, and the income from T-Punkt companies and the cable companies (only in 2003). Net revenue in 2004 fell by EUR 0.7 billion compared with 2003. This decline is attributable to the sale of the remaining interests held in the cable companies and the reorganization of the business model for selling mobile terminals. T-Com no longer sells these devices under its own name but, instead, acts as a broker, thereby earning income, which since May 2004 has been reported as sales commissions. Moreover, in the services business, individual business models with the relevant customers were transferred to Vivento. The campaign to give away terminals at reduced prices as part of the broadband campaign led to an additional decline in revenue compared to the previous year. In this area, the projections are for slight revenue growth. This may be attributed to increasing net revenue from the value-added services business. In this regard, growth is seen as coming from value-added telephone services, which are based on the introduction of innovative services and higher sales of existing products.

Revenue development in the fixed network business in **Central and Eastern Europe** is also expected to decline slightly. Some of the same trends can be observed in the fixed network business of the three Central and Eastern European companies, Matáv and Slovak Telecom and HT-Hrvatske telekommunikacije d.d., although the level of progress varies.

In comparison to 2003, Matáv and Slovak Telecom reported significant drops in net revenue, but HT-Hrvatske telekommunikacije d.d. was able to generate net revenue that was slightly higher than the previous year level. In all countries, a decline in network communication revenue is expected for the projection period (specifically revenue from voice telephony lines and calls). In the long-term, growth areas such as data communication brought on by the introduction of new services and broadband applications, online services, value added services and the sale of IT services should increasingly stabilize revenue growth. Beginning in 2010, the aforementioned effects should translate into a slight growth in revenue for this area.

Cost of sales

The cost of sales in **Germany** consists primarily of cost of materials, personnel costs, depreciation/amortization, rental costs, costs related to information and data processing (**"IT-support"**), maintenance costs as well as services for research and development (**"R&D services"**).

Cost of materials includes mostly expenses for raw materials and supplies, costs for merchandise, domestic and international telecommunication services, energy costs and installation services. The EUR 1.5 billion decline in the cost of materials from 2003 to 2004 resulted primarily from fewer telecommunications services (brought on by the loss of market share in the call business), from lower wholesale prices in the international area, reduced personnel costs and the change of the business model regarding the sale of mobile terminals.

In the projections, the cost of materials will increase over time because of the increasing revenue-related wholesale purchases by T-Systems (particularly for IT solutions). The use of materials will fall in the traditional telecommunications business, however. In this case, sales-driven volume effects, price reductions and structural effects, such as the more cost efficient use of IP-based technologies, will have their impact. In addition, there should be greater savings in logistics expenses because of process optimization and the reduction of over-capacities. Significant savings in personnel costs are expected during the projection period. This may be linked, on the one hand, to a reduction and simplification of today's product portfolio with the relevant ramifications for the production processes. On the other hand, improvements in efficiency should be implemented through programmers to optimize today's T-Com processes. The shifting of today's network platforms to IP-based networks (NGN network) is planned for the end of the projection period. By reducing the number of platforms and given the modular structure of an NGN network, T-Com expects operations to be simplified. This should lead to a lower demand for personnel. Among the rental or lease costs, the assumption is that needs will continue to decline consistently with the anticipated lower demand for personnel, a reduction in vacancies, the closure of sites and improvements in the use of office and factory space. The IT-support and the R&D services are expected to be reduced significantly because of the declining demand for personnel, the simplification of the product portfolio, drops in the market price and the launch of the NGN network. The launch of the IP-based NGN network is also expected to lead to lower maintenance costs since after the migration to the new technology, only one network will need to be supported.

For the **Central and Eastern European companies**, the trends in 2004 less demand for personnel and cost reductions in purchasing telecommunication services are expected to continue throughout the projection period.

Compared to the other telecommunication providers, there appears to be significant potential for improving efficiencies given the staffing situation in 2004. In 2004, provisions totaling EUR 0.1 billion were set aside for personnel reduction measures. Additional measures have been identified for planned implementation after approval by the trade unions and other partners involved in social matters.

In the wholesale carrier business, T-Com expects above all an additional drop in interconnection rates (specifically for mobile telephony) and volume-based declines consistent with the sales development. On the other hand, the expansion of the product portfolio might produce corresponding additional costs for purchasing IT and Internet services.

Selling costs

The drop in selling costs in 2004 by approximately EUR 0.5 billion may be attributed primarily to a reduction in personnel costs and personnel-related costs of material and declining losses on receivables. By simplifying the product portfolio and selling procedures and by developing identified potential efficiencies, T-Com expects fewer sales staffing needs during the projection period. This effect should be amplified because of the declining significance of the personnel-intensive consumer business and the growing importance of the supporting work for other divisions and network carriers as well as the rise in transactions supported by e-commerce. T-Com also expects that the newly launched efforts to improve accounts management and collection and declining outside sales will lead to an even greater drop in losses on receivables.

General and administrative costs

The general and administrative costs decreased from 2003 to 2004 mainly as a result of greater efficiency, lower personnel costs and the sale, in 2003, of the cable business. During the course of the projection period, T-Com expects general and administrative costs to fall in step with the declines in the service areas.

Amortization/depreciation

As in the past, amortization and depreciation declined from 2003. The main cause of this trend was the significant cut-back in capital expenditures (particularly in Germany) in recent years, the amounts of which were lower than the original costs of acquiring the old, fully-depreciated assets. Thus, amortization and depreciation were much higher than the capital expenditures, meaning that the level of noncurrent assets fell considerably.

Given the fact that there has been technological advancement, that prices are falling in the procurement market and that capital expenditures made during the reunification of Germany will not be repeated, T-Com expects amortization and depreciation to continue to decline throughout the projection period, even if investments and capital expenditures tend to increase during this time. Thus, amortization and depreciation will continually fall until 2010. Above all, the volume of noncurrent asset depreciation will decrease because today's voice service platform, especially the digital switching technology, will be largely depreciated by 2010. Beginning in 2008, the expansion of the NGN platform will be carried out during the years 2008 through 2011 and will entail very high capital expenditures. As a result, the amount of amortization and depreciation should stabilize by the end of the projection period.

Sustainable earnings (2015 and thereafter)

The assumption that there will be sustainable earnings beginning in 2015 is based primarily on the results of operations of the individual national companies as yielded in 2014. The calculated earnings will be continued under the growth rate assumed for T-Com and will factor in margins achievable in the long term.

In place of the amortization and depreciation, which is to be recorded in 2014, the sustainable earnings must include any long-term reinvestments, which are required to maintain business operations. Based on the investments in and write-offs of intangible assets and property, plant and equipment during the projection period, the requisite investment needs, taking into account the expansion costs necessary to achieve an almost complete area coverage of broadband applications on the basis of VDSL (DSL supporting particularly high transmission rates), were calculated and reported as reinvestment rates.

5.1.2 T-Mobile

The projected income statements of T-Mobile for financial years 2005 through 2015 et seq. (including comparisons with 2003 and 2004) are set forth in the table below:

	Actual		**Medium-term planning**			**Long-term planning**							**Sustainabl**
T-Mobile	**2003 EUR m**	**2004 EUR m**	**2005 EUR m**	**2006 EUR m**	**2007 EUR m**	**2008 EUR m**	**2009 EUR m**	**2010 EUR m**	**2011 EUR m**	**2012 EUR m**	**2013 EUR m**	**2014 EUR m**	**2015 ff. EUR m**
Net revenue	24,198	26,527	29,330	30,932	32,518	34,142	35,627	37,224	38,604	39,913	41,160	42,333	43,60
Cost of sales	12,489	15,184	15,382	15,858	16,297	16,918	17,454	17,914	18,339	18,787	19,330	19,888	21,47
Gross profit	**11,709**	**11,344**	**13,948**	**15,075**	**16,221**	**17,224**	**18,174**	**19,311**	**20,265**	**21,127**	**21,830**	**22,445**	**22,12**
as a % of net revenue	*48.4%*	*42.8%*	*47.6%*	*48.7%*	*49.9%*	*50.4%*	*51.0%*	*51.9%*	*52.5%*	*52.9%*	*53.0%*	*53.0%*	*50.*
Selling costs	6,725	7,208	7,087	7,311	7,467	7,595	7,844	8,068	8,270	8,474	8,683	8,851	9,11
General and admin. costs	1,031	938	1,590	1,658	1,536	1,477	1,501	1,553	1,604	1,646	1,688	1,739	1,79
Other op. inc./exp., net	-520	-1,688	62	61	78	79	79	83	82	83	84	88	9
Operating results	**3,433**	**1,510**	**5,334**	**6,167**	**7,297**	**8,230**	**8,907**	**9,773**	**10,473**	**11,089**	**11,542**	**11,943**	**11,31**
as a % of net revenue	*14.2%*	*5.7%*	*18.2%*	*19.9%*	*22.4%*	*24.1%*	*25.0%*	*26.3%*	*27.1%*	*27.8%*	*28.0%*	*28.2%*	*25.*
Adjustments	789	3,486											
Operating results (adjusted)	**4,222**	**4,996**											
as a % of net revenue	*17.4%*	*18.8%*											
Add. info:													
Operating results	3,433	1,510	5,334	6,167	7,297	8,230	8,907	9,773	10,473	11,089	11,542	11,943	11,31
Amortization/depreciation	3,768	6,953	4,388	4,455	4,237	4,201	4,167	4,114	4,107	4,078	4,146	4,238	5,16
EBITDA	**7,201**	**8,463**	**9,722**	**10,622**	**11,534**	**12,431**	**13,073**	**13,887**	**14,580**	**15,167**	**15,688**	**16,181**	**16,47**
as a % of net revenue	*29.8%*	*31.9%*	*33.1%*	*34.3%*	*35.5%*	*36.4%*	*36.7%*	*37.3%*	*37.8%*	*38.0%*	*38.1%*	*38.2%*	*37.*

Adjustments

In connection with the impairment test, which must be conducted once annually in accordance with IFRS, the company took a EUR 2.2 billion goodwill write-down on its T-Mobile UK unit in 2004 and a EUR 0.8 billion goodwill write-down on its T-Mobile USA unit in 2003. In addition, in 2004, a one-time EUR 1.3 billion write-down was taken on the New York mobile phone licenses, which had resulted from the dissolution of the joint venture between T-Mobile USA and Cingular Wireless (GSM Facilities) as well as from the future swap of some New York mobile phone licenses for other mobile communication licenses of Cingular Wireless.

Net revenue

The development of T-Mobile's net revenue is set forth in the table below:

	Actual		Medium-term planning			Long-term planning						
T-Mobile	2003 EUR m	2004 EUR m	2005 EUR m	2006 EUR m	2007 EUR m	2008 EUR m	2009 EUR m	2010 EUR m	2011 EUR m	2012 EUR m	2013 EUR m	2014 EUR m
USA	7,363	9,278	11,093	12,132	13,016	13,889	14,733	15,679	16,493	17,221	17,872	18,377
Germany	8,479	8,745	9,212	9,504	9,968	10,331	10,705	11,090	11,391	11,741	12,096	12,544
Rest of Europe	8,622	8,822	9,330	9,629	9,883	10,265	10,540	10,814	11,087	11,325	11,573	11,801
Intra-division revenue	-266	-318	-305	-333	-349	-343	-351	-360	-367	-374	-382	-390
Net revenue T-Mobile	**24,198**	**26,527**	**29,330**	**30,932**	**32,518**	**34,142**	**35,627**	**37,224**	**38,604**	**39,913**	**41,160**	**42,333**

In 2004, T-Mobile's net revenue equaled approximately EUR 26.5 billion. The increase over 2003 can be attributed above all to the dynamic growth of T-Mobile in the United States. By 2014, revenue is expected to have increased by a total of 60% to EUR 42.3 billion. Revenue growth at T-Mobile Deutschland and T-Mobile UK should be approximately 43% and 28% respectively, and should be approximately 34% in the other European companies. T-Mobile USA should grow above average at approximately 98% so that the T-Mobile USA share of overall net revenue would rise from approximately 35% in 2004 to approximately 43% in 2014.

The strongest growth is expected for the period through to 2007 (totaling approximately 23%). In the follow-up period between 2008 and 2014, a decline in the growth rate is expected.

From 2003 to 2004, revenue at **T-Mobile USA** rose by 26% to EUR 9.3 billion. The main engine for this favorable development was the high customer growth of 4.2 million new customers in 2004 compared to 3.2 million customers in 2003. T-Mobile USA will also continue to be the main growth engine for the mobile communication division of Deutsche Telekom.

The main reasons for the anticipated high growth compared to Europe is that mobile communication penetration is currently low in the United States (measured on the basis of SIM cards), which was only slightly over 60% at the end of 2004. Mobile phone penetration in Europe, on the other hand, lies between 80% and in some cases over 100%. For purposes of revenue planning at T-Mobile USA, the company targeted a penetration rate of approximately 78% by year 2010. Another engine of sales growth for T-Mobile USA is the industry consolidation, which has begun in the U.S. mobile communication market (Cingular Wireless LLC / AT&T Wireless (AWE) as well as, presumabely, the Sprint FON / Nextel Communications, Alltel Corp. / Western Wireless). T-Mobile USA is assuming that during the integration phase its own market position will be increased both in the short- and medium-term and that it will be able to strengthen its customer growth. In general, an expected consolidation to four nationally operating mobile communication carriers will tend to reduce competitive pressure. This development together with considerably growing market penetration should lead to disproportionately strong growth at T-Mobile USA (relative to the other T-Mobile companies) in the coming two to three years. Thereafter, growth is expected to slow to market levels.

The average revenue per user (ARPU) is expected to be approximately USD 50 in the projection period. The significantly higher ARPU relative to Europe may be attributed primarily to the higher number of call minutes per customer. In this respect revenue generated through voice calls might be slightly lower. Increasing revenue is expected above all in the data services business, which is underdeveloped in comparison to Europe.

As a consequence of the merger between Cingular Wireless and AT&T Wireless, T-Mobile USA acquired from Cingular the GSM network, which had previously been jointly operated with Cingular, and various mobile communication licenses in California and Nevada. In addition, T-Mobile USA will surrender some of its New York mobile communication licenses to Cingular.

The German market already exhibits a high level of mobile communication penetration at approximately 86.4% (as of December 2004). In the long-term, only low market growth is expected from the introduction of marketing of data services (UMTS networks) and the resulting multiple card usage per customer. In today's competitive environment of four mobile communication companies, the current market position of **T-Mobile Deutschland** according to its own financial planning will stabilize, and the company might have approximately 30 million SIM cards (customers) in its network by 2014. This development should lead to increased revenue per customer. As a whole, this development should lead to an increase in revenue of approximately 43% during the period from 2004 through 2014, although the average annual growth rates through 2007 will probably be higher than in the years thereafter.

The ARPU at T-Mobile Deutschland was approximately EUR 24 in 2004. As a result of the UMTS roll-out in Germany in 2004, growth in ARPU is expected in the medium-and long-term because of increased data services.

The item **"Rest of Europe"** includes revenues, which have been generated or are expected to be generated in the Great Britain, Austria, The Netherlands, the Czech Republic, Slovakia, Croatia, Hungary and Macedonia. Since the Slovakian mobile communication company, EuroTel, will first be fully consolidated in 2005, information on 2003 and 2004 are not included in this company's revenue figures.

Under the item "Rest of Europe", T-Mobile UK holds a special position. The market in Great Britain is highly competitive among the five mobile communication companies. Although the net revenue of T-Mobile UK increased from 2003 by almost 1% to EUR 4.3 billion in 2004, the anticipated devaluation of the British pounds and the decline in the termination fees will likely lead to only minor revenue increases in Euro through 2006. The market penetration was 91% in June of 2004 and was therefore already very high. As in Germany, additional market growth is expected to be generated mostly from the data business, which began in the previous year, and from the use of multiple cards. The average revenue per user (ARPU) might rise moderately in the coming years as the result of the increased use of wireless voice telephony and data transmission.

The market conditions in the other countries are currently very different. Competition is high in some countries (*e.g.*, Austria and The Netherlands), while less intense in other countries. In general, cell phones are expected to displace fixed networks calls more quickly in Eastern European countries so that there will be a higher willingness on the part of customers to spend more on wireless phone services. Although the T-Mobile companies reported a revenue growth of almost 4% in 2004, revenue is projected to continue growing by approximately EUR 1.8 billion in these countries through 2014 and, once again, the strongest annual growth in revenue is expected in the period ending 2007.

Cost of sales

According to the business plans, beginning in 2004 the cost of sales should increase by approximately EUR 4.7 billion to EUR 19.9 billion in 2014. Mostly as a result of expected economies of scale, the cost of sales will probably increase more slowly than net revenue so that as a percentage of net revenue, cost of sales will decline from 52% in 2005 to 47% in 2014.

The cost of sales includes primarily call charges (termination costs), roaming charges, expenses for purchasing mobile terminals, SIM cards etc., the costs of operating mobile communication networks and the personnel costs incurred in each of these areas. Cost of sales also includes the depreciation taken on the mobile communication network and the amortization of the mobile communication licenses.

Call fees are charged on all calls made by T-Mobile customers, which terminate outside the network operated by T-Mobile. Roaming charges are those costs, which a (foreign) mobile communication operator will invoice T-Mobile companies, if a T-Mobile customer, for example, uses his or her cell phone in that foreign wireless network during a visit abroad. The major personnel costs included under cost of sales relate to network operations.

The cost of sales for **T-Mobile USA** rose significantly in 2004 compared to 2003. The cause of this development was the very large growth in the customer base, which resulted in a greater use of terminals. Also in 2004, nonscheduled write-downs of FCC licenses (U.S. mobile communication licenses) had to be recognized under IFRS in connection with the dissolution of the joint venture with Cingular, as described under Adjustments. Cost of sales as a percentage of net revenue decreased slightly during the projection period, from 46% to 44%. In evaluating this development and in order to draw comparisons with other European wireless companies it should be noted that the FCC licenses will not be amortized on a scheduled basis under IFRS and that the U.S. business model is different from the European business model inasmuch as termination fees in the United States are considerably lower. The projected relative decline in cost of sales is a result of expected economies of scale, which arise from the high customer growth and from the costs for network operations, depreciation, call charges and mobile terminals, which probably will increase at a slower rate than net revenue.

The cost of sales at **T-Mobile Deutschland** rose by approximately 9% during 2004 compared to 2003. The main cause of this increase was the expansion of the UMTS network and the ensuing increased depreciation as well as the beginning of scheduled amortization on the UMTS licenses. During the projection period, the cost of sales at T-Mobile Deutschland as a percentage of net revenue is expected to decrease by approximately six percentage points. The main cause for this trend is the decline in depreciation of property, plant and equipment. Other factors contributing to a relative decline in cost of sales are the costs for terminals, which should increase only slowly given the greater degree of market saturation as well the decrease in interconnection fees as forecasted in the projections.

For the first time in 2004, scheduled amortization of the UMTS licenses was also reported at T-Mobile UK. For this reason and as a result of UMTS network expansion, cost of sales in 2004 increased by approximately 11% compared to the previous year. With respect to the cost of sales as a percentage of net revenue, a decline of approximately ten percentage points by 2014 is expected. This trend may be attributed to declining depreciation, a market growth at T-Mobile UK that is lower than at T-Mobile Deutschland, which slows the increase in handset costs, and the initially strongly declining interconnection fees resulting from the regulation of these fees.

The same cost of sales developments are being seen in other European countries even though they may be slightly delayed. This delay is caused primarily by the priorities set by the Eastern European companies, which are seeking to reduce the cost of sales as a percentage of net revenue beginning only after 2007, because the UMTS investments would be made later and there is a lower degree of market saturation.

Selling costs

Beginning in 2004, the selling costs should increase by approximately EUR 1.6 billion to EUR 8.9 billion in 2014. Given the expected economies of scale with respect to the personnel and advertising costs and the structural improvements in commission payments, the selling costs will likely increase at a slower rate than net revenue so that as a percentage of net revenue, this item should fall from 27% in 2004 to 21% in 2014.

The selling costs include primarily commissions and premiums, marketing expenses, bad debt allowances and personnel costs. When new contracts are executed or contracts with existing clients extended, commissions and premiums are paid to the sales channels involved. By placing greater emphasis on creating and focusing on its own internal sales and distribution network (for example, through the Internet), the company hopes in the long-term to reduce its dependency on dealers and to lower commission expenses paid to dealers. The marketing expenses include supra- regional promotional campaigns as well as media advertising and sponsoring, which communicate the worldwide appearance of the brand (global footprint). By funding advertising allowances to dealers and incurring expenses for direct marketing, T-Mobile also supports advertising efforts at the regional level.

The personnel costs included in selling costs relate almost exclusively to customer service personnel. A significantly smaller portion is attributable to sales personnel. The number of staff members employed in these areas in Europe is projected to be largely constant, whereby additional requirements were assumed for the United States in the coming years given the anticipated growth in the number of customers. Losses on accounts receivable at the national company levels were estimated on the basis of past experience. For budget projection purposes, losses on receivables at T-Mobile USA in relation to revenue will continue to be higher than among the European companies.

General and administrative costs

According to the business plans, beginning in 2004, the general and administrative costs will increase by approximately EUR 0.8 billion to EUR 1.7 billion in 2014. Based on expected economies of scale, the general and administrative costs will probably increase more slowly than revenue. In 2014, these costs as a percentage of revenue should be approximately 4.1%. The administrative costs include in particular expenses for accounting and finance, the human ressources department, the executive offices of the various national companies and other support offices.

The administrative staff in Europe is projected to remain largely constant, whereas in the United States the expected revenue and customer growth will necessitate more personnel.

Other operating income/expenses

Other operating income/expenses consist of other operating income netted against other operating expenses. Other operating income includes, *inter alia*, income from passing on costs and income from revaluations of accounts receivables. Other operating expenses include primarily losses from the sale of noncurrent assets as well as the goodwill written down at T-Mobile UK and T-Mobile USA in 2003 and 2004, which was adjusted as a one-time effect. In the long-term, T-Mobile assumes that other operating income and other operating expenses will roughly net each other out.

In order to continue permanently strengthening its national companies in Germany, Great Britain, Austria, The Netherlands and the Czech Republic, T-Mobile is planning to initiate a growth and efficiency program (the so-called "Save for Growth" program), which should yield approximately EUR 1 billion in savings per annum, from which other growth investments of approximately EUR 500 million per annum are expected to be financed. The largest savings effect would be experienced at T-Mobile Deutschland and T-Mobile UK as well as at T-Mobile International AG & Co. KG. The goal is to realize significant savings as early as 2005. By 2006, the actions should be completed and the savings and growth programs should be fully implemented by 2008. The savings should be achieved by optimizing the management of equipment funding, by adopting lean product and service portfolios, by strengthening the package tie-ins and improving purchasing conditions, and by enhancing human resource productivity. The savings, which affect primarily cost of sales and selling costs, should create the necessary resources to drive, above all, the continued development of the wireless Internet, the packaging of more affordable and simplified mobile communication tariffs and the further development of a wireless integrated network platform (GPRS, UMTS, W-LAN).

Amortization/depreciation

The amortization and depreciation reported by T-Mobile in 2004 (as adjusted) equaled approximately EUR 3.5 billion and will rise in 2005 by approximately EUR 0.9 billion to approximately EUR 4.4 billion as a result of the first-time inclusion of UMTS amortization for the whole year. Thereafter, amortization and depreciation remain almost constant in the projections. Since the scale of investments in the United States is expected to increase, T-Mobile USA's amortization and depreciation during the projection period will increase by approximately 18%. In addition to the purchase of additional licenses, capital expenditures will also be made to expand existing network capacity. During the same period, amortization and depreciation are expected to decline by approximately 13% in Europe, since the investment activities are declining due to the extensive network infrastructure.

The depreciation of property, plant and equipment includes primarily the depreciation of technical equipment and machinery, as well as office and plant equipment. The amortization of intangible assets includes the amortization of the spectrum licenses, software and internally generated intangible assets. The spectrum licenses will be amortized on a scheduled basis, only where the spectra had been granted for limited periods of time. In terms of value, this relates mainly to the UMTS licenses in Germany and Great Britain. If the licenses are granted for unlimited periods of time, as is generally the case in the United States, there is no scheduled annual amortization pursuant to IFRS.

Sustainable earnings (2015 and thereafter)

The assumptions about the sustainable earnings for the period beginning in 2015 are based primarily on the yielded earnings situation at the individual national companies in 2014. The calculated earnings are projected with the total growth rates assumed for T-Mobile while factoring in long-term achievable margins. The growth rate was based on the individual market situation for the individual national companies and aggregated for T-Mobile on a weighted scale.

Starting with amortization and depreciation reported in 2014, the sustainable earnings must factor in the reinvestments, which are required in the long term in order to maintain business operations. With respect to the amortization of intangible assets, which occurred during the planning period, an adjustment was made for the licenses. The UMTS license auctions in Germany and Great Britain generated licensing proceeds for the respective governments. These proceeds were considerably higher than the average proceeds yielded in other European countries. Regarding the extensions of the licenses, an assumption was made for Germany and Great Britain that the prices will be significantly lower than the earlier UMTS license auction price.

Since the mobile telecommunications market is a highly innovative and capital intensive industry, T-Mobile has assumed in its projections that during the sustainable period customers will demand services, some of which today cannot yet be precisely predicted and which will therefore require more detailed development. In order to secure T-Mobile's long-term market share in the individual countries, it is essential for it to make the investments necessary to launch such services. Thus, it has been assumed that for the sustainable period the depreciation of property, plant and equipment as reported in 2014 will be inadequate to reflect the long-term capital expenditures needed. For this reason, the sustainable period includes additional capital expenditures, which will extend beyond the last projected year. These investments are intended to ensure that the national companies will also be in a position to keep a lasting hold on their market position and to generate their projected revenue and margins by offering their customers the mobile services that will be required in the future.

5.1.3 T-Systems

The projected income statements of T-Systems for financial years 2005 through 2015 et seq. (including comparisons with 2003 and 2004) are set forth in the table below:

	Actual		**Medium-term planning**			**Long-term planning**							**Sustainable**
T-Systems	**2003 EUR m**	**2004 EUR m**	**2005 EUR m**	**2006 EUR m**	**2007 EUR m**	**2008 EUR m**	**2009 EUR m**	**2010 EUR m**	**2011 EUR m**	**2012 EUR m**	**2013 EUR m**	**2014 EUR m**	**2015 ff. EUR m**
Net revenue	10,469	10,369	10,845	11,655	12,500	13,167	13,916	14,712	15,560	16,465	17,431	18,466	18,835
Cost of sales	8,908	8,347	8,753	9,374	10,017	10,537	11,124	11,748	12,413	13,122	13,898	14,710	15,004
Gross profit	**1,561**	**2,021**	**2,092**	**2,282**	**2,483**	**2,629**	**2,791**	**2,963**	**3,147**	**3,343**	**3,532**	**3,756**	**3,831**
as a % of net revenue	*14.9%*	*19.5%*	*19.3%*	*19.6%*	*19.9%*	*20.0%*	*20.1%*	*20.1%*	*20.2%*	*20.3%*	*20.3%*	*20.3%*	*20.3%*
Selling costs	656	806	868	907	946	979	1,018	1,058	1,100	1,143	1,188	1,234	1,259
General and admin. costs	710	713	713	746	767	796	828	860	893	927	963	1,000	1,020
Other op. inc./exp., net	311	-114	0	-43	-33	-34	-35	-36	-36	-37	-38	-38	-39
Operating results	**506**	**388**	**511**	**585**	**737**	**820**	**911**	**1,010**	**1,118**	**1,235**	**1,344**	**1,483**	**1,513**
as a % of net revenue	*4.8%*	*3.7%*	*4.7%*	*5.0%*	*5.9%*	*6.2%*	*6.5%*	*6.9%*	*7.2%*	*7.5%*	*7.7%*	*8.0%*	*8.0%*
Adjustments	-87	117											
Operating results (adjusted)	**420**	**505**											
as a % of net revenue	*4.0%*	*4.9%*											
Add. info:													
Operating results	506	388	511	585	737	820	911	1,010	1,118	1,235	1,344	1,483	1,513
Amortization/depreciation	1,021	921	890	924	950	983	1,026	1,072	1,119	1,168	1,238	1,291	1,317
EBITDA	**1,527**	**1,309**	**1,401**	**1,509**	**1,686**	**1,803**	**1,937**	**2,082**	**2,236**	**2,403**	**2,582**	**2,774**	**2,830**
as a % of net revenue	*14.6%*	*12.6%*	*12.9%*	*12.9%*	*13.5%*	*13.7%*	*13.9%*	*14.2%*	*14.4%*	*14.6%*	*14.8%*	*15.0%*	*15.0%*

Adjustments

Adjustments were made of approximately EUR 87 million (on balance) in book profits and losses, which were reported under the other income/expenses item in 2003 and which had been generated from the sale of subsidiaries. The adjustments in 2004 (EUR 117 million) relate primarily to restructuring costs and transfer payments to Vivento.

Net revenue

T-Systems generates its net revenue in the information technology and telecommunication businesses. The Telecommunication unit comprises the service lines International Carrier Sales & Solutions, Network Services and Media & Broadcast. The Information Technology unit consists of the service lines Systems Integration, Computing Services, Desktop Services and Consulting.

In 2004, net revenue was virtually unchanged from the previous year at approximately EUR 10.4 billion. Regarding revenue development in 2004, declining net revenue was reported primarily in the International Carrier Sales & Solutions line. On the other hand, the information technology business, specifically the service lines Computing Services and Desktop Services, showed favorable results. Revenue is expected to grow by approximately 78% through 2014 and is estimated to reach EUR 18.5 billion by that year.

Net revenue should increase during the projection period at an average annual growth rate of 5.9%. Intragroup revenue was EUR 3.3 billion in 2004 and will increase to EUR 4.2 billion in 2014. Given T-Systems' large market share in Germany, additional revenue growth is expected to be generated mostly abroad. Moreover, efforts will be increasingly made to solicit orders in excess of EUR 250 million. In addition, so-called "Focus Solutions" have been developed with the involvement of several service lines. The solutions not only closely track customer needs, but also cover areas showing higher-than-average growth opportunities. For example, T-Systems offers solutions for comprehensive systems in managing customer relations for telecommunications companies. The anticipated improvement in utilizing the medium-size company market will also have an additional effect on revenue. This separately budgeted revenue was not allocated to the areas described below.

In 2004, T-Systems generated EUR 5.1 billion (before consolidating intradivision revenue) in net revenue in the **Telecommunication** unit. For the period 2004 through 2014, the average annual net revenue growth is expected to be approximately 4.8%. The main factor contributing to revenue development in the service line Network Services is strong growth in the following businesses: IP voice and data solutions, local networking, mobile telecommunication solutions, and telecommunication network-based outsourcing solutions. These improvements are met with declining net revenue in voice traffic with business customers and data communication services. In the service line International Carrier Sales & Solutions, revenue will be generated primarily from traditional bilateral business in outgoing and incoming telephone traffic between formerly state-owned telecommunication companies and from transporting traffic, the origin and destination of which is outside Germany, on bilateral networks such as the Telecom Global Network. In the medium-term, the revenue for this business is expected to be consolidated at a low level. The long-term moderate growth may be attributed primarily to voice telephony over the Internet (Voice over IP) as well as "operator outsourcing" the transfer of the customer network to T-Systems. The projected increase in net revenue for the Media & Broadcast service line is likewise relatively small. The growth from constructing digital transmitters will be offset in part by declining net revenue from businesses based on analogue transmitters and by price competition among satellite services.

In 2004, the **Information Technology** unit generated net revenues of EUR 6 billion (before consolidating intradivision revenue). The projected average annual net revenue growth is 5.5% for the period 2004 through 2014. In contrast, the business of outsourcing complete business processes is expected to achieve a relatively high average annual market growth rate of 9.2%. The revenue development at the Computing Services and Desktop Services service lines depends on the consistent strategy of outsourcing complete business processes. In order to utilize market opportunities in the financial services sector, for example, a joint venture company with HSBC Trinkaus & Burkhardt is planned. The growth of the Systems Integration service line will be achieved primarily through a committed strategy of providing industry solutions, such as SAP Integration & Consolidation and Enterprise Application Integration, as well as expanding near-shore and offshore platforms in St. Petersburg and India.

In addition, the strategic realignment of the Group is expected to affect revenue and earnings. The goal here is, above all, to exploit market opportunities in the medium-size company market. The planned courses of action focus primarily on gaining a greater market share in the telecommunication business with medium-size corporate customers. Furthermore, the market share in the information technology business with larger medium-size customers should also be expanded. The additional effects should be brought about mainly through a close working relationship between T-Systems and T-Com in the corporate customer area. These effects should be made possible through the new structure, which to a large extent has been introduced in the strategic business with corporate customers, the impact of which has been fully included in the business plans and reported under the results of the T-Systems and T-Com divisions. The projected revenue in 2014 from this new structure at T-Systems is expected to total approximately EUR 1.2 billion.

Cost of sales

In the Telecommunication unit, cost of sales includes primarily amortization and depreciation, wholesale supplies from T-Com and personnel costs. In the Information Technology unit, the cost of sales has different components which vary according to the service line in question. In the System Integration service line, cost of sales includes, above all, personnel costs and purchased services. In the Computing Services service line, amortization/depreciation also represents a significant component of cost of sales. In the Desktop Services service line, material costs are incurred for pure retail business. Moreover, in connection with the service business, amortization and depreciation as well as personnel costs are also reported under cost of sales.

Cost of sales fell from EUR 8.9 billion in 2003 to EUR 8.3 billion in 2004. This savings resulted primarily from the cost savings program launched in connection with the restructuring. The consolidation of the portfolio of the service line International Carrier Sales & Solutions and the integration of the computer centers will also help to lower the cost of sales. In addition, the expenses incurred for the Computing and Desktop Services service line employees, who are used in sales-like positions, are being reported under selling costs beginning in 2004. The company projects that the cost of sales will increase to EUR 14.7 billion in 2014. As a result of expected economies of scale, the cost of sales will probably rise more slowly than net revenue so that, as a percentage of net revenue, it will fall slightly from 80.5% in 2004 to 79.7% in 2014.

In the System Integration service line, savings in cost of sales will be achieved primarily through an increasing standardization caused by the planned strategic change from individualized solutions to standard/modular solutions and through the additional effects resulting from the greater use of offshoring. Offshoring entails outsourcing software development work to subsidiaries in low-wage countries such as Russia and India. In the Computing Services service line, digression effects should be achieved mostly through integrating various computer centers.

In the Network Services service line, the expected medium-term decline in the cost of sales ratio results primarily from the product mix. In the long-term, T-Systems assumes that it can increase the value added share among customers through innovative products such as the new Internet protocol technologies and to achieve higher margins as a result of improved customer loyalty. With respect to the International Carrier Sales & Solutions service line, the assumption is that the earnings will be consolidated in the medium-term.

Selling costs

From 2003 to 2004, the selling costs increased by approximately 23% to EUR 0.8 billion. The increase is based primarily on the reporting changes previously described. The projected improvement in the selling costs ratio from 7.8% in 2004 to 6.7% in 2014 is based on the fact that among new customers, there should be an increase in the volume of solicited orders and an improved success rate in the rewards for such orders. Moreover, it is expected that there will be increasing cross-selling opportunities with regard to existing customers as Information Technology and the Telecommunication units increasingly converge. In addition, the close working relationship between T-Com and T-Systems in the area of business customers should create synergies.

General and administrative costs

For the general and administrative costs, an increase from EUR 0.7 billion in 2004 to EUR 1 billion in 2014 is expected. Based on expected economies of scale, the administrative costs will likely increase more slowly than net revenue so that as a percentage of net revenue administrative costs will decline from 6.9% in 2004 to 5.4% in 2014. General and administrative costs include, above all, expenses for executive offices, accounting and finance and the human ressources department.

Other operating income/expenses, net

The item other operating income/expenses, net, includes mostly pass-through income and expenses. The passed-through income and expenses result from the use of intragroup services. This relates specifically to office leases, as well as the shared operating costs for central functions and central services.

Amortization/depreciation

In 2004, depreciation and amortization was approximately EUR 0.9 billion and will rise to EUR 1.3 billion by 2014. The anticipated increase in amortization and depreciation may be attributed primarily to the rising business volume. The depreciation relates primarily to property, plant and equipment. The business of the Computing Service service line relies particularly heavily on property, plant and equipment. The property, plant and equipment of this service line include especially mainframe computers and servers. Property, plant and equipment in the Telecommunication unit involve primarily customer infrastructure and networks.

The capital expenditures made in 2003 and 2004, which resulted especially from the strategic realignment of T-Systems, related primarily to investments in new technology, the development of solutions meeting specific customer needs across several service lines (Focus Solutions), and international expansion. In addition, the nature of the predominantly long-term orders will dictate the volume of capital expenditures. Thus, for instance, the investments in new servers by the Computing Services service line will also depend on the number and volume of new outsourcing contracts. Beginning in 2005, capital expenditures at T-Systems relative to net revenue are expected to decline. The main factors contributing to this development are declining investments based on the drop in prices in the information technology area.

Sustainable earnings (2015 and thereafter)

The assumptions for the period involving sustainable earnings beginning in 2015 are based primarily on the earnings situation of T-Systems in 2014. The calculated earnings will be continued on the basis of the growth rates assumed for T-Systems.

Instead of the amortization and depreciation reported in 2014, the sustainable earnings must factor in the reinvestments, which are required in the long-term in order to maintain business operations. In this respect, the reinvestment rate was calculated on the basis of the required investment volume.

5.1.4 GHS

The projected income statements of GHS for financial years 2005 through 2015 et seq. (including comparisons with 2003 and 2004) are set forth in the table below:

	Actual		**Medium-term planning**			**Long-term planning**							**Sustainable**
GHS	**2003 EUR m**	**2004 EUR m**	**2005 EUR m**	**2006 EUR m**	**2007 EUR m**	**2008 EUR m**	**2009 EUR m**	**2010 EUR m**	**2011 EUR m**	**2012 EUR m**	**2013 EUR m**	**2014 EUR m**	**2015 ff. EUR m**
Net revenue	4,266	4,483	4,790	4,907	4,872	4,740	4,784	4,816	4,809	4,843	4,899	4,976	4,976
Cost of sales	3,180	3,681	3,633	3,632	3,636	3,560	3,595	3,603	3,593	3,733	3,713	3,664	3,764
Gross profit	**1,086**	**802**	**1,157**	**1,275**	**1,236**	**1,180**	**1,189**	**1,213**	**1,216**	**1,110**	**1,186**	**1,312**	**1,212**
as a % of net revenue	*25.5%*	*17.9%*	*24.2%*	*26.0%*	*25.4%*	*24.9%*	*24.8%*	*25.2%*	*25.3%*	*22.9%*	*24.2%*	*26.4%*	*24.4%*
Selling costs	276	141	139	139	139	136	137	138	137	143	142	140	140
General and admin. costs	1,934	1,939	1,913	1,913	1,915	1,875	1,893	1,897	1,892	1,966	1,955	1,930	1,930
Other op. inc./exp., net	191	-10	-166	-324	-307	-288	-320	-351	-438	-435	-460	-488	33
Operating results	**-933**	**-1,287**	**-1,060**	**-1,101**	**-1,125**	**-1,120**	**-1,162**	**-1,172**	**-1,251**	**-1,434**	**-1,370**	**-1,245**	**-824**
as a % of net revenue	*-21.9%*	*-28.7%*	*-22.1%*	*-22.4%*	*-23.1%*	*-23.6%*	*-24.3%*	*-24.3%*	*-26.0%*	*-29.6%*	*-28.0%*	*-25.0%*	*-16.6%*
Adjustments	-107	8											
Operating results (adjusted)	-1,040	-1,279											
as a % of net revenue	*-24.4%*	*-28.5%*											
Add. info:													
Operating results	-933	-1,287	-1,060	-1,101	-1,125	-1,120	-1,162	-1,172	-1,251	-1,434	-1,370	-1,245	-824
Amortization/depreciation	820	914	758	778	800	795	801	797	785	779	762	738	705
EBITDA	**-113**	**-373**	**-302**	**-323**	**-325**	**-324**	**-361**	**-375**	**-467**	**-655**	**-608**	**-507**	**-119**
as a % of net revenue	*-2.7%*	*-8.3%*	*-6.3%*	*-6.6%*	*-6.7%*	*-6.8%*	*-7.5%*	*-7.8%*	*-9.7%*	*-13.5%*	*-12.4%*	*-10.2%*	*-2.4%*

The adjustments include the extraordinary income earned by Vivento from the transfer payments made in connection with the transfer of T-Com and T-Systems employees as well as the cost of redundancy payments.

The net revenue of GHS relates to Group Headquarters and Shared Services and includes primarily income in Real Estate as well as Billing & Collection and, to a lesser extent, net revenue in the other areas (Vivento, DeTeFleet Services, "Other"). Since Shared Services act first and foremost as internal service providers, the majority of that revenue is generated with Group customers so that the same intragroup net revenue for GHS is reflected as an expense among the other divisions. The following is a brief description of the development of the individual segments:

Net revenue from **Real Estate** (approximately EUR 3.1 billion in 2004) relates primarily to income from leasing office space, technology space and antennae sites to other divisions as well as the use of building services. The net revenue will remain largely the same during the projection period. A slight decline in intragroup revenue from approximately EUR 2.9 billion in 2004 to approximately EUR 2.8 billion in 2014 is expected to be more than offset by the rise in outside net revenue, from approximately EUR 0.2 billion 2004 to EUR 0.4 billion in 2014.

Consistent with the staff reductions at T-Com, net revenue generated with T-Com is expected to drop off as a result of passing through cost advantages, leasing out microwave systems and the diminished use of resources. On the other hand, more services will be demanded by T-Mobile as a result of the upgrade and expansion of the mobile communication sites (GSM/UMTS) by DFMG. The net revenue generated with T-Systems will decline slightly since the lower demand for resources in the broadcasting area (analog technology) will be offset only in part by the technical substitution in connection with the launch of digital television. The basis for the increase of external revenue is the expansion of the third market strategy for leasing and facility management and the increasing use of services by non-group mobile communication providers.

The sale of real estate properties identified as non-operating is one of the objectives of the Real Estate business of GHS. The expected sales proceeds are included in both the projected income statements and the projected cash flow statements. Accordingly, the value contributed by the real estate is factored into the discounted earnings value both with regard to projected earnings and with respect to cash inflow resulting from a property sale. Thus, this real estate did not require any special valuation. As was done previously, the commercialization of the property is expected to be managed by the marketing company, Sireo Real Estate Asset Management GmbH.

The costs relating to Real Estate relate primarily to the cost of materials, which is typically shown under cost of sales, and to personnel costs, miscellaneous operating expenses and depreciation. Material expenses include mostly the purchased facility management services and third party leasing, including the ancillary operating costs and electricity. The commencement of business operations by Power and Air Condition Solution Management GmbH & Co. KG (**"PASM"**) as of 1 January 2005 should optimize energy management with respect to securing energy and air ventilation technology for Deutsche Telekom in Germany. Given the projected capital expenditures, depreciation at DFMG and PASM is expected to rise during the projection period and will largely offset the declining depreciation on other office and miscellaneous technology sites. The personnel consist of mostly employees for real estate management and building management. Personnel expenses will be modified on the basis of the employee numbers, which will be almost unchanged during the projection period.

In 2004, net revenue from **Billing & Collection** was approximately EUR 1 billion. The internal revenue development is influenced by declining net revenue based on the continued improvement of the billing procedures and the sharing of any efficiencies achieved in the areas of information technology, postage and printing with T-Com, which is the primary intragroup customer of Billing & Collection. This decline will be offset by the expected increases in revenue from expanding the third market business through T-Systems, which will more than compensate for the drop in sales in the existing business. Net revenue totaling approximately EUR 1.2 billion is projected for 2014.

The costs relating to Billing & Collection consist primarily of personnel costs, information technology costs, printing costs and postage costs. As a result of expected economies of scale and more improvements in the cost structure, savings will probably be realized in information technology as well as printing and postage during the projection period. These savings effects will be more than offset by higher personnel costs resulting from the projected moderate increase in costs per employee and from the slight rise in the number of staff members and by growth-related higher costs specifically for information technology to accommodate the rise in business with third party customers. The amortization, which relates mostly to capitalized software, will remain relatively unchanged during the projection period.

The net revenue from **DeTeFleet Services** (approximately EUR 0.2 billion in 2004) has also been subject to this contrary trend. The internal net revenue will fall during the projection period as a result of lower personnel needs in the service/production business at T-Com. In contrast, there will be an increase in outside net revenue, which, on the one hand, will be generated from the increased net revenue from the sale of motor vehicles in connection with the reduced periodic cycles for exchanging business vehicles and the return of any leased vehicles in favor of owned vehicles and, on the other hand, will be based on the planned entry into the third party customer business. For DeTeFleet Services, total net revenue of approximately EUR 0.3 billion is expected in 2014. Given the business purpose of DeTeFleet Services, the accounting rules require that vehicle sales show both net revenue and expenses arising from disposals of equipment.

As is typical for the industry, the costs relating to DeTeFleet Services are driven by depreciation, maintenance and fuel costs, and leasing and personnel costs. The costs will develop commensurately with the growth of the fleet. With the planned renewal of the vehicle fleet, the ongoing costs per vehicle are expected to decline since newer vehicles are more fuel efficient and have lower maintenance costs. The planned renewal of the vehicle fleet and the expansion of outside business through 2007 will lead to higher depreciation. In the years thereafter, depreciation will lessen as a result of lower demand for vehicles at T-Com.

The net revenue at **Vivento** (approximately EUR 0.2 billion in 2004), Telekom's own personnel placement agency, is influenced by the performance of the individual business models. In 2004, the intragroup personnel placement agency, Vivento, established two business models VCS and VTS with which new jobs were created in promising business fields. VCS was formed at the beginning of the year as part of the Call Center Unit and provides integrated call center services. With its goal of creating qualified technical jobs, VTS commenced operations in July 2004. The Vivento companies provide installation services and services in the technical infrastructure business, working specifically for companies in the telecommunication and information technology industries.

The planned expansion of VCS and VTS services will lead to increasing internal and external net revenue during the projection period. The larger share of internal net revenue will be generated with T-Com. There are additional plans to develop the same type of new business models for purposes of employing workers.

In addition to the net revenue, Vivento will generate income from contract and temporary work, which is reported under the item operating income/expenses, net. Income from contract and temporary work is raised by using employees, who are not already working under the business models. Contract and temporary work involves loaning out employees to other divisions of Deutsche Telekom and to non-group partners in connection with co-operative ventures, including those with the government. How the contract and work will contribute to earnings will depend on how human resources develop for this business, which in turn will be affected to a large extent by the budgeted additions and reductions (the additions relate primarily to T-Com employees) and the planned staffing of the business model.

The costs at Vivento are driven mostly by the development in personnel and include personnel costs, other operating expenses (which also cover the personnel-related operating costs), and the cost of materials, which VTS incurred. Since its formation, approximately 31,100 employees left divisions of Deutsche Telekom and moved to Vivento. Approximately 12,900 employees have since left Vivento. Of the current 19,000 employees (approximation) at Vivento, roughly 10,000 are contract and temporary workers, 4,600 are working under the business models, 800 as training programmers, and roughly 700 are regular employees. A significant impact on personnel development was the reduction of the weekly working hours from 38 to 34, a decision which was based on an agreement entered into with the labor union, ver.di Vereinte Dienstleistungsgewerkschaft in March of 2004. The plan is to continue reducing staff up to 2014 by spinning off business models and not replacing staff leaving as a result of fluctuation.

Vivento's other operating income/expenses net result, which was lower in 2004 due to increased staffing, will be largely offset by a higher other operating income/expenses net result generated in the "Other" area attributable mostly to a lower allocation to provisions for, inter alia, the postal workers' health care program, and to lower consulting and legal costs as well as advertising costs. In the years thereafter, the development of the other operating income/expenses net result might be affected primarily by planned income from the "Other" area and the other income/expenses item of Vivento.

Net revenue from the **"Other"** area (approximately EUR 0.03 billion in 2004) is projected to stay at a very low constant level (approximately EUR 0.04 billion in 2014). The net revenue generally reflects services for training and insurance brokering. Internal net revenue is generated above all with T-Systems.

The larger share of income relating to the "Other" area is shown under the other income/expenses item, since GHS as a central office would initially assume the pass-through social benefit costs for the civil servants of the other divisions and the costs for training. The reasoning for this is that the GHS, acting as the formal employer of all Deutsche Telekom civil servants, must pay on behalf of the government all claims brought by civil servants (civil servant pensions, cost assumption for the Federal Posts and Telecommunications Agency). In addition, GHS manages the entire training program in Germany. Since the trainees also work in other divisions, these costs are shared within the Group in accordance with a group agreement which came into effect from 2005 onwards.

The costs relating to the "Other" area depend on the duties Group Headquarters or central units assumed. A main cost item involves personnel costs, which are incurred for the responsible staff members in Group Headquarters or for the centralized functions positions at GHS (accounting, human resource management). Personnel costs will continue in line with staff size, which is projected to remain almost unchanged in the years going forward. All other significant costs will be continued at a standard level since no changes are planned in the responsibilities of Group Headquarters.

This area also reports the social benefit costs and benefits for civil servants as well as the total costs of training, as described above. In addition, the "Other" area also includes other cost items, which relate to the areas of innovation, group marketing and public relations, costs in helping the foreign companies convert to the T-brand, the portal and/or shopping contract with T-Online, and personnel-related cost of materials (for example, information technology work station systems, travel costs).

During the projection period, the amortization item includes, among other things, the budgeted capital expenditures for trademark support in connection with the realignment and expansion of the T-Punkt shops.

Generally the projected results for 2014 will be used as the basis for forecasting the **sustainable earnings** in the years from 2015 onwards. Notwithstanding this approach, the expiration of the portal and shopping agreement with T-Online on 31 December 2014 will produce fewer costs. Results will also be aided by the anticipated expiration of the personnel placement agency, Vivento. To this end, the long-term expiration of Vivento was taken into account in the other operating income/expenses items in the form of an equivalent annuity (*wertäquivalente Annuität*). Furthermore, long-term property maintenance costs have been included in the cost of sales.

Instead of the amortization/depreciation expense, which is included in the projection years 2005 through 2014, the projection used the average reinvestment rate, which would be required to maintain business operations, as based on the long-term forecast, which serves as the foundation for the sustainable earnings. Except for real estate, the depreciation reported for the last projection year will be used as the sustainable reinvestment rate for investments in all areas. For purposes of factoring in the required maintenance of the real estate assets, the age structure and average use periods of the asset groups (*Anlagengruppen*) must be included in the calculation of a reinvestment rate. Thus, in order to calculate the reinvestment rate, the depreciation on the real estate portfolio as reported at the end of the projection period and the depreciation for the replacement investments, which must be made annually in the later years, were both taken into account for the individual asset groups. Based on the depreciation applied in the later years, the reinvestment rate for these asset groups was calculated as an equivalent annuity.

5.1.5 Deutsche Telekom business plans

The consolidated business plans of Deutsche Telekom (including comparisons with 2003 and 2004) are set forth in the table below. The consolidated income statements prepared in accordance with IFRS for 2003 and 2004 and listed alongside the consolidated business plans have been reconciled with the consolidated income statements publicly filed under German GAAP, and this reconciliation statement is set forth in the attached Annex ("Presentation of the preliminary consolidated balance sheets, consolidated income statements and consolidated net financial debt prepared in accordance with IFRS").

	Actual		**Medium-term planning**			**Long-term planning**							**Sustainable**
Deutsche Telekom	**2003 EUR m**	**2004 EUR m**	**2005 EUR m**	**2006 EUR m**	**2007 EUR m**	**2008 EUR m**	**2009 EUR m**	**2010 EUR m**	**2011 EUR m**	**2012 EUR m**	**2013 EUR m**	**2014 EUR m**	**2015 ff. EUR m**
Net revenue	55,503	57,360	61,114	63,992	66,518	67,976	70,795	73,758	76,547	79,323	82,170	84,846	86,543
Cost of sales	29,369	31,559	30,892	32,199	33,275	34,246	35,835	37,121	38,418	39,504	40,708	42,130	44,283
Gross profit	**26,134**	**25,801**	**30,222**	**31,793**	**33,243**	**33,729**	**34,960**	**36,637**	**38,129**	**39,819**	**41,461**	**42,716**	**42,260**
as a % of net revenue	*47.1%*	*45.0%*	*49.5%*	*49.7%*	*50.0%*	*49.6%*	*49.4%*	*49.7%*	*49.8%*	*50.2%*	*50.5%*	*50.3%*	*48.8%*
Selling costs	12,747	12,837	13,546	13,824	13,964	14,108	14,458	14,660	14,864	15,111	15,233	15,457	15,794
General and admin. costs	4,596	4,506	5,917	6,029	5,884	5,820	5,941	6,013	6,018	6,113	6,170	6,238	6,318
Other op. inc./exp., net	-406	-2,198	97	-83	-25	-23	-76	-105	-204	-202	-246	-252	270
Operating results	**8,385**	**6,261**	**10,856**	**11,856**	**13,370**	**13,778**	**14,485**	**15,860**	**17,043**	**18,392**	**19,812**	**20,769**	**20,418**
as a % of net revenue	*15.1%*	*10.9%*	*17.8%*	*18.5%*	*20.1%*	*20.3%*	*20.5%*	*21.5%*	*22.3%*	*23.2%*	*24.1%*	*24.5%*	*23.6%*
Financial expense, net	-4,236	-2,753	-3,234	-2,822	-2,464	-2,146	-1,917	-1,830	-1,519	-1,284	-1,108	-1,037	-1,134
Income taxes	1,744	1,528	2,406	600	2,571	4,470	4,815	5,355	5,931	6,527	7,150	7,514	7,344
Income after taxes	**2,404**	**1,980**	**5,216**	**8,434**	**8,336**	**7,162**	**7,753**	**8,674**	**9,593**	**10,581**	**11,554**	**12,218**	**11,940**
Inc. appl. to minority shareh.	-457	-426	-357	-414	-478	-532	-572	-606	-639	-668	-691	-717	-731
Net income	**1,946**	**1,554**	**4,859**	**8,019**	**7,857**	**6,630**	**7,182**	**8,068**	**8,954**	**9,913**	**10,863**	**11,501**	**11,209**
as a % of net revenue	*3.5%*	*2.7%*	*8.0%*	*12.5%*	*11.8%*	*9.8%*	*10.1%*	*10.9%*	*11.7%*	*12.5%*	*13.2%*	*13.6%*	*13.0%*
Add. info:													
Operating result	8,385	6,261	10,856	11,856	13,370	13,778	14,485	15,860	17,043	18,392	19,812	20,769	20,418

	Actual		Medium-term planning			Long-term planning							Sustainable
Amortization/depreciation	10,304	13,128	9,948	9,873	9,476	9,216	9,250	9,080	9,285	9,108	8,878	8,927	10,100
EBITDA	**18,689**	**19,389**	**20,804**	**21,730**	**22,845**	**22,994**	**23,734**	**24,940**	**26,328**	**27,501**	**28,690**	**29,696**	**30,518**
as a % of net revenue	*33.7%*	*33.8%*	*34.0%*	*34.0%*	*34.3%*	*33.8%*	*33.5%*	*33.8%*	*34.4%*	*34.7%*	*34.9%*	*35.0%*	*35.3%*

The consolidated financial projections of Deutsche Telekom were derived from the business plans made by the T-Com, T-Mobile, T-Systems, GHS and T-Online divisions. For that purpose, the requisite consolidating entries were made.

The reconciliation of net revenue and operating results as between the divisions and the Group is set forth below:

	Medium-term planning			**Long-term planning**							**Sustainable**
Deutsche Telekom	**2005 EUR m**	**2006 EUR m**	**2007 EUR m**	**2008 EUR m**	**2009 EUR m**	**2010 EUR m**	**2011 EUR m**	**2012 EUR m**	**2013 EUR m**	**2014 EUR m**	**2015 ff. EUR m**
Net revenue											
T-Com	26,254	25,854	25,505	23,925	23,729	23,535	23,404	23,264	23,382	23,507	23,507
T-Mobile	29,330	30,932	32,518	34,142	35,627	37,224	38,604	39,913	41,160	42,333	43,603
T-Systems	10,845	11,655	12,500	13,167	13,916	14,712	15,560	16,465	17,431	18,466	18,835
T-Online	2,517	3,474	4,551	5,595	6,638	7,506	8,358	9,174	9,793	10,292	10,652
GHS	4,790	4,907	4,872	4,740	4,784	4,816	4,809	4,843	4,899	4,976	4,976
Subtotal	**73,736**	**76,822**	**79,946**	**81,569**	**84,695**	**87,793**	**90,734**	**93,659**	**96,665**	**99,573**	**101,572**
Inter-division revenue	12,622	12,830	13,428	13,593	13,900	14,035	14,187	14,336	14,495	14,727	15,030
Group net revenue	**61,114**	**63,992**	**66,518**	**67,976**	**70,795**	**73,758**	**76,547**	**79,323**	**82,170**	**84,846**	**86,543**
Operating results											
T-Com	5,870	5,781	5,711	4,780	4,534	4,734	4,940	5,536	6,198	6,314	6,064
T-Mobile	5,334	6,167	7,297	8,230	8,907	9,773	10,473	11,089	11,542	11,943	11,312
T-Systems	511	585	737	820	911	1,010	1,118	1,235	1,344	1,483	1,513
T-Online	202	424	751	1,068	1,295	1,514	1,764	1,966	2,097	2,274	2,353
GHS	-1,060	-1,101	-1,125	-1,120	-1,162	-1,172	-1,251	-1,434	-1,370	-1,245	-824
Group operating results	**10,856**	**11,856**	**13,370**	**13,778**	**14,485**	**15,860**	**17,043**	**18,392**	**19,812**	**20,769**	**20,418**

Consolidation entries as part of financial planning co-ordinated between the divisions did not affect net income. The business plans of the individual divisions up to projected operating results were supplemented at the group level by the additional entries, "net financial result" and "taxes on income"; these items were calculated as follows:

The **net financial result** in 2004 consisted of net interest expenses (EUR 3.8 billion) and the result from associated and related companies (EUR 1 billion). The net interest in 2004 comprises interest expenses of approximately EUR 4.9 billion and interest income of approximately EUR 1.1 billion. The improvement in the net financial result in 2004 compared to the previous year is mostly a reflection of lower interest expenses, which may be attributed to the repayment of certain bond positions. Results from associated and related companies include primarily the pro rata earnings of PTC and the dividends of MTS as well as the one-time gain on the 2004 sale of a 15% shareholding in this company.

Provision was made in the financial statements of Deutsche Telekom for the year ended 31 December 2004 for anticipated additional costs of operating services in connection with the Toll Collect project. The projections include the impact of the provision used and the current costs incurred by T-Systems for Toll Collect.

The net interest result was derived from integrated financial statements and cash flow statements. The contracted bonds and loan accounts were rolled forward to reflect their individual interest rates and settlement terms, and taking into consideration movements in derivative positions. These debts comprise, for the most part, fixed interest bonds with fixed maturity dates and long-term notes. The improved interest result was caused principally through the settlement of bonds and repayment of bank loans. Since part of the operating cash flow was transferred to retained earnings, bonds and bank loan debt (excluding derivatives) decreased from approximately EUR 47.3 billion in 2004 to approximately EUR 12.5 billion in 2014. Furthermore, the net interest result includes interest expenses relating to asset backed securities, finance leasing and pension provisions; it will increase slightly from EUR 0.4 billion in 2004 to EUR 0.6 billion in 2014. Cash and cash equivalents are accounted for at the expected rate for three-month money.

The projected net result from associated and related companies is made up mainly of the share of the PTC result. Since, after the sale of 15% of the shares in MTS in 2004, the remaining 10% participation is to be treated as a non-operating asset for the purposes of this valuation, the value of the remaining shares was classified as a special item.

The **taxes on income** charge for Deutsche Telekom Group was projected on the basis of the expected taxes on income charge in the companies consolidated, taking into account movements in deferred tax assets and liabilities.

Deutsche Telekom is subject to trade tax on income at an average rate of 17%. Corporation tax is reflected at a tax rate of 25% (plus the solidarity surcharge of 5.5%). Available unutilized tax losses in particular of Deutsche Telekom, after allowing for the minimum tax charge to be paid, were taken into account. The same applies to deductions and additions to be made in determining the amount on which corporation tax is based.

In addition to Deutsche Telekom, unutilized tax losses are available mainly at T-Mobile USA and T-Mobile UK.

Deferred taxes reflect temporary differences arising between the impact of taxes on the annual accounts for tax reporting purposes and those used for the projections in which group transactions and available tax losses, insofar as they can be regarded as utilizable, are taken into consideration. Deferred taxes have been calculated in accordance with IAS 12 at the tax rates expected to be applicable in the individual countries at the time the tax losses are utilized, based on the regulations valid on the effective date of the valuation. Deferred taxes have been determined, based on the tax rates applicable to the individual countries.

The low tax rate in 2006 and 2007 is mainly the impact in those years of the IFRS available option to capitalize deferred taxes on unutilized tax losses; this impact relates to T-Mobile USA.

The **minority shares** relate mainly to third party interests in Matáv, HT-Hrvatske telekommunikacije d.d., T-Mobile CZ and T-Online.

5.1.6 Calculation of the discounted earnings value

The discounted earnings value of Deutsche Telekom's operating assets as of 1 January 2005 is calculated on the basis of Deutsche Telekom's consolidated net income and the application of the period-specific discount rates as set forth below:

	Medium-term planning			**Long-term planning**							**Sustainable**
Deutsche Telekom	**2005 EUR m**	**2006 EUR m**	**2007 EUR m**	**2008 EUR m**	**2009 EUR m**	**2010 EUR m**	**2011 EUR m**	**2012 EUR m**	**2013 EUR m**	**2014 EUR m**	**2015 ff. EUR m**
Net income	**4,859**	**8,019**	**7,857**	**6,630**	**7,182**	**8,068**	**8,954**	**9,913**	**10,863**	**11,501**	**11,209**
Retention	2,266	4,849	4,074	0	0	0	0	0	0	0	949
Value impact of retention	0	0	0	2,556	2,860	3,389	3,955	4,838	5,361	5,723	4,656
Value impact of distribution	2,593	3,170	3,784	4,074	4,322	4,679	4,999	5,075	5,503	5,777	5,605
Typified shareholder income tax on distribution	-454	-555	-662	-713	-756	-819	-875	-888	-963	-1,011	-981
Net earnings received	**2,139**	**2,615**	**3,121**	**5,917**	**6,425**	**7,249**	**8,079**	**9,025**	**9,900**	**10,490**	**9,280**
Net earnings received	2,139	2,615	3,121	5,917	6,425	7,249	8,079	9,025	9,900	10,490	9,280
Present value as of 12/31	124,011	131,895	139,662	144,967	150,163	154,681	158,781	162,057	164,642	166,708	
Capitalization subtotal	126,151	134,510	142,783	150,884	156,588	161,930	166,861	171,082	174,542	177,198	9,280
Discount rate	8.55%	8.47%	8.26%	8.04%	8.02%	7.84%	7.87%	7.75%	7.70%	7.63%	5.57%
Present value factor applicable to the year	0.9212	0.9220	0.9237	0.9256	0.9258	0.9273	0.9270	0.9281	0.9285	0.9291	17.9648
Applicable present value as of 01/01	116,212	124,011	131,895	139,662	144,967	150,163	154,681	158,781	162,057	164,642	166,708
Discounted earnings value as of 01/01/2005	**116,212**										

	Medium-term planning			**Long-term planning**							**Sustainable**
Deutsche Telekom	**2005 EUR m**	**2006 EUR m**	**2007 EUR m**	**2008 EUR m**	**2009 EUR m**	**2010 EUR m**	**2011 EUR m**	**2012 EUR m**	**2013 EUR m**	**2014 EUR m**	**2015 ff. EUR m**
Risk-free interest rate before typified shareholder income tax	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%
Typified shareholder income tax	-1.75%	-1.75%	-1.75%	-1.75%	-1.75%	-1.75%	-1.75%	-1.75%	-1.75%	-1.75%	-1.75%
Risk-free interest rate after typified shareholder income tax	3.25%	3.25%	3.25%	3.25%	3.25%	3.25%	3.25%	3.25%	3.25%	3.25%	3.25%
Market risk premium after typified shareholder income tax	5.50%	5.50%	5.50%	5.50%	5.50%	5.50%	5.50%	5.50%	5.50%	5.50%	5.50%

	Medium-term planning			Long-term planning							Sustainable
Beta factor unlevered	0.72	0.72	0.72	0.72	0.72	0.72	0.72	0.72	0.72	0.72	0.72
Applicable present value as of 01/01	*116,212*	*124,011*	*131,895*	*139,662*	*144,967*	*150,163*	*154,681*	*158,781*	*162,057*	*164,642*	*166,708*
Interest-bearing debt as of 01/01	*51,573*	*47,746*	*42,250*	*36,439*	*34,827*	*31,292*	*29,742*	*25,355*	*23,092*	*20,910*	*19,681*
Debt to equity ratio	0.44	0.39	0.32	0.26	0.24	0.21	0.19	0.16	0.14	0.13	0.12
Beta factor levered	0.96	0.95	0.91	0.87	0.87	0.83	0.84	0.82	0.81	0.80	0.78
Risk premium	5.30%	5.22%	5.01%	4.79%	4.77%	4.59%	4.62%	4.50%	4.45%	4.38%	4.32%
Growth rate	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	2.00%
Discount rate	**8.55%**	**8.47%**	**8.26%**	**8.04%**	**8.02%**	**7.84%**	**7.87%**	**7.75%**	**7.70%**	**7.63%**	**5.57%**

It has been assumed that the dividend payable in the year 2005 will be the same as the amount expected to be payable in respect of 2004. For the years from 2006 onwards, it was assumed that a dividend of 50% of the consolidated net income, after taking the impact of deferred taxes into account, will be paid. This dividend rate orients itself on the observed dividend rate of comparative companies.

The amounts transferred to retained earnings in the years 2005 through 2007 are used for the repayment of third party debt on which interest is being charged and thus have a favorable impact on interest. Since the factoring in of a discount rate before company-level taxes on income in respect of amounts available can be reflected at the same value by a fictitious direct transfer of the retained earnings to the shareholders, the retained earnings from 2008 onwards, were, for simplification purposes, treated as net income received by the shareholders.

The dividends are subject to a typified shareholder income tax charge of 17.5% (half credit method).

The total of the values representing net earnings received attributed to retained earnings and dividends (less typified shareholder income tax) has been capitalized at the period-specific discount rate. The period-specific discount rate was calculated based on the unlevered cost of capital taking into account the debt to equity ratio applicable to each year which will be decreased due to the expected repayment of third party debt, on which interest is charged.

5.2 Special items

Participating interests

Deutsche Telekom holds participations not only in associated and related companies, which are not operational or are of less significance and for which no investment income was assumed in the business plans for that very reason, but also non-operating participations. Non-operating participations include, above all, the shares held in MTS. These holdings were valued on the basis of their (potential) sale price. The value of specially appraised participating interests totals EUR 1,295 million.

Pension provision

In comparison with the amount of the future pension obligations as computed actuarily, the pension provision as of 31 December 2004, established in accordance with IFRS, discloses an underfunding in the provision, which under IFRS, cannot be reflected in the balance sheet. As the projected financial statements do not provide for this underfunding, the underfunding is to be accounted for as a special item in connection with the valuation of Deutsche Telekom. The negative balance after taxes of the special item arising from this underfunding amounts to EUR 309 million.

T-Online special items

Deutsche Telekom has recorded the special T-Online items related to shares in comdirect bank AG and the stock options on its own accounts as a special item in amounts, which were based on its ownership interest in T-Online (88.02% as of 28 February 2005). Deutsche Telekom recorded these *pro rated* special items at EUR 176 million.

From Deutsche Telekom's perspective, T-Online's cash and cash equivalents are required for operations and were therefore incorporated into the projected net financial result and bank debt. Recording these items as a special item would therefore lead to a double entry at Deutsche Telekom.

Stock options and convertible bonds

Under various stock option plans, Deutsche Telekom granted its employees stock options in Deutsche Telekom. If the options are exercised, then the equity value per share as established under the company valuation must be lowered, to the extent that the calculated per share price is higher than the exercise price for the option prior to the exercise of such option (dilution effect).

For purposes of calculating the negative special item caused by the stock options, a simplified assumption was made (due to the number of different stock option plans having different exercise periods) that all outstanding options, which had not yet been exercised as of 31 December 2004 and for which the exercise price was lower than the projected stock price (to be matched with the calculated equity value per share), will be fully exercised on the day of the annual shareholders' meeting.

Thus, the dilution effect from the stock options is calculated as follows:

Dilution effect of Deutsche Telekom stock options		
Preliminary equity value (discounted earnings value plus aforementioned special items) as of 01/01/2005	EUR m	117,375
Number of shares outstanding (excluding treasury stock)	Number	4,195,183,321
Preliminary value per share	EUR	27.98
Outstanding options	Number	3,661,546
Exercise price	EUR	12.36
Incoming cash flow	EUR m	45.26
Value of equity after exercise of options	EUR m	117,420
Number of shares after exercise of options	Number	4,198,844,867
Value per share after dilution	EUR	27.96
Dilution effect per share	EUR	0.01
Dilution effect as of 01/01/2005	**EUR m**	**-57**

Deutsche Telekom took over the U.S. mobile communication subsidiary's stock options plan in connection with its acquisition of the company. The outstanding **U.S. options** are served from a trust account; these options are included in Deutsche Telekom's outstanding options. Accordingly, the exercise of these options will not have a dilution effect. Ownership of the stocks remaining in the trust account, after options are exercised or the right to exercise the options has expired, returns to Deutsche Telekom. To simplify the computation of the special item U.S. stock options, it was assumed, in view of the large number of option plans and different exercise dates, that all option rights outstanding as of 31 December 2004, for which the exercise price was lower than the projected stock price, will be fully exercised on the day of the annual shareholders' meeting. The options exercised are to be stated as a special item at the exercised price. The stocks remaining in the trust account are included as a special item at their expected realizable value: this was equal to the value per stock determined by the equity value. The special item resulting from the U.S. options amounted to EUR 484 million.

On 24 February 2003, Deutsche Telekom issued a **mandatory convertible bond** on an outstanding amount of approximately EUR 2.289 million. The terms of this bond provide that the outstanding bonds must be converted into Deutsche Telekom shares on or before 1 June 2006. The conversion ratio is based on the stock price of Deutsche Telekom observed immediately before the stipulated date. The conversion ratio is, however, limited to a maximum conversion ratio of 4,237.2881 shares per bond (with a face value of EUR 50,000) on stock prices below EUR 11.80, and to a minimum conversion ratio of 3,417.1679 on stock prices higher than EUR 14.632 per share.

The mandatory bond accrues 6.5% annual interest. The converted shares will be entitled to dividends beginning in the financial year in which the conversion takes place. Any adjustments (settlement payment), which were agreed under the terms of the bond relating to dividend payments, were factored in pursuant to the contract.

The mandatory conversion will lower the equity value per share, to the extent that the calculated equity value per share is higher than the implied conversion price prior to the actual conversion (dilution effect). Since the projected stock price will be higher than EUR 14.632 per share (to be matched with the calculated equity value per share), a conversion ratio of 3,417.1679 shares per partial amount of EUR 50,000 was assumed in the calculations below.

An assumption was made that all outstanding mandatory bonds would be converted on the maturity date of 1 June 2006. Given that the debt instrument is a mandatory convertible bond, its value has been discounted to the effective date of the valuation at the discount rate for Deutsche Telekom with the same maturity.

Thus, the dilution effect from the mandatory convertible bond may be calculated as follows:

Dilution effect of Deutsche Telekom convertible bond

Preliminary equity value (discounted earnings value plus aforementioned special items) as of 06/01/2006	EUR m	129,081
Number of shares outstanding (excluding treasury stock)	Number	4,195,183,321
Preliminary value per share as of 06/01/2006	EUR	30.77
Principal amount	EUR m	2,289
Nominal amount	EUR	50,000
Conversion ratio	Number	3,417.17
Implicit number of shares outstanding due to convertible bond	Number	156,403,775
Conversion price	EUR	14.632
Implicit incoming cash flow	EUR m	2,289
Equity value after exercise of convertible bond	EUR m	131,369
Number of shares after exercise of convertible bond	Number	4,351,587,096
Value per share after dilution	EUR	30.19
Dilution effect per share	EUR	-0.58
Dilution effect convertible bond as of 06/01/2006	EUR m	-2,433
Compensation for dividend payments according to bond terms and conditions at maturity 06/01/2006	EUR m	-145
Corporate taxes	EUR m	48
Compensation payment after corporate taxes as of 06/01/2006	EUR m	-98
Special item convertible bond as of 06/01/2006	**EUR m**	**-2,531**
Discount rate		0.8898
Special item convertible bond as of 01/01/2005	**EUR m**	**-2,252**

5.3 Equity value

Thus, the equity value of Deutsche Telekom can be calculated as follows:

Derivation of Deutsche Telekom equity value	**EUR m**
Discounted earnings value	116,212
Special items	
Participating interests	1,295
Underfunding of pension provision	-309
T-Online Special items	176
Stock options program	-57
US stock options	484
Convertible bond	-2,252
Equity value as of 01/01/2005	115,550
Accumulation factor	1.027882
Equity value as of 04/29/2005	**118,771**

In order to calculate the Merger Exchange Ratio, the equity value calculated as of 1 January 2005 amounting to EUR 115,550 million must be adjusted upwards to reflect interest up to the effective date of the valuation, on which the merger of T-Online into Deutsche Telekom is approved. The equity value of Deutsche Telekom as of that date amounts to EUR 118,771 million.

The value per share of Deutsche Telekom's stock derived from the calculated equity value and the relevant number of shares is as follows:

Derivation of Deutsche Telekom value per share	
Equity value as of 04/29/2005 in EUR m	118,771
Number of shares	4,195,183,321
Value per share in EUR	**28.31**

The capital stock of Deutsche Telekom as of 31 December 2004 consisted of 4,197,854,149 registered no par value shares which, after deduction of the 2,670,828 shares in treasury stock, amounts to 4,195,183,321 shares. This number has changed marginally in the period up to the effective date of the valuation due to the exercise of options. As there has been no significant impact on the value per share, the calculation of the value per share has been based, for simplification reasons, applying the number of shares as of 31 December 2004.

6. Calculation of the merger exchange ratio

On the basis of the valuations described above for T-Online and Deutsche Telekom, the Merger Exchange Ratio is presented as follows:

Merger Exchange Ratio	T-Online	Deutsche Telekom
Equity value in EUR m	17,998	118,771
Number of relevant shares	1,223,890,578	4,195,183,321
Value per share in EUR	14.71	28.31
Calculated exchange ratio	**1**	**0.5196**

Based on the company valuations carried out and the resulting calculated Merger Exchange Ratio of the shares, the Board of Management of Deutsche Telekom and T-Online have agreed on the following Merger Exchange Ratio: the shareholders of T-Online will receive 13 shares of Deutsche Telekom stock in exchange for 25 shares of T-Online stock. This is equivalent to a rounded Merger Exchange Ratio of 1 to 0.52.

This document is a convenience translation of the German language original.
In case of discrepancy between the English and German versions, the German version shall prevail.

Annex to the Merger Report Extract from the Combined Management Report (zusammengefasster Lagebericht) of the Deutsche Telekom Group and Deutsche Telekom AG for the 2004 financial year

Presentation of the preliminary consolidated balance sheets and consolidated income statements as well as net debt under IFRS.

According to Article 4 of Regulation (EC) 1606/2002 of the European Parliament and of the Council of July 19, 2002 concerning the application of international accounting standards (Official Journal EC No. L 243 P. 1), Deutsche Telekom is required to prepare consolidated financial statements in accordance with the International Financial Reporting Standards (IFRS) for the 2005 financial year and thereafter; the opening IFRS consolidated balance sheet will be prepared for the period beginning January 1, 2003 (date of transition to IFRS in accordance with IFRS 1).

The Committee of European Securities Regulators recommends that selected IFRS financial information be disclosed in the reporting on the 2004 financial year. In line with this recommendation, we are presenting below the preliminary consolidated balance sheets, consolidated income statements and net debt under IFRS as well as the preliminary reconciliation of shareholders' equity, net income and net debt from German GAAP (HGB) to IFRS for the 2003 and 2004 financial years. The disclosure of net debt is not based on any IFRS guidance. This measure is disclosed voluntarily.

In accordance with IFRS 1, the assets and liabilities carried in the preliminary consolidated balance sheets and consolidated income statements under IFRS that are presented below are measured in line with the relevant IFRS standards, compliance with which is mandatory as of December 31, 2005, the date on which the consolidated financial statements under IFRS are prepared for the first time, to the extent that these statements were published up until December 31, 2004. Deutsche Telekom has applied IFRIC 4 since January 1, 2003. The resulting differences between the IFRS carrying amounts and the carrying amounts of the assets and liabilities in the consolidated balance sheet under German GAAP for the period ended December 31, 2002 are recognized directly in equity at the date of transition to IFRS.

There can be no guarantee that the final consolidated balance sheets, consolidated income statements and net debt under IFRS will not deviate from the preliminary consolidated balance sheets, consolidated income statements and net debt presented below, because the IASB may make further pronouncements before the final consolidated financial statements as of December 31, 2005 are prepared. Moreover, the EU Commission has yet to endorse individual pronouncements by the IASB that have already been taken into account in the financial information presented below. We would also like to point out that the statements presented below are not a full set of consolidated financial statements under IFRS as defined by IAS 1. In this respect, there are no first-time consolidated financial statements under IFRS within the meaning of IFRS 1. Deutsche Telekom will prepare its first set of consolidated IFRS financial statements as defined by IFRS 1 for the period ended December 31, 2005. IFRS will replace German GAAP in Deutsche Telekom's external reporting from the first quarter of 2005.

In general, the carrying amounts of the assets and liabilities from the consolidated balance sheet under German GAAP for the period ended December 31, 2002 must be measured retrospectively in the IFRS opening consolidated balance sheet as of January 1, 2003 on the basis of those IFRSs in force at December 31, 2005. IFRS 1 nevertheless provides exemptions from this principle in specific cases. The main exemptions used by Deutsche Telekom are explained below:

Business combinations

IFRS 3 does not need to be applied retrospectively to business combinations that took place before the date of the transition to IFRS. Deutsche Telekom applies this exemption. The classification of a business combination under German GAAP must be maintained in this case. As a rule, all assets and liabilities that were acquired or taken over in business combinations must be carried in the IFRS opening consolidated balance sheet. Assets and liabilities that do not meet the IFRS recognition criteria are not taken over into the IFRS opening consolidated balance sheet. The carrying amount of goodwill under German GAAP is taken over subject to any necessary adjustments. The only adjustment to be made at Deutsche Telekom is the recognition of impairment losses on goodwill at the date of transition.

Revaluation as deemed cost

Deutsche Telekom applies the exemption of revalutation as deemed cost and transferred the fair values carried in the opening consolidated balance sheet on the occasion of the privatization as of January 1, 1995 to the IFRS financial statements as the deemed cost of the relevant assets and liabilities as of January 1, 1995. For the period from January 1, 1995 to January 1, 2003 (IFRS opening consolidated balance sheet), these figures were carried in accordance with the IFRS regulations on subsequent measurement.

Employee benefits

Contrary to the corridor approach in IAS 19, actuarial gains and losses from defined benefit plans may be recognized in shareholders' equity at the date of transition to IFRS. Deutsche Telekom applies this exemption.

Cumulative translation differences

Differences from the translation of financial statements presented in a foreign currency must be directly recognized in equity in accordance with IAS 21. In line with the principle of retrospective application of IFRS, these differences would have to be determined retrospectively. According to the exemption in IFRS 1, currency translation adjustments may be deemed to be zero at the date of transition. Deutsche Telekom applies this exemption.

Share-based payments

Under IFRS 1, equity instruments from share-based options granted on or before November 7, 2002 and those granted after November 7, 2002 and vested before January 1, 2005, do not have to be recognized under IFRS 2 by a first-time adopter. Deutsche Telekom makes use of this exemption.

Preliminary consolidated balance sheets under IFRS.

Assets	Dec. 31, 2004	Dec. 31, 2003	Jan. 1, 2003
	billions of €	billions of €	billions of €
Current assets	**19.0**	**21.5**	**15.2**
Cash and cash equivalents	8.0	9.1	1.9
Trade and other receivables	6.7	7.6	7.6
Current recoverable income taxes	0.3	1.0	1.3
Other current financial assets	1.8	2.1	2.5
Inventories	1.2	1.0	1.2
Other current assets	1.0	0.7	0.7
Noncurrent assets	**110.1**	**118.1**	**132.2**
Intangible assets	50.7	55.4	61.9
Property, plant, and equipment	46.3	49.3	54.9
Equity-accounted financial assets	2.7	2.4	2.8
Other noncurrent financial assets	1.7	1.4	2.2
Deferred tax assets	8.3	9.3	10.2
Other noncurrent assets	0.4	0.3	0.2
	129.1	**139.6**	**147.4**

Shareholders' equity and liabilities

Current liabilities	**26.2**	**30.4**	**26.7**
Current financial liabilities	14.1	18.9	15.5
Trade and other payables	6.2	6.4	6.5
Income tax liabilities	0.7	0.2	0.3
Current provisions	3.7	3.4	3.0
Other current liabilities	1.5	1.5	1.4
Noncurrent liabilities	**57.0**	**65.4**	**75.5**
Noncurrent financial liabilities	38.1	46.3	56.9
Provisions for pensions and other employee benefits	4.2	4.2	4.1
Other noncurrent provisions	3.1	2.6	2.1
Deferred tax liabilities	9.7	10.6	10.7
Other noncurrent liabilities	1.9	1.7	1.7
Liabilities	**83.2**	**95.8**	**102.2**
Shareholders' equity	**45.9**	**43.8**	**45.2**
Issued capital	10.7	10.7	10.7
Capital reserves	49.5	49.5	49.6
Retained earnings incl. carryforwards	(17.7)	(19.6)	(19.6)
Other comprehensive income	(2.6)	(2.9)	0.4
Consolidated net profit	1.6	1.9	
	41.5	**39.6**	**41.1**
Minority interest	**4.4**	**4.2**	**4.1**
	129.1	**139.6**	**147.4**

Preliminary consolidated income statements under IFRS.

	2004 **billions of €**	**2003** **billions of €**
Net revenue	**57.4**	**55.5**
Cost of sales	(31.6)	(29.4)
Gross profit	**25.8**	**26.1**
Selling expenses	(12.8)	(12.7)
General and administrative expenses	(4.5)	(4.6)
Other operating income	1.7	2.4
Other operating expenses	(3.9)	(2.8)
Profit (loss) from operations	**6.3**	**8.4**
Net interest income (loss)	(3.5)	(3.9)
Share of profit (loss) of equity-accounted investments	0.9	0.3
Other financial income (finance costs)	(0.2)	(0.7)
Financial income (finance costs)	**(2.8)**	**(4.3)**
Accounting profit	**3.5**	**4.1**
Income taxes	(1.5)	(1.7)
Net profit	**2.0**	**2.4**
Profit attributable to minority interests	0.4	0.5
Consolidated net profit	1.6	1.9

Preliminary reconciliations of shareholders' equity.

		Dec. 31, 2004 billions of €	Dec. 31, 2003 billions of €	Jan. 1, 2003 billions of €
Shareholders' equity under German GAAP		**37.9**	**33.8**	**35.4**
Goodwill	(1)	(3.1)	(3.5)	(6.0)
Mobile communications licenses	(1)	9.8	13.1	14.0
Software	(2)	0.6	0.6	0.6
Borrowing costs	(3)	(0.5)	(0.6)	(0.8)
Measurement of investments in companies not fully consolidated and not accounted for in the consolidated financial statements under the equity method	(4)	0.9	0.3	0.3
Leases	(5)	(0.6)	(0.5)	(0.2)
Provisions	(6)	1.6	1.5	1.1
Pension provisions		0.4	0.3	(0.1)
Other provisions		1.2	1.2	1.2
Deferred revenue	(7)	(1.2)	(1.1)	(1.1)
Other IFRS adjustments	(8)	0.7	0.6	0.7
Deferred taxes	(9)	(0.2)	(0.4)	1.2
Deferred tax assets		6.4	7.4	9.1
Deferred tax liabilities		(6.6)	(7.8)	(7.9)
Preliminary shareholders' equity under IFRS		**45.9**	**43.8**	**45.2**

Preliminary reconciliations of net profit.

		2004 billions of €	**2003 billions of €**
Income after taxes under German GAAP		**4.9**	**1.6**
Goodwill	(1)	0.1	1.6
Mobile communications licenses	(1)	(3.1)	1.1
Software	(2)	(0.0)	(0.0)
Borrowing costs	(3)	0.1	0.2
Measurement of investments in companies not fully consolidated and not accounted for in the consolidated financial statements under the equity method	(4)	(0.0)	(0.0)
Leases	(5)	(0.1)	(0.3)
Provisions	(6)	0.1	0.4
Pension provisions		0.1	0.4
Other provisions		(0.0)	0.0
Deferred revenue	(7)	(0.1)	0.0
Other IFRS adjustments	(8)	(0.0)	(0.2)
Deferred taxes	(9)	0.1	(2.0)
Preliminary net profit under IFRS		**2.0**	**2.4**

Explanatory notes on the reconciliation of preliminary shareholders' equity and the preliminary net profit under IFRS.

(1)

Goodwill and mobile communications licenses

In contrast to German GAAP, under IFRS U.S. mobile communications licenses are not amortized on account of their indefinite useful life but instead are reviewed for impairment once a year ("impairment-only approach"). The impairment test is not performed separately for individual assets, however, but at the level of the cash-generating unit T-Mobile USA. Since goodwill is also allocated to the cash-generating unit T-Mobile USA under IFRS, this goodwill must be initially written down under IAS 36 in case of an impairment. For this reason, the amortization and impairment of the U.S. mobile communications licenses charged in accordance with German GAAP as of January 1, 2003 and the write-up recognized in 2004 were reversed. The impairment test performed in accordance with IFRS resulted in an impairment of the cash-generating unit T-Mobile USA as of January 1, 2003 and December 31, 2003 which was recognized through a reduction in the goodwill carrying amount. As part of the winding up of the U.S. mobile communications joint venture with Cingular Wireless in 2004 and the ensuing transfer of mobile communications licenses, these assets were partially written down.

The impairment test of the cash-generating unit T-Mobile UK, which is part of the T-Mobile division, resulted in an impairment under IFRS as of January 1, 2003 and December 31, 2004. The impairment loss of T-Mobile UK's UMTS license recognized in the individual measurement under German GAAP was reversed under IFRS as of January 1, 2003.

The impairment test of the cash-generating unit T-Mobile Netherlands, which is part of the T-Mobile division, resulted in an impairment under IFRS as of January 1, 2003 which was recognized through a reduction in the goodwill carrying amount.

The impairment test of the cash-generating unit MATÁV, which is part of the T-Com division, resulted in impairment under IFRS as of January 1, 2003 and December 31, 2003; the impairment test of the cash-generating unit Slovak Telecom, which is part of the T-Com division, resulted in impairment under IFRS as of December 31, 2004. These impairments were recognized through a goodwill write-down.

In connection with UMTS licenses, adjustments have to be made on account of the fact that under German GAAP amortization begins at the date of acquisition, while under IFRS the date on which the network starts operating is relevant for the start of amortization. The reversal of the amortization already charged under German GAAP increases shareholders' equity under IFRS on all of the dates presented.

(2)

Software

Recognizing internally generated software, which is not permissible under German GAAP, increases shareholders' equity under IFRS in all of the periods presented. In the periods following the recognition, the net profit under IFRS remains largely unaffected.

(3)

Borrowing costs

The fact that Deutsche Telekom does not make use of the option under IFRS to recognize borrowing costs results in adjustments having to be made. Under German GAAP, borrowing costs accounted for during the construction period were recognized. Not recognizing borrowing costs reduces shareholders' equity under IFRS in all periods. The lower amortization than under German GAAP increases net profit.

(4)

Measurement of investments in companies not fully consolidated and not accounted for in the consolidated financial statements under the equity method

Investments in companies not fully consolidated and not accounted for in the consolidated financial statements under the equity method must be measured at fair value according to IAS 39. As a rule, the resulting unrealized gains and losses are recognized directly in equity. According to German GAAP, these assets are measured at amortized cost or, if appropriate, at the lower fair value. As a result of the different accounting policies used under IFRS and German GAAP, the IFRS shareholders' equity increases in all of the periods presented.

(5)

Leases

The tax treatment of leases is generally used for the classification of leases in consolidated financial statements under German GAAP. Under IFRS, the classification of leased assets is defined in IAS 17. A considerably larger number of leases tends to be classified as finance leases under IFRS. While in an operating lease it is the lessor that recognizes the asset, it is the lessee that recognizes the asset in a finance lease.

Deutsche Telekom has entered into sale and leaseback transactions in connection with its real estate portfolio. Under German GAAP, these transactions were usually treated as a sale of the real estate that was subsequently leased back, whereas under IFRS the buildings must be classified as finance leases and the land as operating leases. Under IFRS, this results in the recognition of interest expense and a depreciation charge for the buildings and the recognition of rental expense for the land; the disposal gain must be spread over the term of the lease. Under German GAAP, gains or losses from the sale of real estate are recorded, as is rental expense.

This reduces shareholders' equity and net profit under IFRS in all of the periods presented.

(6)

Provisions

Provisions must be recognized for pension obligations under both German GAAP and IFRS. Under German commercial law, Deutsche Telekom's pension obligations were calculated in accordance with the provisions of SFAS 87. Differences between the carrying amounts under IFRS and SFAS 87 arise in particular from the different treatment of actuarial gains and losses and the fact that the additional minimum liability is not recognized under IFRS. This reduces shareholders' equity in the IFRS opening consolidated balance sheet and increases it at the two other reporting dates presented. Net profit increases in the two periods presented.

In the other provisions, it is primarily the restructuring provisions that increase shareholders' equity in all of the periods presented because the recognition of restructuring provisions under IFRS is subject to more detailed and stricter criteria than under German GAAP. Furthermore, provisions for future internal expenses that may be recognized under German GAAP are not carried under IFRS.

(7)

Deferred revenue

The main difference between German GAAP and IFRS is the way up-front fees are recognized. Under German GAAP, the up-front fees are recognized as revenue on the date on which the line is activated. Under IFRS, on the other hand, the up-front fees and the incremental costs are accrued over the average duration of the customer relationship. This reduces shareholders' equity in all of the periods presented. Net profit remains largely unaffected.

(8)

Other IFRS adjustments

Other IFRS adjustments relate, for example, to the different accounting principles regarding asset-backed securities (ABS) transactions, long-term construction contracts (percentage-of-completion method), derivatives and measurement of property, plant, and equipment. All in all this increased shareholders' equity in all of the periods presented. Net profit remains largely unaffected.

(9)

Deferred taxes

Deutsche Telekom did not apply GAS 10 in its consolidated financial statements under German GAAP up to December 31, 2004. The differences in the definition of deferred taxes under IFRS and German GAAP relate in particular to Deutsche Telekom AG's "contribution goodwill", tax loss carryforwards, and general recognition and measurement differences between IFRS and German GAAP.

As a result of the privatization of Deutsche Telekom AG, goodwill was recognized in the tax accounts ("contribution goodwill"), yet no goodwill is to be capitalized in Deutsche Telekom AG's consolidated balance sheets under IFRS. Deutsche Telekom recognizes deferred taxes on this temporary difference in accordance with IAS 12 that will be reversed on a pro rata basis through goodwill amortization. The recognition of deferred taxes on goodwill increases shareholders' equity under IFRS in all of the periods presented; net profit decreases in all of the periods presented.

Furthermore, under IFRS in contrast to German GAAP deferred tax assets are recognized on future expected tax reductions from the deduction of tax loss carryforwards. Taking the forecast development of earnings into account, it is sufficiently certain that the recognized deferred tax assets from loss carryforwards will be realized. The recognition of these deferred tax assets increases shareholders' equity and reduces net profit under IFRS in all of the periods presented.

The deferred taxes recognized on measurement differences primarily relate to deferred tax liabilities on measurement differences between IFRS and German GAAP in connection with the realized hidden reserves for U.S. mobile communications licenses. The recognition of these deferred tax liabilities reduces shareholders' equity under IFRS. Since these licenses are not amortized, the deferred tax liabilities are initially not released. The impairment recognized under IFRS in 2004 and the reversal of the write-up of these licenses under German GAAP resulted in the corresponding release of the deferred tax liabilities and, consequently, in an increase in net profit under IFRS.

Preliminary net debt under IFRS.

	Dec. 31, 2004	**Dec. 31, 2003**	**Jan. 1, 2003**
	billions of €	**billions of €**	**billions of €**
Bonds	39.4	51.2	56.4
Liabilities to banks	3.1	3.8	6.3
Liabilities to non-banks from promissory notes	0.7	0.8	0.8
Liabilities from derivatives	1.1	1.3	1.2
Lease liabilities	2.5	2.4	1.8
Liabilities arising from ABS transactions	1.6	1.2	1.2
Other financial liabilities			0.1
Gross debt under IFRS	**48.4**	**60.7**	**67.8**
Cash and cash equivalents	8.0	9.1	1.9
Available-for-sale financial assets	0.1	0.1	0.5
Derivatives	0.3	0.3	0.8
Other financial assets	0.4	0.5	0.3
Preliminary net debt under IFRS	**39.6**	**50.7**	**64.3**

Preliminary reconciliations of net debt.

		Dec. 31, 2004 billions of €	Dec. 31, 2003 billions of €	Jan. 1, 2003 billions of €
Net debt under German GAAP		**35.2**	**46.6**	**61.1**
Lease liabilities	(1)	2.5	2.4	1.8
Liabilities arising from ABS transactions	(2)	1.6	1.2	1.2
Other IFRS differences	(3)	0.3	0.5	0.2
Preliminary net debt under IFRS		**39.6**	**50.7**	**64.3**

Explanatory notes on the reconciliation of preliminary net debt.

(1) Lease liabilities

In the case of a finance lease, the assets are measured at the lower of the fair value of the leased property and the present value of the minimum lease payments in the lessee's balance sheet. At the same time, a lease liability is recognized. As a result, Deutsche Telekom's net debt increases.

(2) Liabilities arising from ABS transactions

As part of asset-backed securities (ABS) transactions, mostly financial assets are sold to a special-purpose entity (SPE). The SPE refinances itself on the capital market. Under IFRS, SPEs must generally be consolidated by the economic beneficiary. In total, there are three SPEs arising from ABS transactions that have to be consolidated by Deutsche Telekom. The capital market liabilities recognized by the SPEs increase Deutsche Telekom's net debt.

(3) Other IFRS differences

The other differences primarily consist of the more extensive incorporation of derivatives as well as the cash collaterals included in other financial assets with regard to ABS transactions.