

HUNGARIAN TELEPHONE & CABLE CORP

Form 10-Q

August 11, 2008

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

**FORM 10-Q**

(Mark One)

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended June 30, 2008

OR

**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 1-11484

**HUNGARIAN TELEPHONE AND CABLE CORP.**

(Exact name of registrant as specified in its charter)

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**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**13-3652685**  
(I.R.S. Employer  
Identification No.)

**1201 Third Avenue, Suite 3400 Seattle, WA 98101-3034**

(Address of principal executive offices)

**(206) 654-0204**

(Registrant's telephone number, including area code)

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 ninety days. Yes  No

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 the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated Filer

Accelerated filer

Non-accelerated Filer

Smaller reporting company

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest possible date:

Common Stock, \$.001 par value  
(Class)

16,425,733 Shares  
(Outstanding as of August 8, 2008)

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HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARIES

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## Part I. Financial Information

## HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARIES

**Item 1. Financial Statements****Condensed Consolidated Balance Sheets**

(In thousands, except share and per share data)

**Assets**

|   | <b>June 30, 2008</b><br><b>(unaudited)</b> | <b>December 31, 2007</b> |
|---|--|--------------------------|
| Current assets:   |  |                          |
| Cash and cash equivalents   | \$ 31,538                                  | \$ 20,897                |
| Receivable from escrow  | 17,077                                     |                          |
| Accounts receivable, net of allowance of \$26,255 in 2008 and \$17,633 in 2007                | 101,282                                    | 85,684                   |
| Derivative financial instruments  | 1,045                                      | 977                      |
| Prepaid expenses and accrued income   | 5,410                                      | 5,049                    |
| Other current assets  | 9,836                                      | 6,228                    |
| Total current assets  | 166,188                                    | 118,835                  |
| Property, plant and equipment, net of depreciation of \$296,659 in 2008 and \$216,090 in 2007 | 917,773                                    | 691,485                  |
| Goodwill, net   | 83,589                                     | 81,534                   |
| Intangibles assets, net of amortization of \$50,641 in 2008 and \$35,310 in 2007              | 311,676                                    | 200,948                  |
| Deferred costs  | 18,239                                     | 14,828                   |
| Deferred tax asset  | 653  |                          |
| Derivative financial instruments  | 2,403                                      | 2,076                    |
| Other non-current assets  | 1,248                                      | 485                      |
| Total assets  | \$ 1,501,769                               | \$ 1,110,191             |

See accompanying notes to condensed consolidated financial statements.

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## Part I. Financial Information

## HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARIES

**Condensed Consolidated Balance Sheets**

(In thousands, except share and per share data)

**Liabilities and Stockholders' Equity**

|  | June 30, 2008<br>(unaudited) | December 31, 2007   |
|--|------------------------------|---------------------|
| <b>Current liabilities:</b>  |                              |                     |
| Current installments of long-term debt   | \$ 74,604                    | \$ 37,114           |
| Current obligations under capital leases   | 8,661                        | 430                 |
| Accounts payable   | 55,720                       | 58,797              |
| Accrued expenses and deferred income   | 84,610                       | 70,169              |
| Derivative financial instruments   | 29,913                       | 22,138              |
| Other current liabilities  | 22,742                       | 9,499               |
| Due to related parties   | 1,153                        | 1,706               |
| <b>Total current liabilities</b>   | <b>277,403</b>               | <b>199,853</b>      |
| Long-term debt, excluding current installments   | 1,046,236                    | 812,865             |
| Long-term obligations under capital leases, excluding current portion  | 9,484                        | 13                  |
| Derivative financial instruments   | 42,951                       | 17,381              |
| Deferred tax liabilities   | 20,262                       | 19,642              |
| Deferred income  | 58,949                       | 17,265              |
| Other non-current liabilities  | 7,144                        | 7,020               |
| <b>Total liabilities</b>   | <b>1,462,429</b>             | <b>1,074,039</b>    |
| <b>Commitments and contingencies</b>   |                              |                     |
| Minority interest  | 11                           | 8                   |
| Redeemable equity securities   | 15,049                       | 15,049              |
| <b>Stockholders' equity:</b>   |                              |                     |
| Cumulative convertible preferred stock, \$.01 par value; \$70.00 liquidation value. Authorized 200,000 shares; issued and outstanding 30,000 shares in 2008 and 2007 |                              |                     |
| Common stock, \$.001 par value. Authorized 25,000,000 shares; issued and outstanding 15,487,183 shares in 2008 and 15,471,950 shares in 2007                         | 15                           | 15                  |
| Additional paid-in capital   | 193,013                      | 193,013             |
| Accumulated deficit  | (212,116)                    | (188,298)           |
| Accumulated other comprehensive income   | 43,368                       | 16,365              |
| <b>Total stockholders' equity</b>  | <b>24,280</b>                | <b>21,095</b>       |
| <b>Total liabilities and stockholders' equity</b>  | <b>\$ 1,501,769</b>          | <b>\$ 1,110,191</b> |

See accompanying notes to condensed consolidated financial statements.



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## Part I. Financial Information

## HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARIES

**Condensed Consolidated Statements of Operations and Comprehensive Income (Loss)**

For the Three and Six Month Periods Ended June 30, 2008 and 2007

(In thousands, except share and per share data)

(unaudited)

|   | Three Months Ended<br>June 30, |             | Six Months Ended<br>June 30, |             |
|---|--------------------------------|-------------|------------------------------|-------------|
|   | 2008                           | 2007        | 2008                         | 2007        |
| Revenue   | \$ 148,060                     | \$ 92,850   | \$ 279,522                   | \$ 141,988  |
| Cost of Sales   | 59,533                         | 41,710      | 115,192                      | 66,854      |
| Gross margin  | 88,527                         | 51,140      | 164,330                      | 75,134      |
| Operating expenses                                    |                                |             |                              |             |
| Selling, general and administrative                   | 34,850                         | 23,691      | 61,483                       | 33,556      |
| Depreciation and amortization                         | 32,246                         | 17,979      | 58,933                       | 25,423      |
| Total operating expenses                              | 67,096                         | 41,670      | 120,416                      | 58,979      |
| Income from operations                                | 21,431                         | 9,470       | 43,914                       | 16,155      |
| Other income (expenses)                               |                                |             |                              |             |
| Foreign exchange gains (losses), net                  | 47,346                         | 3,455       | 34,122                       | 6,500       |
| Interest expense                                      | (30,304)                       | (14,403)    | (57,948)                     | (18,153)    |
| Interest income                                       | 402                            | 185         | 832                          | 482         |
| Gains (losses) on derivative financial instruments    | (66,672)                       | (21,841)    | (37,586)                     | (65,901)    |
| Gains (losses) from fair value changes of warrants    |                                |             |                              | (15,075)    |
| Loss on extinguishment of debt                        |                                | (2,807)     |                              | (2,087)     |
| Other, net  | (1,390)                        | 28          | (2,000)                      | (25)        |
| Income before income taxes                            | (29,187)                       | (25,913)    | (18,666)                     | (78,824)    |
| Income tax benefit (expense)                          |                                |             |                              |             |
| Current   | (1,964)                        | (968)       | (3,821)                      | (3,514)     |
| Deferred  | 3,360                          | 10,734      | (1,276)                      | 11,542      |
| Total income tax benefit (expense)                    | 1,396                          | 9,766       | (5,097)                      | 8,028       |
| Minority interest                                     | 2                              | 8           | (3)                          | 8           |
| Net income (loss)                                     | \$ (27,789)                    | \$ (16,139) | \$ (23,766)                  | \$ (70,788) |
| Cumulative convertible preferred stock dividends      | (26)                           | (26)        | (52)                         | (52)        |
| Net income (loss) attributable to common stockholders | (27,815)                       | (16,165)    | (23,818)                     | (70,840)    |
| Foreign currency translation adjustment               | (38,139)                       | (879)       | (27,003)                     | 2,557       |
| Total comprehensive income (loss)                     | (65,954)                       | (17,044)    | (50,821)                     | (68,283)    |

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Net income (loss) per common share:

|       |    |        |    |        |    |        |    |        |
|-------|----|--------|----|--------|----|--------|----|--------|
| Basic | \$ | (1.69) | \$ | (1.00) | \$ | (1.45) | \$ | (4.87) |
|-------|----|--------|----|--------|----|--------|----|--------|

|         |    |        |    |        |    |        |    |        |
|---------|----|--------|----|--------|----|--------|----|--------|
| Diluted | \$ | (1.69) | \$ | (1.00) | \$ | (1.45) | \$ | (4.87) |
|---------|----|--------|----|--------|----|--------|----|--------|

Weighted average number of common shares outstanding:

|       |            |            |            |            |
|-------|------------|------------|------------|------------|
| Basic | 16,421,302 | 16,154,120 | 16,419,011 | 14,561,931 |
|-------|------------|------------|------------|------------|

|         |            |            |            |            |
|---------|------------|------------|------------|------------|
| Diluted | 16,421,302 | 16,154,120 | 16,419,011 | 14,561,931 |
|---------|------------|------------|------------|------------|

See accompanying notes to condensed consolidated financial statements.



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## Part I. Financial Information

## HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARIES

**Condensed Consolidated Statements of Stockholders Equity**

(In thousands, except share data)

(unaudited)

|  | Shares     | Common<br>Stock | Preferred<br>Stock | Additional<br>Paid-in<br>Capital | Accumulated<br>deficit | Accumulated<br>Other<br>Comprehensive<br>Income | Total<br>Stockholders<br>Equity |
|--|------------|-----------------|--------------------|----------------------------------|------------------------|---|---------------------------------|
| Balances at December 31, 2007                    | 15,471,950 | \$ 15           |                    | 193,013                          | (188,298)              | 16,365  | \$ 21,095                       |
| Net settlement of stock option exercise          | 9,233      |                 |                    |                                  |                        |   |                                 |
| Issue of shares to directors                     | 6,000      |                 |                    |                                  |                        |   |                                 |
| Cumulative convertible preferred stock dividends |            |                 |                    |                                  | (52)                   |   | (52)                            |
| Net loss   |            |                 |                    |                                  | (23,766)               |   | (23,766)                        |
| Foreign currency translation adjustment          |            |                 |                    |                                  |                        | 27,003  | 27,003                          |
| Balances at June 30, 2008                        | 15,487,183 | 15              |                    | 193,013                          | (212,116)              | 43,368  | \$ 24,280                       |

See accompanying notes to condensed consolidated financial statements.

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## Part I. Financial Information

## HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARIES

**Condensed Consolidated Statements of Cash Flows**

For the Six Month Periods Ended June 30, 2008 and 2007

(In thousands)

(unaudited)

|   | <b>2008</b> | <b>2007</b> |
|---|-------------|-------------|
| Net cash provided by / (used in) operating activities                     | \$ 55,632   | \$ 39,732   |
| Cash flows from investing activities:                                     |             |             |
| Acquisition of telecommunications network equipment and intangible assets | (52,895)    | (17,800)    |
| Acquisition of subsidiaries, net of cash acquired                         | (49,315)    | (107,519)   |
| Settlement of derivative financial instruments                            | (12,876)    | (2,177)     |
| Proceeds from sale of assets  | 513         | 1,157       |
| Net cash provided by / (used in) investing activities                     | (114,573)   | (126,339)   |
| Cash flows from financing activities:                                     |             |             |
| Repayments of long-term debt  | (90,559)    | (158,277)   |
| Proceeds from new long-term borrowings                                    | 166,508     | 272,242     |
| Refinancing costs paid  | (7,508)     | (14,308)    |
| Principal payments under capital lease obligations                        | (2,773)     | (238)       |
| Release of restricted cash  |             | 12,251      |
| Net cash provided by / (used in) financing activities                     | 65,668      | 111,670     |
| Effect of foreign exchange rate changes on cash                           | 3,914       | 2,146       |
| Net increase in cash and cash equivalents                                 | 10,641      | 27,209      |
| Cash and cash equivalents at beginning of period                          | 20,897      | 18,794      |
| Cash and cash equivalents at end of period                                | \$ 31,538   | \$ 46,003   |

## Summary of material non-cash transactions:

We had derivative financial instruments with a negative non-cash effect of \$62.8 million for the six months ended June 30, 2007 and a negative non-cash effect of \$37.6 million for the six months ended June 30, 2008.

On March 5, 2008, in connection with the Memorex Acquisition, we assumed net debt of \$105.9 million.

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After negotiations, on July 4, 2008 we entered into a Settlement Agreement with the selling shareholders of Memorex pursuant to which the Escrow Agent was directed to return EUR 11.3 million (approximately \$17.9 million at closing foreign exchange rates) to us and the remaining EUR 0.9 million (approximately \$1.4 million at closing foreign exchange rates) was paid out to the selling shareholders of Memorex. We received our funds on July 9, 2008.

On March 28, 2007, TDC exercised its warrants for 2.5 million shares by exchanging notes in the principal amount of \$25,000,000, which were issued by us and held by TDC. We recorded a non-cash expense of \$15.1 million for the six months ended June 30, 2007 relating to the change in the fair market value of the warrants.

On April 27, 2007 in connection with the Invitel Acquisition we issued 938,550 shares with an assigned value of \$15 million and assumed debt of Invitel in the amount of \$525 million.

See accompanying notes to condensed consolidated financial statements.

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Part I. Financial Information

HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARIES

(1) Summary of Significant Accounting Policies

(a) Basis of Presentation

The accompanying unaudited condensed consolidated financial statements of Hungarian Telephone and Cable Corp. ( HTCC ) with its consolidated subsidiaries, HTCC Holdco I B.V. ( Holdco I ), HTCC Holdco II B.V. ( Holdco II ), Matel Holdings N.V. ( Matel Holdings ) Magyar Telecom B.V. ( Matel ), Invitel Tavkozlesi Szolgaltato zRt. ( Invitel ), Euroweb Romania S.A. ( Euroweb Romania ), Memorex Telex Communications AG ( Memorex ), Invitel Telecom Kft. ( Tele2 Hungary ) and Invitel Technocom Kft. ( Invitel Technocom ) (together, the Company ) include all adjustments, consisting mainly of normal recurring accruals, necessary for a fair statement of the results of the interim periods. Invitel and Memorex own and consolidate several minor non-Hungarian subsidiaries within the Central and Eastern European region.

Unless the context requires otherwise, references in this report to the Company , we , us and our refer to Hungarian Telephone and Cable Corp. and its consolidated subsidiaries.

Results for interim periods are not necessarily indicative of the results for a full year. All inter-company balances and transactions have been eliminated.

On March 5, 2008 we acquired 95.7% of the outstanding equity in Austrian-based Memorex Telex Communication AG (the Memorex Acquisition ). Memorex has operations in numerous countries within the Central and Eastern European region, including Austria, Turkey, Slovakia, Czech Republic, Germany and Romania. The final purchase price for Memorex was EUR 18.8 million (approximately \$28.6 million) plus the assumption of debt. We refinanced a significant portion of Memorex s debt at closing. We funded the Memorex Acquisition and the refinancing of the Memorex debt with a subordinated bridge loan facility. We intend to replace this bridge loan facility with longer term financing. We also intend to buy out the remaining minority shareholders in Memorex.

The accompanying unaudited condensed consolidated financial statements are prepared in accordance with generally accepted accounting principles in the U.S. (U.S. GAAP). In preparing financial statements in conformity with U.S. GAAP, management is required to make estimates and assumptions. These estimates and assumptions affect reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements, as well as revenues and expenses during the reporting period. Actual results could differ from those estimates.

The unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements of the Company for the year ended December 31, 2007, including the notes thereto, which are filed with the Unites States Securities and Exchange Commission ( SEC ).

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## Part I. Financial Information

## HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARIES

## (b) Earnings per Share

Basic earnings per share ( EPS ) is computed by dividing income attributable to common stockholders by the weighted average number of common shares outstanding for the period. The computation of diluted EPS is similar to the computation of basic EPS, except that the weighted average number of common shares outstanding is increased to include additional shares from the assumed exercise of stock options and warrants and the conversion of the convertible preferred stock, where dilutive. The number of additional shares is calculated by assuming that preferred securities were converted and that outstanding stock options and warrants were exercised and the proceeds were used to acquire shares of our common stock at the average market price during the reporting period.

The following is the reconciliation from basic earnings (loss) per share to diluted earnings (loss) per share for the three and six months ended June 30, 2008 and 2007:

| (\$ in thousands, except share data)  | 3 months ended |             | 6 months ended |             |
|---|----------------|-------------|----------------|-------------|
|   | 2008           | 2007        | 2008           | 2007        |
| Net loss attributable to common stockholders (A)  | \$ (27,815)    | \$ (16,165) | \$ (23,818)    | \$ (70,840) |
| plus: preferred stock dividends   | 26             | 26          | 52             | 52          |
| Net loss (B)  | \$ (27,789)    | \$ (16,139) | \$ (23,766)    | \$ (70,788) |
| Determination of shares:  |                |             |                |             |
| Weighted average common shares outstanding basic (C)                                    | 16,421,302     | 16,154,120  | 16,419,011     | 14,561,931  |
| Assumed conversion of dilutive stock options and cumulative convertible preferred stock |                |             |                |             |
| Weighted average common shares outstanding diluted (D)                                  | 16,421,302     | 16,154,120  | 16,419,011     | 14,561,931  |
| Net loss per common share:  |                |             |                |             |
| Basic (A/C)   | \$ (1.69)      | \$ (1.00)   | \$ (1.45)      | \$ (4.87)   |
| Diluted (B/D)   | \$ (1.69)      | \$ (1.00)   | \$ (1.45)      | \$ (4.87)   |

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Part I. Financial Information

HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARIES

For the three months ended June 30, 2008 and 2007, common stock equivalents and convertible preferred stock of 507,709 and 3,601,284, respectively, were excluded from the computation of diluted loss per share because the effect of their inclusion would be anti-dilutive.

For the six months ended June 30, 2008 and 2007, common stock equivalents and convertible preferred stock of 505,396 and 575,896, respectively, were excluded from the computation of diluted loss per share because the effect of their inclusion would be anti-dilutive.

(c) Foreign Currency Translation

We use the Hungarian forint ( HUF ) as the functional currency for our Hungarian subsidiaries. Our Hungarian subsidiaries' assets and liabilities are translated into U.S. dollars using the exchange rates in effect at the balance sheet date. Results of operations are translated using the average exchange rates prevailing throughout the period. Euro denominated debt is re-measured into HUF with a corresponding charge to earnings as exchange gains (losses). The effects of exchange rate fluctuations on translating HUF assets and liabilities into U.S. dollars are accumulated as part of other comprehensive income in stockholders' equity.

We use the applicable local currency as the functional currency of Invitel's non-Hungarian subsidiaries except for Memorex and its subsidiaries. Accordingly, foreign currency assets and liabilities of these non-Hungarian subsidiaries are translated into HUF using the exchange rates in effect at the balance sheet date. Results of operations are translated using the average exchange rates prevailing throughout the period. The effects of exchange rate fluctuations on translating the local currency assets and liabilities of these subsidiaries into HUF are accumulated as part of foreign exchange gains (losses) in the consolidated statement of operations.

We use the euro ( EUR ) as the functional currency of Memorex and Memorex's subsidiaries. Accordingly, foreign currency assets and liabilities of Memorex's subsidiaries are translated into EUR using the exchange rates in effect at the balance sheet date. Results of operations are translated using the average exchange rates prevailing throughout the period. The effects of exchange rate fluctuations on translating the local currency assets and liabilities of Memorex's subsidiaries into EUR are accumulated as part of foreign exchange gains (losses) in the consolidated statement of operations. The effects of exchange rate fluctuations on translating EUR assets and liabilities into U.S. dollars are accumulated as part of other comprehensive income in stockholders' equity.

The translation of the subsidiaries' Hungarian forint denominated balance sheets into U.S. dollars as of June 30, 2008, has been affected by the strengthening of the Hungarian forint against the U.S. dollar from 172.61 as of December 31, 2007 to 149.76 as of June 30, 2008, an approximate 15% depreciation in value of the U.S. dollar against the HUF. The average Hungarian forint/U.S. dollar exchange rates used for the translation of the subsidiaries' Hungarian forint denominated statements of operations and statements of cash flows into U.S. dollars for the three months ended June 30, 2008 and 2007 were 158.64 and 184.29, respectively. The average

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Part I. Financial Information

HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARIES

Hungarian forint/U.S. dollar exchange rates used for the translation of the subsidiaries' Hungarian forint denominated statements of operations and statements of cash flows into U.S. dollars for the six months ended June 30, 2008 and 2007 were 165.99 and 188.53, respectively.

The translation of the subsidiaries' euro denominated balance sheets into U.S. dollars as of June 30, 2008, has been affected by the strengthening of the euro against the U.S. dollar from 1.47 as of December 31, 2007 to 1.58 as of June 30, 2008, an approximate 7% depreciation in value of the U.S. dollar against the euro. The average euro/U.S. dollar exchange rates used for the translation of the subsidiaries' euro denominated statements of operations and statements of cash flows into U.S. dollars for the three months ended June 30, 2008 and 2007 were 1.56 and 1.35, respectively. The average euro/U.S. dollar exchange rates used for the translation of the subsidiaries' euro denominated statements of operations and statements of cash flows into U.S. dollars, for the six months ended June 30, 2008 and 2007 were 1.53 and 1.33, respectively.

(d) Stock Based Compensation

We have three equity compensation plans: the stock option plan that was adopted by our Board of Directors in April 1992, which was amended and renamed upon the approval of our stockholders in 2002 (the "2002 Plan"); the Non-Employee Director Stock Option Plan (the "Directors' Plan") which was established by our Board of Directors in 1997; and the 2004 Long-Term Incentive Plan (the "2004 Plan") which was approved by our stockholders in 2004.

As of June 30, 2008, we had outstanding options to purchase 80,000 shares of common stock issued from the 2002 Plan; outstanding options to purchase 85,000 shares of common stock issued from the Directors' Plan; and outstanding options to purchase 410,000 shares of common stock under the 2004 Plan. Upon the approval of the 2004 Plan, we agreed not to issue any more options from either the 2002 Plan or the Directors' Plan.

Statement of Financial Accounting Standard (SFAS) No. 123 (revised 2004), Share-Based Payment, (SFAS 123R) requires the measurement and recognition of compensation expense based on the fair value of the employee stock based awards issued. Compensation expense for awards and related tax effects are recognized as they vest. We adopted SFAS 123R using the modified prospective transition method. Under this transition method, compensation cost recognized effective January 1, 2006 includes: (1) compensation cost for all share based awards granted prior to, but not yet vested as of, January 1, 2006 based on the original measure of the grant date fair value method under the provisions of SFAS 123R for pro-forma disclosure; and (2) compensation cost for all share-based awards granted subsequent to January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS 123R. Results for periods prior to the adoption of the new standard were not restated at the time of transition.

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In addition, awards previously treated as variable awards are classified as liability awards under the new standard and are subject to revaluation each period, with a corresponding adjustment in earnings for changes in the fair value of outstanding awards.

(e) Recently Adopted Accounting Pronouncements

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements ( SFAS 157 ), which defines fair value, establishes a framework for measuring fair value in GAAP, and enhances disclosures about fair value measurements. SFAS 157 applies when other accounting pronouncements require fair value measurements; it does not require new fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those years. In February 2008 the FASB issued a Staff Position that delays the effective date of SFAS 157. Delayed application of SFAS 157 is permitted for non-financial assets and non-financial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually), until fiscal years beginning after November 15, 2008, and interim periods within those fiscal years. We adopted SFAS 157 as of January 1, 2008 for financial assets and liabilities. The adoption of SFAS 157 has not had a material effect on our financial position or results of operations.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115 ( SFAS 159 ), which permits entities to choose to measure many financial instruments and certain warranty and insurance contracts at fair value on a contract-by-contract basis. SFAS 159 applies to all reporting entities and contains financial statement presentation and disclosure requirements for assets and liabilities reported at fair value as a consequence of the election. SFAS 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. We adopted SFAS 159 as of January 1, 2008. The adoption of SFAS 159 has not had a material effect on our financial position or results of operations.

(f) Recently Issued Accounting Pronouncements

In March 2008, the FASB issued FASB Statement No. 161, Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133 ( SFAS 161 ). SFAS 161 changes disclosure requirements for derivative instruments and hedging activities. The Statement requires enhanced disclosures about (a) how and why derivative instruments are used, (b) how derivative and related hedged items are accounted for under FASB Statement No. 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect financial position, financial performance, and cash flows. We are currently assessing the impact of SFAS 161.



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(2) Related Parties

The net balance of receivables from and payables to related parties was a net payable to TDC A/S ( TDC ) in the amount of \$981,000 at June 30, 2008. This represents cumulative preferred stock dividends in arrears payable to TDC in the amount of \$908,000 and a net \$73,000 payable in connection with the transport of international voice, data and Internet traffic over our and TDC 's respective telecommunications networks for each other and other items.

On March 28, 2007, TDC exercised its warrants to purchase 2,500,000 shares of our common stock in exchange for notes issued by us and held by TDC in the principal amount of \$25 million. As of June 30, 2008 and December 31, 2007, TDC owned 64% of our outstanding common stock and 30,000 shares of our preferred stock convertible into 300,000 shares of common stock.

Robert Dogonowski, Jesper Theill Eriksen, Carsten Dyrup Revsbech and Henrik Scheinemann, current directors of the Company, are officers of TDC. Torben V. Holm was an employee of TDC when he served as our President and Chief Executive Officer and as the head of management 's executive committee through April 2007. Alex Wurtz was also an employee of TDC when he served as our head of Corporate Business Development and as a member of management 's executive committee through April 2007.

For Mr. Holm, we paid EUR 981,371 (approximately \$1.6 million) for his services for the period from May 2005 through April 2007. We were also responsible for paying other costs pertaining to Mr. Holm, including housing in Budapest and for certain of Mr. Holm 's travel costs back to his home in Denmark.

For Mr. Wurtz, we paid EUR 501,707 (approximately \$0.8 million) for his services for the period from June 2005 through April 2007. We were also responsible for paying Mr. Wurtz 's housing in Budapest.

All of our directors are covered by a directors and officers liability policy taken out by TDC. As of June 30, 2008, we had approximately \$64,000 in expenses for our portion of the overall premium paid by TDC.

We have agreements in place with TDC, pursuant to which TDC and we transport international voice, data and Internet traffic for each other over our respective telecommunications networks. For the three months ended June 30, 2008 and 2007, we transported these services for TDC and recorded revenue in the amount of approximately \$155,000 and \$539,000, respectively, pursuant to such agreements. For the six months ended June 30, 2008 and 2007, we transported these services for TDC and recorded revenue in the amount of approximately \$773,000 and \$1,057,000, respectively, pursuant to such agreements. For the three months ended June 30, 2008 and 2007, TDC transported these services and charged us approximately \$187,000 and \$178,000, respectively, pursuant to such agreements. For the six months ended June 30, 2008 and 2007, TDC transported these services and charged us approximately \$291,000 and \$506,000, respectively, pursuant to such agreements.

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(3) Acquisition of Memorex Telex Communications AG

On March 5, 2008 we acquired 95.7% of the outstanding equity in Austrian-based Memorex Telex Communication AG (the Memorex Acquisition ).

The preliminary purchase consideration for Memorex was EUR 30.1 million (approximately \$45.7 million) plus the assumption of debt and transaction costs and other directly related expenses. We used a discounted cash flow methodology and comparable trading multiples in determining the purchase price. From the preliminary purchase price EUR 17.9 million (approximately \$27.2 million) was paid in cash and the remaining EUR 12.1 million (approximately \$18.5 million) was paid into escrow.

Invitel and the selling shareholders of Memorex entered into an Escrow Agreement to set aside a portion of the purchase price cash consideration to cover any breach of the selling shareholders' warranties or covenants and to cover any indemnity claims that we might have against the selling shareholders under the purchase agreement. The Escrow Agreement governed the terms and conditions under which the Escrow Amount is released to the selling shareholders of Memorex. Following negotiations, we entered into a Settlement Agreement with the selling shareholders pursuant to which the Escrow Agent was directed to return EUR 11.2 million (approximately \$17.1 million at closing foreign exchange rate) to us and the remaining EUR 0.9 million (approximately \$ 1.4 million at closing foreign exchange rate) was paid out to the selling shareholders. We received our funds on July 11, 2008.

The total purchase consideration as at June 30, 2008 was EUR 90.9 million (approximately \$138.1 million at closing), which included: (i) the payment of cash in the amount of EUR 17.9 million (approximately \$27.2 million at closing), (ii) the payment into Escrow in the amount of EUR 12.1 million (approximately \$18.4 million at closing); (iii) a receivable from Escrow in the amount of EUR 11.2 million (approximately \$17.1 million at closing foreign exchange rate); (iv) the assumption of net debt of EUR 69.7 million (approximately \$105.8 million at closing); and (iii) transaction costs and other directly related expenses of EUR 2.4 million (approximately \$3.7 million at closing foreign exchange rate).

We refinanced a significant portion of Memorex's debt at the closing of the acquisition. We funded the Memorex Acquisition and the refinancing of the Memorex debt with a subordinated bridge loan facility. We intend to either refinance our bridge loan or, if we choose not to or the market conditions make a refinancing prohibitive, convert the bridge loan to term loans maturing in 2016, which conversion right is permitted, subject to certain conditions, pursuant to the bridge loan agreement. We also intend to buy out the remaining minority shareholders in Memorex.

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The primary reason for the Memorex Acquisition was Memorex's business is complementary to Invitel's existing regional wholesale data business. Memorex is a leading alternative telecommunications infrastructure and bandwidth provider in the Central and Eastern European region and has a diversified customer base.

Under the purchase method of accounting, and in accordance with SFAS No. 141 "Business Combinations", we are required to allocate the cost of an acquired business based on the estimated fair values of the assets acquired and liabilities assumed. We determined the estimated fair values of assets acquired and liabilities assumed as of March 5, 2008, the closing date of the Memorex Acquisition.

The following represents our preliminary allocation of the purchase price paid for Memorex based on the estimated fair values of the acquired assets and liabilities assumed as of March 5, 2008. The preliminary allocation of the purchase price is not necessarily indicative of the final allocation of the purchase price consideration. We intend to complete the valuation and establish a final purchase price allocation by December 31, 2008, following the completion of valuation studies and integration activities.

|   | <b>March 5, 2008</b><br><b>(in thousands)</b> |
|---|---|
| Current assets  | \$ 31,107                                     |
| Property, plant and equipment                         | 124,783                                       |
| Intangible assets                                     | 93,286  |
| Deferred tax  | 4,843   |
| Current and non-current liabilities                   | (115,902)                                     |
| <br>Net assets acquired                               | <br>\$ 138,117                                |
| <br><b>Purchase Price:</b>                            |   |
| Cash paid to shareholders                             | 27,223  |
| Cash to escrow account                                | 18,402  |
| Receivable from escrow account                        | (17,077)                                      |
| Assumption of debt                                    | 105,879                                       |
| Transaction costs and other directly related expenses | 3,690   |
| <br>Total purchase price                              | <br>\$ 138,117                                |

The following table presents the fair values of major components of the intangible assets acquired:

|                                | <b>March 5, 2008</b><br><b>(in</b><br><b>thousands)</b> | <b>Weighted average</b><br><b>amortization period</b> |
|--------------------------------|---|---|
| Concession rights and licences | \$ 741  | 10 years  |
| Customer relationships         | 21,212  | 14 years  |
| Trademark                      | 156   | 6 months  |
| Property rights                | 53,664  | 16-20 years   |
| Software                       | 200   | 4 years   |
| Vodafone contract              | 17,313  | 20 years  |
| <br><b>Total:</b>              | <br><b>\$ 93,286</b>                                    |   |

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The closing of the Memorex Acquisition occurred on March 5, 2008 and the consolidated results of Memorex from that date (and the balance sheet of Memorex as at June 30, 2008) were consolidated into our financial statements for the three and six months ended June 30, 2008.

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The following table presents our unaudited summarized consolidated financial information, on a pro-forma basis, as though HTCC, Invitel, Tele2 Hungary and Memorex had been combined at the beginning of the respective periods:

|                                      | Three months ended<br>June 30, |            | Six months ended<br>June 30, |            |
|--------------------------------------|--------------------------------|------------|------------------------------|------------|
|                                      | 2008                           | 2007       | 2008                         | 2007       |
|                                      | Pro-forma                      | Pro-forma  | Pro-forma                    | Pro-forma  |
| Revenue                              | \$ 148,060                     | \$ 135,043 | \$ 289,716                   | \$ 270,236 |
| Income from operations               | 21,431                         | 1,060      | 43,362                       | 25,537     |
| Foreign exchange gains (losses), net | 47,346                         | 7,095      | 31,831                       | 12,794     |
| Interest expense                     | (30,304)                       | (26,073)   | (61,157)                     | (53,339)   |
| Net income (loss)                    | (27,815)                       | (24,531)   | (29,190)                     | (83,682)   |
| Net income (loss) per basic share    | \$ (1.69)                      | \$ (1.49)  | \$ (1.78)                    | \$ (5.75)  |

The above unaudited pro-forma summarized combined financial information is intended for informational purposes only and is not indicative of the results of our operations had the acquisitions actually taken place at the beginning of the respective periods. The unaudited pro-forma summarized combined financial information does not include potential cost savings from operating efficiencies or synergies that may result from the acquisitions.

(4) Short and long-term debt

Short-term portion of long-term debt and long-term debt at June 30, 2008 and December 31, 2007 consist of the following:

|   | June 30,<br>2008    | December 31,<br>2007 |
|---|---------------------|----------------------|
| (in thousands)                              |                     |                      |
| Memorex Turkey Loan                         | 15,828              |                      |
| Amended Facilities Agreement                | 58,776              | 37,114               |
| <b>Short-term portion of long-term debt</b> | <b>\$ 74,604</b>    | <b>\$ 37,114</b>     |
| Amended Facilities Agreement                | \$ 95,223           | \$ 107,907           |
| Memorex Bridge Loan                         | 158,273             |                      |
| 1 <sup>st</sup> Memorex Prep Loan           | 12,662              |                      |
| 2 <sup>nd</sup> Memorex Prep Loan           | 4,748               |                      |
| 2007 Notes                                  | 316,546             | 293,552              |
| 2006 PIK Notes                              | 235,558             | 204,566              |
| 2004 Notes                                  | 223,226             | 206,840              |
| <b>Total long-term debt</b>                 | <b>\$ 1,046,236</b> | <b>\$ 812,865</b>    |

In connection with the Invitel Acquisition on April 27, 2007, we completed the issuance of EUR 200 million aggregate principal amount of floating rate senior notes maturing in 2013 (the 2007 Notes), the proceeds of which were used to partly finance the Invitel

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Acquisition and to refinance our existing bank credit facility. As part of the Invitel Acquisition, we also assumed an estimated net indebtedness on closing of EUR 391 million (approximately \$528 million at closing, the Assumed Debt ). The Assumed Debt consisted primarily of (i) EUR 133 million in aggregate principal amount and accrued interest of Floating Rate Senior PIK Notes due 2013 (the 2006 PIK Notes ), (ii) EUR 142 million in aggregate principal amount of 10.75% Senior Notes due 2012 (the 2004 Notes ), and (iii) a Facilities Agreement in the amount of EUR 116 million, which was amended and restated in connection with the Invitel Acquisition.

In connection with the Memorex Acquisition on March 5, 2008, we entered into a EUR 100 million (approximately \$158 million at closing) Bridge Loan Agreement (the Bridge Loan Agreement ) and further amended and restated our Facilities Agreement (the Amended Facilities Agreement ).

In order to establish the relative rights of certain of our creditors under our financing arrangements, we have entered into an amended and restated Intercreditor Agreement (the Intercreditor Agreement ). Summaries of the terms and conditions of the Amended Facilities Agreement, the 2007 Notes, the 2006 PIK Notes, the 2004 Notes, the Bridge Loan Agreement and the Intercreditor Agreement are set forth below. The summaries do not purport to be complete and are qualified in their entirety by reference to the full text of such documents, copies of which are filed with the Securities and Exchange Commission. We have also summarized three loan agreements that we assumed as part of the Memorex Acquisition.

*The Amended Facilities Agreement*

In connection with the Invitel Acquisition on April 27, 2007, an amendment was made to the Facilities Agreement, dated August 6, 2004, between Matel, Invitel, as borrower, certain subsidiary companies as original guarantors, and certain financial institutions. The Amended Facilities Agreement provides for facilities of up to EUR 145 million (or the euro equivalent thereof), comprised of (i) a euro amortizing term loan of EUR 96.9 million, (ii) a Hungarian forint amortizing term loan of HUF 4,628 million (approximately EUR 18.5 million), (iii) a revolving credit facility of EUR 4.2 million and HUF 200 million (approximately EUR 0.8 million), and (iv) a euro liquidity facility of EUR 25 million. Neither the revolving facility nor the liquidity facility has been drawn down.

Advances under the Amended Facilities Agreement bear interest for each interest period at annual rates equal to EURIBOR or BUBOR (based on the Budapest interbank offer rates) plus an applicable margin. The applicable margin is set based on the ratio of all of our senior debt to EBITDA, based on our most recently delivered quarterly management accounts and financial statements. Under the Amended Facilities Agreement, we are obligated to pay customary fees to the lenders, including an up-front fee and a commitment fee in relation to available and undrawn commitments under the revolving facility and the liquidity facility.

Our obligations under the Amended Facilities Agreement are guaranteed and are collateralized on a senior basis by (i) a first ranking pledge of all the share capital of the

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obligors, (ii) assignments of intercompany loans and any relevant cross guarantees of the obligors from time to time, (iii) a pledge of accounts by the obligors, and (iv) floating charges over all assets. Such security interests also collateralize, on a *pari passu* basis, all hedging obligations with respect to the Amended Facilities Agreement, the 2007 Notes and the 2004 Notes.

The Amended Facilities Agreement contains certain negative covenants that restrict us (subject to certain agreed upon exceptions) from, among other things, (i) creating or permitting to subsist any security interest over any part of our assets, (ii) merging or consolidating with or into any other person, (iii) selling, transferring, leasing, lending or otherwise disposing of any assets, (iv) incurring or permitting to be outstanding any financial indebtedness (including guarantees), (v) reducing capital or purchasing any class of our shares, (vi) making any investment, including (1) loans to any person, (2) the acquisition of indebtedness or capital or securities of any person, (3) the acquisition of the assets, property or business of any other person, or (4) the creation or acquisition of a subsidiary, (vii) entering into any derivative instruments, (viii) changing the nature of our business or amending our constitutive documents, (ix) entering into any agreement or arrangement other than on an arm's-length basis, (x) paying dividends or making any repayment, prepayment or redemption of principal under any subordinated finance documents including the 2004 Notes, the 2007 Notes and the Bridge Loan Agreement except in accordance with the Intercreditor Agreement, (xi) changing our ownership structure, and (xii) maintaining any bank account that has a credit balance with any person that is not a lender under the Amended Facilities Agreement.

Additionally, the Amended Facilities Agreement requires us to maintain specified consolidated financial ratios, such as leverage ratios (total senior debt to EBITDA and total debt to EBITDA), an interest coverage ratio (EBITDA to total debt interest charges) and a fixed charge coverage ratio (EBITDA minus capital expenditure and cash taxes to total debt charges).

Under the terms of the Amended Facilities Agreement, we are required to observe certain affirmative undertakings, including, but not limited to, undertakings relating to (i) maintenance of all relevant consents, authorizations and licenses, (ii) conduct of business, (iii) periodic financial statements, management accounts and reports, (iv) auditors and information, (v) insurance and inspection, (vi) notification of environmental claims and expenditures, (vii) compliance with laws, (viii) taxes, and (ix) maintenance of a cost capitalization policy and an interest rate hedging policy.

The term facilities are amortizing term loans with a maturity date of June 30, 2011. No amount repaid or prepaid in relation to the term facilities may be redrawn.

The revolving facility and the liquidity facility are each repayable in an amount equal to 100% of the principal amount outstanding on June 29 and December 30 of each calendar year until the maturity date of June 30, 2010.

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Subject to certain exceptions, all loans under the Amended Facilities Agreement will be required to be prepaid upon the occurrence of certain change of control events. Voluntary prepayments and cancellations are permitted.

The Amended Facilities Agreement contains certain events of default customary for senior debt financings as well as an event of default related to Matel Holdings engaging in non-holding company-related activities, the occurrence of which would preclude further borrowings under the revolving facility and permit the lenders to accelerate all outstanding loans and terminate their commitments under the facilities.

*The 2007 Notes*

Upon the completion of the Invitel Acquisition on April 27, 2007, we completed the issuance of the 2007 Notes pursuant to an Indenture, dated as of April 27, 2007 (the 2007 Notes Indenture). We received EUR 189 million following the payment of financing costs associated with the issuance of the 2007 Notes in the amount of EUR 11 million, which costs were deferred and are amortized to interest expense using the effective interest method over the term of the 2007 Notes. The proceeds from the issuance of the 2007 Notes were used to partly finance the Invitel Acquisition and to refinance our credit facility.

The 2007 Notes mature on February 1, 2013, and bear interest at a rate of EURIBOR plus 3.0% per annum, payable quarterly in arrears on February 1, May 1, August 1 and November 1 of each year, beginning on August 1, 2007. The 2007 Notes are guaranteed by some of our subsidiaries. The 2007 Notes and subsidiary guarantees are collateralized by second-priority liens over certain inter-company funding loans, the capital stock of some of our subsidiaries, which liens rank *pari passu* with the liens over such assets securing our obligations under the 2004 Notes described below.

We have the option to redeem the 2007 Notes, as a whole or in part, at any time or from time to time, at redemption prices specified in the 2007 Notes Indenture. In the event of certain change of control events, we must make an offer to purchase the 2007 Notes at a purchase price equal to 101% of the principal amount thereof. We are also required to offer to purchase the 2007 Notes with the excess proceeds following certain asset sales at a purchase price equal to 100% of the principal amount thereof.

The 2007 Notes Indenture contains covenants restricting our ability to, among other things, (i) incur additional indebtedness or issue preferred shares, (ii) make investments and certain other restricted payments, (iii) issue or sell shares in subsidiaries, (iv) agree to restrictions on the payment of dividends by subsidiaries, (v) enter into transactions with affiliates, (vi) create certain liens, (vii) merge, consolidate or combine with other entities, (viii) layer debt, (ix) designate subsidiaries as unrestricted subsidiaries, (x) engage in unrelated business activities and (xi) impair any security interests. The 2007 Notes Indenture also contains customary events of default, including non-payment of principal, interest, premium or other amounts, violation of covenants, bankruptcy events, cross-defaults, material judgments and invalidity of any guarantee, security document or security interest.



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*The 2006 PIK Notes*

On October 30, 2006, Invitel Holdings issued the 2006 PIK Notes pursuant to an Indenture, dated as of October 30, 2006 (the 2006 PIK Notes Indenture ). In connection with the closing of the Invitel Acquisition on April 27, 2007, we entered into a supplemental indenture with Invitel Holdings and the 2006 PIK Notes Indenture trustee, pursuant to which we replaced Invitel Holdings as the issuer of the 2006 PIK Notes and assumed all of the rights and obligations of the issuer under the 2006 PIK Notes Indenture.

Interest on the 2006 PIK Notes is payable quarterly in cash or in the form of additional 2006 PIK Notes at an annual rate of EURIBOR plus 8.25%, reset quarterly, plus a ratchet margin, on January 15, April 15, July 15 and October 15 of each year beginning January 15, 2007. The ratchet margin is zero for the period to but excluding October 15, 2009 and 2.00% if the consolidated leverage ratio of our subsidiary, Matel, is greater than 2.50 to 1.00 for any interest period beginning on or after October 15, 2009. The maturity date of the 2006 PIK Notes is April 15, 2013.

Our obligations under the 2006 PIK Notes are general unsubordinated obligations and are collateralized by a first priority lien over the shares of Matel Holdings and effectively subordinated to all existing and future debt of our subsidiaries.

We have the option to redeem the 2006 PIK Notes, as a whole or in part, at any time or from time to time, at redemption prices specified in the 2006 PIK Notes Indenture. In the event of certain change of control events, we must make an offer to purchase the 2006 PIK Notes at a purchase price equal to 101% of the principal amount thereof. We are also required to make an offer to purchase the 2006 PIK Notes with the excess proceeds following certain asset sales at a purchase price equal to 100% of the principal amount of thereof.

The 2006 PIK Notes Indenture contains covenants restricting our ability to, among other things, (i) incur additional indebtedness or issue preferred shares, (ii) make investments and certain other restricted payments, (iii) enter into transactions with affiliates, (iv) create certain liens, (v) enter into sale and leaseback transactions, (vi) issue or sell shares of subsidiaries, (vii) merge, consolidate or combine with other entities, (viii) designate subsidiaries as unrestricted subsidiaries, (ix) engage in unrelated business activities and (x) impair any security interests. The 2006 PIK Notes Indenture also contains customary events of default, including, among other things, non-payment of the principal, interest or premium, if any, on any 2006 PIK Notes, certain failures to comply with any covenant of the 2006 PIK Notes Indenture, certain defaults under other indebtedness, failure to pay certain indebtedness or judgments, bankruptcy or insolvency events and invalidity of any security document or security interest.

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*The 2004 Notes*

In August 2004, Matel issued the 2004 Notes pursuant to an Indenture, dated as of August 6, 2004, (the 2004 Notes Indenture ) with some of Matel's subsidiaries as guarantors.

The 2004 Notes mature on August 15, 2012. Interest on the 2004 Notes is payable semi-annually at an annual rate of 10.75% on February 15 and August 15 of each year, beginning on February 15, 2005.

We have the option to redeem the 2004 Notes, as a whole or in part, at any time or from time to time, at redemption prices specified in the 2004 Notes Indenture. Upon certain change of control events, we are required to make an offer to purchase all of the 2004 Notes, at a purchase price equal to 101% of the principal amount thereof, plus accrued and unpaid interest to the date of purchase. We are also required to offer to purchase the 2004 Notes with the excess proceeds from certain sales of assets at 100% of the principal amount of the 2004 Notes, plus accrued and unpaid interest to the date of repurchase.

Our obligations under the 2004 Notes are guaranteed on a senior subordinated basis by some of our subsidiaries that guaranteed our obligations under the 2007 Notes and are collateralized by the same collateral securing the 2007 Notes.

The 2004 Notes Indenture contains covenants which, among other things, limit the ability of Matel and its restricted subsidiaries to (i) incur additional indebtedness and issue preferred shares, (ii) make certain restricted payments and investments, (iii) transfer or sell assets, (iv) enter into transactions with affiliates, (v) create certain liens, (vi) create restrictions on the ability of some of our subsidiaries to pay dividends or other payments to Matel, (vii) guarantee other indebtedness, (viii) enter into sale and leaseback transactions, (ix) issue or sell shares of certain restricted subsidiaries, (x) merge, consolidate, amalgamate or combine with other entities, (xi) designate restricted subsidiaries as unrestricted subsidiaries, and (xii) engage in any business other than a permitted business.

The 2004 Notes Indenture contains customary events of default, including, among others, the non-payment of principal, interest or premium on the 2004 Notes, certain failures to perform or observe any other covenant in the 2004 Notes Indenture, the occurrence of certain defaults under other indebtedness, failure to pay certain indebtedness or judgments, bankruptcy or insolvency events and invalidity of any guarantee, security document or security interest.

*The Bridge Loan Agreement*

In connection with the Memorex Acquisition, we entered into a EUR 100 million Bridge Loan Agreement on March 3, 2008 with our subsidiary Matel as borrower and our subsidiaries Invitel, Invitel Telecom, Invitel Technocom, Memorex and Memorex's Turkish subsidiary as guarantors. The Bridge Loan Agreement was arranged by Merrill Lynch and BNP Paribas, who are the original lenders. On March 5, 2008, the closing date of the Memorex Acquisition, we borrowed the full EUR 100 million pursuant to which we used EUR 30.1 million to fund the purchase price for 95.7% of the outstanding equity in Memorex and EUR 46.6 million to refinance some of Memorex's existing debt that we assumed at closing. We used EUR 7.6 million to pay fees and expenses in connection with the Bridge Loan Agreement and transaction costs in connection with the Memorex

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Acquisition and we set aside the remaining EUR 15.7 million for working capital purposes. In addition, EUR 12.1 million of the EUR 30.1 million purchase price was paid into escrow. Following settlement, EUR 11.2 million of escrow balance was returned to us and added to our working capital.

The Bridge Loan Agreement loans (the Bridge Loans ) mature one year following the completion of the Memorex Acquisition, on March 5, 2009 (the Initial Maturity Date ). The Bridge Loans bear interest at a rate per annum equal to the sum of EURIBOR plus the applicable margin plus the Mandatory Cost (if any, as defined in the Bridge Loan Agreement), which is set at the beginning of each three month interest period. The applicable margin for the first six months is the greater of 4.25% per annum and 0.50% per annum over the 2007 Notes Spread to Maturity (the quoted spread over EURIBOR to maturity). For the next three months, the applicable margin is the greater of 4.75% per annum and 0.50% per annum over the 2007 Notes Spread to Maturity. For the three months up to the Initial Maturity Date, the applicable margin is the greater of 5.25% per annum and 0.50% per annum over the 2007 Notes Spread to Maturity. The interest rate may not exceed 11.5% per annum for any interest period. The current interest rate on the Bridge Loans is 11.5% per annum, the maximum contractual rate.

Subject to certain conditions, including our not being in default under certain provisions of the Bridge Loan Agreement at the Initial Maturity Date, we may convert the Bridge Loans to term loans ( Term Loans ) with a maturity date of seven years following the Initial Maturity Date (March 5, 2016, the Extended Maturity Date ). The terms of the Bridge Loan Agreement will generally govern the Terms Loans, provided that certain covenants and events of default under the Bridge Loan Agreement will be replaced by covenants and events of default from the 2007 Notes Indenture. From the Initial Maturity Date (March 5, 2009) until the Extended Maturity Date (March 5, 2016), the applicable margin shall be 6.25% per annum, provided the interest rate for any three month interest period shall not exceed 11.5%. If we elect to convert the Bridge Loans to Term Loans, a lender may, upon the sale of its Term Loan to a third party, subject to certain conditions, exchange all or any portion of its Term Loan into one or more exchange notes (the Exchange Notes ), which Exchange Notes will be governed by an indenture, which indenture shall contain covenants, events of default, repayment and other provisions based on those contained in the indenture governing the 2007 Notes. The Exchange Notes shall bear interest at a rate equal to 11.5% per annum.

Upon a change in our control (as defined in the Bridge Loan Agreement), each lender may require us to prepay an amount equal to 100% of the Bridge Loans outstanding plus any accrued and unpaid interest and 101% of any Term Loan outstanding plus any accrued and unpaid interest.

We may prepay the Bridge Loans, and any accrued and unpaid interest and any breakage costs, without penalty. We may prepay the Term Loans within the first four years following the Initial Maturity Date by paying the outstanding principal, and any accrued and unpaid interest and any breakage costs, plus the greater of (i) 1% of the outstanding

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principal amount of the Term Loan and (ii) the excess of (a) the present value at such redemption date of (x) the redemption price of such Term Loan four years after the Initial Maturity Date (March 5, 2013), plus (y) all required interest payments that would otherwise be due to be paid on such Term Loan during the period between the redemption date and the date four years after the Initial Maturity Date (March 5, 2013), computed using a discount rate equal to the German bund rate at such redemption date plus 50 basis points over (b) the then outstanding principal amount of the Term Loan. Following the fourth year after the Initial Maturity Date (March 5, 2013), we may prepay the Term Loans, plus any accrued and unpaid interest and any breakage costs, as follows: (i) at par plus 50% of the coupon through March 5, 2014, (ii) at par plus 25% of the coupon through March 5, 2015 or (iii) at par through March 5, 2016. For any Term Loans held by the original lenders, we may prepay the Terms Loans following March 5, 2013 by paying the original lenders the outstanding principal plus accrued and unpaid interest and any breakage costs.

Our obligations under the Bridge Loan Agreement are currently guaranteed by some of our subsidiaries and are collateralized by the same collateral securing the 2004 Notes and the 2007 Notes.

The Bridge Loan Agreement contains customary representations and warranties and events of default. The Bridge Loan Agreement contains covenants restricting our ability, under certain circumstances, to, among other things, (i) make certain restricted payments such as dividends or loans, (ii) create certain liens, (iii) merge or consolidate with other entities, (iv) borrow money other than as permitted, (v) make guarantees, (vi) make loans, acquire assets or companies other than as permitted or (vii) enter into hedging arrangements other than as permitted.

*The Intercreditor Agreement*

In order to establish the relative rights of certain of our creditors under our financing arrangements, including the Bridge Loan Agreement (including priority of claims and subordination), we have entered into an amended and restated Intercreditor Agreement with, among others, the lenders under the Amended Facilities Agreement and the Bridge Loan Agreement, certain hedging counterparties, the security trustee, the trustee for the 2007 Notes and the trustee for the 2004 Notes. The Intercreditor Agreement provides that if there is an inconsistency between the provisions of the Intercreditor Agreement (regarding subordination, turnover, ranking and amendments only), and certain other documents, including the 2007 Notes Indenture governing the 2007 Notes, the Intercreditor Agreement will prevail.

*The Assumed Memorex Debt*

In connection with the Memorex Acquisition, in addition to the Memorex debt that we refinanced with some of the proceeds from the Bridge Loan Agreement, we assumed approximately EUR 26.4 million (approximately \$41.8 million at closing) of net debt

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primarily consisting of (i) a loan to Memorex's Turkish subsidiary MTCTR Memorex Telekomünikasyon Sanayi ve Ticaret Limited Sirketi ( Memorex Turkey ) in the amount of EUR 10 million (the Memorex Turkey Loan ), (ii) a subordinated loan to Memorex in the amount of EUR 8 million (the 1st Memorex Prep Loan), (iii) a subordinated loan to Memorex in the amount of EUR 3 million (the 2nd Memorex Prep Loan) and (iv) finance leases.

The Memorex Turkey Loan is a bank loan with a current variable interest rate that is adjusted quarterly and presently equal to EURIBOR plus 2.0%. The current interest rate is 6.61%. The lender may unilaterally alter or increase the rate of interest as permitted by applicable law. The Memorex Turkey Loan matures, with the principal to be repaid in full, in November 2013. The lender may, in its discretion, require early repayment upon three days written notice. Memorex Turkey may prepay the loan in whole or in part on three days written notice. The Memorex Turkey Loan is collateralized by some of Memorex Turkey's trade receivables.

The 1st Memorex Prep Loan is an un-collateralized subordinated loan from a syndicated group of lenders. Memorex has to make an annual interest payment at the rate of 0.75% per annum and a quarterly interest payment at the rate of 6.8% per annum. The 1st Memorex Prep Loan matures, with the principal to be repaid in full, in July 2012. The lender or Memorex may require early termination of the loan upon important reasons . Important reasons that would enable the creditor to terminate the loan agreement and require early repayment include, but are not limited to, certain events such as the liquidation of Memorex, the institution of insolvency proceedings or a change-in-control of Memorex under certain circumstances. If the loan is terminated prior to maturity, Memorex would owe, in addition to the unpaid principal and accrued interest, the residual term interest consisting of the interest that would have been payable up to the original maturity date of the loan. Memorex would receive a credit against such residual interest for the hypothetical amount which the loan principal would earn if it was reinvested in bonds issued by the Republic of Austria with a residual term equal to the time remaining to the original maturity date of the loan.

The 2nd Memorex Prep Loan is an un-collateralized subordinated loan from a syndicated group of lenders. Memorex has to make an annual interest payment at the rate of 1.0% per annum and a quarterly interest payment at the rate of 6.9% per annum. The 2nd Memorex Prep Loan matures, with the principal to be repaid in full, in December 2012. The lender or Memorex may require early termination of the loan upon important reasons . Important reasons that would enable the creditor to terminate the loan agreement and require early repayment include, but are not limited to, certain events such as the liquidation of Memorex, the institution of insolvency proceedings or a change-in-control of Memorex under certain circumstances. If the loan is terminated prior to maturity, Memorex would owe, in addition to the unpaid principal and accrued interest, the residual term interest consisting of the interest that would have been payable up to the original maturity date of the loan. Memorex would receive a credit against such residual interest for the hypothetical amount which the loan principal would earn if it was reinvested in bonds issued by the Republic of Austria with a residual term equal to the time remaining to the original maturity date of the loan.

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(5) Derivative Financial Instruments

We engage in foreign currency and interest rate hedging activities to reduce the risk that changes in currency exchange rates and interest rates will adversely affect the eventual net cash flows resulting from our debt obligations.

We do not enter into financial instruments for trading or speculative purposes. However, the derivative instruments used by us are not designated as hedges under SFAS 133 for accounting purposes and, as such, are referred to as undesignated hedges. Changes in the fair value of undesignated hedges are therefore recorded in current period earnings as a gain or loss on derivative instruments.

*Interest rate risk hedging*

To limit the variability of interest rates on a substantial portion of our cash pay debt, we entered into interest rate swap agreements to manage some of our fluctuations in cash flows resulting from interest rate risk. Under the terms of the interest rate swaps, we receive variable interest rate payments from the hedging counterparty and make fixed interest rate payments in the same currency, thereby creating the equivalent of fixed-rate debt.

*Foreign exchange rate risk hedging*

To limit the impact of fluctuations between the Hungarian subsidiaries' functional currency, the Hungarian forint, and the euro, we entered into currency swap agreements and foreign exchange forward agreements, to receive euros and pay forint, thereby creating the equivalent of Hungarian forint debt obligations.

In addition to the above instruments, we use cross-currency interest rate swaps to hedge both the interest rate and the currency exposure inherent in foreign currency denominated debt instruments bearing variable interest. By entering into such transactions we receive variable interest payments in euros and make fixed interest payments in Hungarian forint, the functional currency of our Hungarian subsidiaries, thereby creating the equivalent of fixed rate debt in the functional currency of our Hungarian subsidiaries. The cross currency interest rate swaps in effect are the same as the combination of interest rate swaps and foreign exchange forward contracts applied to the same underlying hedged item.

The objective of these contracts is to neutralize the impact of currency exchange rate and interest rate movements on our cash flows. However, given the inherent limitations of forecasting and the anticipatory nature of the exposures intended to be hedged, there can be no assurance that such programs will offset more than a portion of the adverse financial impact resulting from unfavorable movements in either interest or currency exchange rates.

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*Credit risk related to hedging*

By using derivative financial instruments to hedge exposures to changes in interest rates and currency exchange rates, we expose ourselves to the credit risk of the counterparty. Credit risk is the failure of the counterparty to perform its obligations under the terms of the derivative contract. When the fair value of a derivative contract is positive, the counterparty owes us, which creates a credit risk for us. When the fair value of a derivative contract is negative, we owe the counterparty and, therefore, we do not have any credit risk. Our policy requires that counterparties to our hedging activities be large and creditworthy commercial banks. We do not consider the risk of counterparty non-performance associated with hedge contracts to be significant. We do not require and are not required to place collateral for these financial instruments independently of our security arrangements under the Amended Facilities Agreement.

To ensure the adequacy and effectiveness of our interest rate and foreign exchange hedge positions, we continually monitor, from an accounting and economic perspective, our derivatives positions in conjunction with our underlying interest rate and foreign currency exposures.

The following table summarizes the notional amounts and respective fair values of our derivative financial instruments, which mature at varying dates, as of June 30, 2008:

| Asset / (Liability)                | Notional Amount   | Fair Market Value<br>(in thousands) | Fair Value Change for the<br>Six Months ended<br>June 30, 2008 |
|------------------------------------|-------------------|-------------------------------------|--|
| Cross currency interest rate swaps | \$ 650,906        | \$ (68,472)                         | \$ (30,818)  |
| FX forward contracts               |                   |                                     | (22)   |
| Interest rate swaps                | 23,178            | 80                                  | 926  |
| <b>Total</b>                       | <b>\$ 674,084</b> | <b>\$ (68,392)</b>                  | <b>\$ (29,914)</b>   |

The following table summarizes the notional amounts and respective fair values of our floating to fixed interest rate swaps, which mature at varying dates, as of June 30, 2008:

| Asset / (Liability)              | Notional Amount   | Fair Market Value<br>(in thousands) | Maturity        | Fixed Interest Rate |
|----------------------------------|-------------------|-------------------------------------|-----------------|---------------------|
| Amended Facilities Agreement     | \$ 114,993        | \$ (9,443)                          | June 30, 2011   | 9.379%              |
| Amended Facilities Agreement     | 23,178            | 80                                  | June 30, 2011   | 10.160%             |
| 2007 Notes                       | 64,938            | (6,204)                             | August 1, 2009  | 10.780%             |
| 2007 Notes                       | 64,938            | (6,176)                             | August 1, 2009  | 10.740%             |
| 2007 Notes                       | 94,175            | (8,928)                             | August 1, 2009  | 10.724%             |
| 2007 Notes                       | 87,114            | (8,258)                             | August 1, 2009  | 10.724%             |
| 2004 Notes                       | 224,748           | (29,463)                            | August 15, 2009 | 14.955%             |
| <b>Total Interest Rate Swaps</b> | <b>\$ 674,084</b> | <b>\$ (68,392)</b>                  |                 |                     |

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The notional principal amount provides one measure of the transaction volume outstanding as of the end of the period, and does not represent the amount of our exposure to market loss.

We estimate the fair values by using a model which discounts future contractual cash-flows determined based on market conditions (foreign exchange rates, yield curves in the functional currency and in the foreign currency) prevailing on the date of the valuation. The model used by us is regularly tested against third party prices for reasonableness. The fair value represents the estimated amounts that we would pay or receive to terminate the contracts as of June 30, 2008. The amounts ultimately realized upon settlement of these financial instruments, together with the gains and losses on the underlying exposures, will depend on actual market conditions during the remaining life of the instruments.

*Embedded derivatives*

An embedded derivative is an implicit or explicit term within a contract that does not in its entirety meet the definition of a derivative instrument but affects some or all of the cash-flows or the value of other exchanges required by the contract in a manner similar to a derivative. An embedded derivative therefore is a derivative instrument within another contract that is not a derivative. For example, a euro denominated operating lease contract that one of our Hungarian subsidiaries enters into for a given period of time will give rise to foreign currency exposure for that period since our Hungarian subsidiary will need to buy euro from its functional currency, the Hungarian forint, thereby having an impact on cash-flows. Therefore, a series of foreign exchange forward contracts are embedded in the lease agreement, the host contract, and are accounted for separately.

Embedded derivatives are separated from the host contract and accounted for separately if (i) the economic characteristics and risks of the host contract and the embedded derivative are not closely related; (ii) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and (iii) the combined instrument is not measured at fair value with changes in fair value reported through earnings. Changes in the fair value of separable embedded derivatives are recognized immediately in the statement of operations.

We review our material contracts regularly to identify embedded derivatives which require bifurcation from the host contract. The following table summarizes the fair values of our net liabilities relating to embedded derivatives as of June 30, 2008 and December 31, 2007:

|                           | <b>June 30,<br/>2008</b> | <b>December 31,<br/>2007</b> |
|---------------------------|--------------------------|------------------------------|
|                           | (in thousands)           |                              |
| Embedded derivatives, net | \$ (1,025)               | \$ (617)                     |



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(6) Fair value of financial assets and liabilities

We adopted SFAS No. 157, Fair Value Measurements ( SFAS 157 ) effective January 1, 2008 as discussed in Note 1(f), which defines fair value, establishes a framework for measuring fair value in GAAP, and requires enhanced disclosures about assets and liabilities carried at fair value and fair value measurements. SFAS 157 applies when other accounting pronouncements require fair value measurements; it does not require new fair value measurements.

SFAS 157 states that fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or liability. As a basis for considering such assumptions, SFAS 157 establishes a three-level fair value hierarchy, which prioritizes the inputs used in measuring fair value as follows: (i) Level 1 observable inputs such as quoted prices in active markets; (ii) Level 2 inputs, other than the quoted prices in active markets, that are observable either directly or indirectly; and (iii) Level 3 unobservable inputs in which there is little or no market data, which require the reporting entity to develop its own assumptions. We utilize valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs.

The three levels of the fair value hierarchy defined by SFAS 157 are as follows:

Level 1 Quoted prices are available in active markets for identical assets or liabilities as of the reporting date. Active markets are those in which transactions for the asset or liability occur in sufficient frequency and volume to provide pricing information on an ongoing basis. Level 1 primarily consists of financial instruments such as exchange-traded derivatives and listed equities.

Level 2 Pricing inputs are other than quoted prices in active markets included in Level 1, which are either directly or indirectly observable as of the reporting date. Level 2 includes those financial instruments that are valued using models or other valuation methodologies. These models are primarily industry-standard models that consider various assumptions, including quoted forward prices for commodities, time value, volatility factors, and current market and contractual prices for the underlying instruments, as well as other relevant economic measures. Substantially all of these assumptions are observable in the marketplace throughout the full term of the instrument and can be derived from observable data or are supported by observable levels at which transactions are executed in the marketplace. Instruments in this category include non-exchange-traded derivatives such as OTC forwards, options and repurchase agreements.

Level 3 Pricing inputs include significant inputs that are generally less observable from objective sources. These inputs may be used with internally developed methodologies that result in the best estimate of fair value. Level 3 instruments include those that may be more structured or otherwise tailored to customers' needs. At each balance sheet date, we perform an analysis of all instruments subject to SFAS 157 and include in Level 3 any of those whose fair value is based on significant unobservable inputs. The following table sets forth by level, within the fair value hierarchy, our financial assets and liabilities that were accounted for at fair value on a recurring basis as at June 30, 2008:

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| Recurring Fair Value Measures    | At fair value as of June 30, 2008 |                  |           |                  |
|----------------------------------|-----------------------------------|------------------|-----------|------------------|
|                                  | Level 1                           | Level 2          | Level 3   | Total            |
|                                  | (in thousands)                    |                  |           |                  |
| <b>Assets:</b>                   |                                   |                  |           |                  |
| Derivative financial instruments | \$                                | \$               | \$        | \$               |
| Embedded derivatives             |                                   | 3,448            |           | 3,448            |
| Other                            |                                   |                  |           |                  |
| <b>Total</b>                     | <b>\$</b>                         | <b>\$ 3,448</b>  | <b>\$</b> | <b>\$ 3,448</b>  |
| <b>Liabilities:</b>              |                                   |                  |           |                  |
| Derivative financial instruments | \$                                | \$ 68,392        | \$        | \$ 68,392        |
| Embedded derivatives             |                                   | 4,472            |           | 4,472            |
| Other                            |                                   |                  |           |                  |
| <b>Total</b>                     | <b>\$</b>                         | <b>\$ 72,864</b> | <b>\$</b> | <b>\$ 72,864</b> |

As required by SFAS 157, financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement. Our assessment of the significance of a particular input to the fair value measurement requires judgment, and may affect the valuation of fair value assets and liabilities and their placement within the fair value hierarchy levels.

The determination of the fair values above incorporates various factors required under SFAS 157. These factors include not only the credit standing of the counterparties involved and the impact of credit enhancements (such as cash deposits, letters of credit and priority interests), but also the impact of our nonperformance risk (such as our credit risk and delivery risk) on our liabilities.

We use a similar model to value similar instruments. Valuation models utilize various inputs which include inputs derived principally from or corroborated by observable market data such as yield curves and foreign exchange rates. Judgment may be necessary to determine the source and timing of the input data used. Where observable inputs are available for substantially the full term of the asset or liability, the instrument is categorized in Level 2.

There were no financial assets and liabilities that were accounted for at fair value on a non-recurring basis as at June 30, 2008.

(7) Losses from Fair Value Changes on Warrants

In May 1999, we issued notes (the "Notes") in an aggregate amount of \$25 million with detachable warrants (the "Warrants") to purchase 2,500,000 shares of common stock of the Company at a price of \$10 per share. The Notes accrued interest at the USD LIBOR rate applicable for the six month interest periods plus 3.5%. The Notes matured in March 2007 and were canceled upon the exercise of the Warrants by TDC on March 28, 2007.

In accordance with SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, we recorded a non-cash expense of \$15.1 million for the first quarter 2007

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relating to the change in the fair value of our common stock, which was reflected in the change in the fair value of the Warrants. The fair market value was determined using the Black-Scholes option pricing formula as of the exercise date of the Warrants. Upon exercise on March 28, 2007, the fair market value of the Warrants of \$53.1 million was recorded to Additional Paid-In Capital.

**(8) Stock Based Compensation**

We have three equity compensation plans: the stock option plan that was adopted by our Board of Directors in April 1992, which was amended and renamed upon the approval of our stockholders in 2002 (the 2002 Plan ); the Non-Employee Director Stock Option Plan (the Directors Plan ) which was established by our Board of Directors in 1997; and the 2004 Long-Term Incentive Plan (the 2004 Plan ) which was approved by our stockholders in 2004.

As of June 30, 2008, we had outstanding options to purchase 80,000 shares of common stock issued from the 2002 Plan; outstanding options to purchase 85,000 shares of common stock issued from the Directors Plan; and outstanding options to purchase 410,000 shares of common stock under the 2004 Plan.

For the three months ended June 30, 2008, we recognized \$514,000 of earnings associated with stock based compensation, which was comprised of non-cash earnings relating to the revaluation of outstanding option awards under FAS 123R.

For the six months ended June 30, 2008, we recognized \$309,000 of expense associated with stock based compensation, which was comprised of non-cash expense of \$136,000 relating to the revaluation of outstanding option awards under FAS 123R and an expense of \$173,000 related to a stock option grant. For the six months ended June 30, 2007, we recognized a compensation expense of \$409,600 related to SFAS 123R.

Upon the adoption of SFAS 123R, expected volatility was based on historical volatilities. The risk-free interest rate is based on U.S. Treasury zero-coupon issues with a remaining term equal to the expected option life assumed at the date of grant. The expected term was calculated based on historical experience and represents the time period options actually remained outstanding. We have estimated zero forfeitures based on historical experience and the limited number of option holders.

The weighted average assumptions used in the Black-Scholes option-pricing model are as follows for the six months ended June 30, 2008 and 2007:

|   | Six months ended |        |
|---|------------------|--------|
|   | June 30,         |        |
|   | 2008             | 2007   |
| Dividend yield                                | 0%               | 0%     |
| Risk free rate                                | 3.70%            | 5.16%  |
| Weighted average expected option life (years) | 5.67             | 6.39   |
| Volatility                                    | 30.10%           | 39.52% |

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The following is a summary of stock options under the stock compensation plans referred to above, which were granted, were exercised and have expired for the six months ended June 30, 2008:

|                   | Outstanding<br>Options | Weighted Average<br>Exercise Price |
|-------------------|------------------------|------------------------------------|
| December 31, 2007 | 570,000                | \$ 10.30                           |
| Granted           | 20,000                 | \$ 17.14                           |
| Exercised         | (15,000)               | \$ 6.52                            |
| June 30, 2008     | 575,000                | \$ 10.64                           |

All options granted during the period were fully vested upon issuance.

The following table summarizes information about shares subject to outstanding options as at June 30, 2008, which were issued to current or former employees or directors pursuant to the above described stock compensation plans.

| Options Outstanding |                             |  |  | Options Exercisable   |   |
|---------------------|-----------------------------|--|--|-----------------------|---|
| Number              | Range of<br>Exercise Prices | Weighted-<br>Average<br>Exercise Price | Weighted-<br>Average<br>Remaining Life<br>in Years | Number<br>Exercisable | Weighted-<br>Average<br>Exercise<br>Price |
| 40,000              | \$ 4.72-\$4.72              | \$ 4.72                                | 3.50   | 40,000                | \$ 4.72                                   |
| 65,000              | \$ 5.78-\$6.49              | \$ 6.15                                | 2.76   | 65,000                | \$ 6.15                                   |
| 200,000             | \$ 7.46-\$9.39              | \$ 9.00                                | 5.30   | 200,000               | \$ 9.00                                   |
| 175,000             | \$ 10.89-\$13.01            | \$ 12.77                               | 6.32   | 175,000               | \$ 12.77                                  |
| 75,000              | \$ 14.64-\$15.62            | \$ 15.36                               | 7.77   | 75,000                | \$ 15.36                                  |
| 20,000              | \$ 17.14-\$17.14            | \$ 17.14                               | 9.50   | 20,000                | \$ 17.14                                  |
| 575,000             | \$ 4.72-\$17.14             | \$ 10.64                               | 5.67   | 575,000               | \$ 10.64                                  |

The aggregate intrinsic value, which represents the amount by which the fair value of our common stock exceeds the option exercise prices, was \$3,381,000 and \$4,210,000 as of June 30, 2008 and December 31, 2007, respectively.

The weighted-average exercise price of stock options granted during the six months ended June 30, 2008 was \$17.14 per share. The weighted-average exercise price of stock options granted during the six months ended June 30, 2007 was \$14.64 per share. The total intrinsic value of stock options exercised during the six months ended June 30, 2008 was \$157,000. The total intrinsic value of stock options exercised during the six months ended June 30, 2007 was \$3,288,000. Compensation expense related to stock options granted has been recorded in selling, general and administrative expenses.

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(9) Selling, General and Administrative Expenses

The following table presents selling, general and administrative expenses by type for the three and six month periods ended June 30, 2008 and 2007:

|   | Three months ended<br>June 30, |                  | Six months ended<br>June 30, |                  |
|---|--------------------------------|------------------|------------------------------|------------------|
|   | 2008                           | 2007             | 2008                         | 2007             |
|   | (in thousands)                 |                  |                              |                  |
| Personal expenses   | \$ 17,512                      | \$ 16,555        | \$ 34,049                    | \$ 22,877        |
| Other administrative expenses                             | 5,463                          | 3,887            | 10,019                       | 5,543            |
| Advertising and marketing costs                           | 1,973                          | 1,462            | 3,342                        | 2,224            |
| Network operating expenses                                | 12,541                         | 8,469            | 23,272                       | 13,299           |
| IT costs  | 3,346                          | 1,580            | 6,634                        | 2,186            |
| Other taxes   | 995                            | 579              | 1,507                        | 845              |
| Bad debt and collection costs                             | 1,507                          | 1,893            | 4,318                        | 1,522            |
| Legal, audit and consultant fees                          | 1,036                          | 59               | 1,610                        | 1,264            |
| Management fees   | 18                             | 17               | 46                           | 17               |
| Other operating expenses                                  | 8,388                          | 852              | 10,094                       | 1,984            |
| <b>Total for segments</b>                                 | <b>\$ 52,779</b>               | <b>\$ 35,353</b> | <b>\$ 94,891</b>             | <b>\$ 51,761</b> |
| Backbone rental expenses                                  | (6,076)                        | (4,256)          | (10,757)                     | (7,225)          |
| Network operating expenses                                | (6,464)                        | (3,980)          | (12,515)                     | (5,575)          |
| Direct personal expenses                                  | (5,389)                        | (3,426)          | (10,136)                     | (5,405)          |
| <b>Total selling, general and administrative expenses</b> | <b>\$ 34,850</b>               | <b>\$ 23,691</b> | <b>\$ 61,483</b>             | <b>\$ 33,556</b> |

Personnel expenses for the six months ended June 30, 2008 and 2007 include restructuring expenses of \$3.1 million and \$5.6 million, respectively relating to the reorganization following the Memorex Acquisition in 2008 and the Invitel Acquisition in 2007.

Bad debt and collection costs for the six months ended June 30, 2008 and 2007 include one-off bad debt expenses as a result of an additional provision made at Memorex in the amount of \$0.2 million in 2008 and at PanTel in the amount of \$1.2 million in 2007.

Legal, audit fees and consultant expenses for the six months ended June 30, 2008 and 2007 include Sarbanes-Oxley and compliance expenses amounting to approximately \$1.0 million for both periods.

Other operating expenses for the six months ended June 30, 2008 include integration costs of \$6.5 million, due diligence expenses of \$1.3 million, start-up expenses relating to Memorex Turkey in the amount of \$1.1 million, a provision for unused vacation days in the amount of \$1.2 million and other non-recurring items of \$1.7 million. Other operating expenses for the six months ended June 30, 2007 include integration costs of \$1.0 million, due diligence expenses of \$0.4 million and a provision for unused vacation days in the amount of \$1.0 million.

The change in the amounts of reconciling items is primarily due to the Invitel Acquisition and the Memorex Acquisition.

(10) Segment Disclosures

We manage our business based on four segments: Mass Market Voice; Mass Market Internet, Business and Wholesale. Our management monitors the revenue streams of these segments and operations are managed and financial performance is evaluated based on these segments.



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These segments are as follows:

*Mass Market Voice.* The revenue generated from the fixed line voice and voice-related services provided to Mass Market customers within our historical concession areas and outside our historical concession areas in Hungary. Mass Market Voice revenue comprises monthly fees charged for accessing our network, time based fixed-to-mobile, local, long distance and international call charges, interconnect charges on calls terminated in our network, monthly fees for value added services, one-time connection and new service fees, as well as monthly fees for packages with built-in call minutes.

*Mass Market Internet.* The revenue generated from dial-up and DSL Internet connections provided to Mass Market customers in Hungary both inside and outside our historical concession areas. Mass Market Internet revenue comprises dial-up revenue, which is generated through a combination of time based and access fees, and DSL revenue, which is generated through a variety of monthly packages.

*Business.* The revenue generated from the fixed line voice, data and Internet services provided to business, government and other institutional customers nationwide. Business revenue comprises access charges, monthly fees, time based fixed-to-mobile, local, long distance and international call charges, interconnect charges on calls terminated in our network, monthly fees for value added services, Internet access packages. In addition, Business revenue includes revenue from leased line, Internet and data transmission services which is comprised of fixed monthly rental fees based on the capacity/bandwidth of the service and the distance between the endpoints of the customers.

*Wholesale.* The revenue generated from voice and data services provided on a wholesale basis to other operators or resellers. Wholesale revenue comprises rental payments for high bandwidth leased line services, which are based on the bandwidth of the service and the distance between the endpoints of the customers, fixed monthly charges for supply of dark fibre or ducts, and voice transit charges from other Hungarian and international telecommunications service providers, which are based on the number of minutes transited. The revenue and gross margin of the acquired Memorex business is disclosed fully in the Wholesale segment.

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The revenue and gross margin by these segments for the three and six months ended June 30, 2008 and 2007 were as follows:

|                             | Three months ended<br>June 30, |                  | Six months ended<br>June 30, |                   |
|-----------------------------|--------------------------------|------------------|------------------------------|-------------------|
|                             | 2008                           | 2007             | 2008                         | 2007              |
| (in thousands of \$)        |                                |                  |                              |                   |
| <b>Revenue:</b>             |                                |                  |                              |                   |
| Mass Market Voice           | \$ 43,677                      | \$ 25,456        | \$ 85,624                    | \$ 34,333         |
| Mass Market Internet        | 14,716                         | 8,357            | 28,235                       | 9,503             |
| Business                    | 39,061                         | 28,590           | 76,269                       | 43,225            |
| Wholesale                   | 50,606                         | 30,447           | 89,394                       | 54,927            |
| <b>Total Revenue</b>        | <b>\$ 148,060</b>              | <b>\$ 92,850</b> | <b>\$ 279,522</b>            | <b>\$ 141,988</b> |
| <b>Cost of sales:</b>       |                                |                  |                              |                   |
| Mass Market Voice           | \$ 8,961                       | \$ 4,487         | \$ 18,079                    | \$ 6,355          |
| Mass Market Internet        | 2,445                          | 1,396            | 4,906                        | 1,454             |
| Business                    | 9,584                          | 7,962            | 18,242                       | 12,479            |
| Wholesale                   | 20,614                         | 16,203           | 40,557                       | 28,361            |
| Total allocated to segments | \$ 41,604                      | \$ 30,048        | \$ 81,784                    | \$ 48,649         |
| Backbone rental expenses    | 6,076                          | 4,256            | 10,757                       | 7,225             |
| Network operating expenses  | 6,464                          | 3,980            | 12,515                       | 5,575             |
| Direct personal expenses    | 5,389                          | 3,426            | 10,136                       | 5,405             |
| <b>Total Cost of sales</b>  | <b>\$ 59,533</b>               | <b>\$ 41,710</b> | <b>\$ 115,192</b>            | <b>\$ 66,854</b>  |
| <b>Gross margin:</b>        |                                |                  |                              |                   |
| Mass Market Voice           | \$ 34,716                      | \$ 20,969        | \$ 67,545                    | \$ 27,978         |
| Mass Market Internet        | 12,271                         | 6,961            | 23,329                       | 8,049             |
| Business                    | 29,477                         | 20,628           | 58,027                       | 30,746            |
| Wholesale                   | 29,992                         | 14,244           | 48,837                       | 26,566            |
| Total allocated to segments | \$ 106,456                     | \$ 62,802        | \$ 197,738                   | \$ 93,339         |
| Backbone rental expenses    | (6,076)                        | (4,256)          | (10,757)                     | (7,225)           |
| Network operating expenses  | (6,464)                        | (3,980)          | (12,515)                     | (5,575)           |
| Direct personal expenses    | (5,389)                        | (3,426)          | (10,136)                     | (5,405)           |
| <b>Total Gross margin</b>   | <b>\$ 88,527</b>               | <b>\$ 51,140</b> | <b>\$ 164,330</b>            | <b>\$ 75,134</b>  |

The change in the amounts of reconciling items is primarily due to the Invitel Acquisition and the Memorex Acquisition.



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Part I. Financial Information

HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARIES

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations  
Cautionary Statement Concerning Forward-Looking Statements**

This Quarterly Report on Form 10-Q contains forward-looking statements. Statements that are not historical facts are forward-looking statements made pursuant to the Safe Harbor Provisions of the Private Securities Litigation Reform Act of 1995. These statements are based on our estimates and assumptions and are subject to risks and uncertainties, which could cause actual results to differ materially from those expressed or implied in the statements. Words such as believes, anticipates, estimates, expects, intends and similar expressions are intended to identify forward-looking statements. Forward-looking statements (including oral representations) are only predictions or statements of current plans, which we review continuously. For all forward-looking statements, we claim the protection of the safe harbor for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995.

The following important factors, along with those factors discussed elsewhere in this Quarterly Report on Form 10-Q and in our other reports filed with the Securities and Exchange Commission, could affect future results and could cause those results to differ materially from those expressed in the forward-looking statements:

Changes in the growth rate of the overall Hungarian, E.U. and Central and Eastern European economies such that inflation, interest rates, currency exchange rates, business investment and consumer spending are impacted;

Materially adverse changes in economic conditions in Hungary and Central and Eastern Europe;

Changes in the currency exchange markets particularly in the Hungarian forint-euro exchange rate, the Hungarian forint-U.S. dollar exchange rate and the euro-U.S. dollar exchange rate which could affect our financial statements and our ability to repay our debt;

Our ability to integrate Invitel's, Memorex's and Tele2 Hungary's operations into the Company and to realize anticipated benefits from these business combinations;

Our ability to effectively manage and otherwise monitor our operations, costs, regulatory compliance and service quality;

Our ability to effectively manage our operating expenses, capital expenses and reduce or refinance our debt;

Our dependence on cash flow from our subsidiaries and certain restrictions on their ability to pay dividends to the parent company;

Regulatory developments; particularly with respect to tariffs, conditions of interconnection and customer access;

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HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARIES

The overall effect of competition from mobile service providers, other fixed line telecommunications services providers, cable television operators, ISPs and others in the markets that we currently compete in and in the markets that we may enter into;

Changes in consumer preferences for different telecommunication technologies, including trends toward mobile and cable substitution;

Our ability to generate growth or profitable growth;

Material changes in available technology and the effects of such changes including product substitutions and deployment costs;

Our ability to retain key employees;

Changes in E.U. laws and regulations, which may require Hungary and other countries to revise their telecommunications laws;

Political changes in Hungary;

The final outcome of certain legal proceedings affecting us;

Our ability to comply with Section 404 of the Sarbanes-Oxley Act of 2002, which requires our management to assess our internal control systems and disclose whether our internal control systems are effective, and the identification of any material weaknesses in our internal control over financial reporting;

Changes in our accounting assumptions that regulatory agencies, including the SEC, may require or that result from changes in the accounting rules or their application, which could result in an impact on our financial results;

The performance of our IT Systems;

Our ability to successfully complete the integration of any businesses or companies that we may acquire into our operations;

Our relationship with our controlling stockholder; and

The factors referred to in the Risk Factors section (Item 1A.) of our 2007 Annual Report on Form 10-K. You should consider these important factors in evaluating any forward-looking statements in this Quarterly Report on Form 10-Q or otherwise made by us or on our behalf. We urge you to read the entire Report for a more complete discussion of the factors that could affect our future

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performance, the Hungarian and Central and Eastern European telecommunications industry and Hungary in general. In light of these risks, uncertainties and assumptions, the events described or suggested by the forward-looking statements in this Report may not occur.

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HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARIES

Except as required by law or applicable stock exchange rules or regulations, we undertake no obligation to update or revise publicly any forward-looking statement, whether as a result of new information, future events or otherwise. All subsequent written and oral forward-looking statements attributable to us or to persons acting on our behalf are expressly qualified in their entirety by the cautionary statements referred to above and contained elsewhere in this Report.

**Overview**

We are the second largest fixed line telecommunications services provider in Hungary and the incumbent provider of fixed line telecommunications services to residential and business customers in our 14 historical concession areas, where we have a dominant market share. We are the number one alternative fixed line operator outside our historical concession areas. We also use our network capacity to transport voice, data and Internet traffic for other telecommunications service providers, and Internet Service Providers ( ISPs ) on a wholesale basis. Our network extends into most other countries in the Central and Eastern European region where we have owned points of presence ( POPs ).

We provide telecommunications services in Hungary and in the region through our Hungarian and other operating subsidiaries under our common brand: Invitel. We also provide Internet and data services to business customers in Romania through our Romanian subsidiary, Euroweb Romania.

Our historical concession areas are geographically clustered and cover an estimated 2.1 million people, representing approximately 21% of Hungary's population. Outside our historical concession areas, we believe that we are well positioned to continue to grow our revenue and market share using our owned state-of-the-art backbone network, our experienced sales force and our comprehensive portfolio of services. Our extensive backbone network (comprising approximately 8,500 route km in Hungary and 19,000 route km outside Hungary) provides us with nationwide and international reach. It allows business customers to be connected directly to our network to access voice, data and Internet services. Our regional network allows us to offer telecommunications network capacity on a wholesale basis to large international carriers.

We have a diversified revenue and cash flow base, making us less susceptible to market pressures in any particular market segment. For the six months ended June 30, 2008, we derived approximately 31% of our revenue from Mass Market Voice, 10% from Mass Market Internet, 27% from Business and 32% from Wholesale.

As of January 1, 2008, we completed the legal consolidation of some of our Hungarian operating subsidiaries. Hungarotel, PanTel and Euroweb Hungary have merged into Invitel. This merger legally completed the consolidation process and we now market our products principally under a single unified brand name Invitel. With the legal merger complete, we will benefit from improved efficiencies and reduced administrative costs.

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HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARIES

On March 5, 2008, we acquired 95.7% of the outstanding equity in Austrian-based Memorex Telex Communication AG (the Memorex Acquisition). The total purchase consideration for Memorex was EUR 90.9 million (approximately \$138.1 million at closing) including the assumption of debt and transaction costs and other directly related expenses. We used a discounted cash flow methodology and comparable trading multiples in determining the purchase price. The total purchase consideration of EUR 90.9 million included: (i) the payment of cash in the amount of EUR 18.8 million (approximately \$28.6 million at closing), (ii) the assumption of net debt of EUR 69.7 million (approximately \$105.8 million at closing); and (iii) transaction costs and other directly related expenses of EUR 2.4 million (approximately \$3.7 million at closing). Following the completion of the Memorex Acquisition we are now the leading provider of wholesale capacity and data services in Central and Eastern Europe.

As of June 30, 2008, we had approximately 395,000 telephone lines connected to our network within our historical concession areas to service Mass Market Voice customers and we had approximately 572,000 active Mass Market Voice customers outside our historical concession areas connected through Carrier Pre-Selection (CPS), Carrier Selection (CS) or Local Loop Unbundling (LLU). This is compared to December 31, 2007 when we had approximately 405,000 telephone lines in service within our historical concession areas to service Mass Market Voice customers and approximately 662,000 active Mass Market Voice customers connected through indirect access outside our historical concession areas. The decrease in the number of active Mass Market Voice customers outside our historical concession areas from 662,000 as of December 31, 2007 to 572,000 as of June 30, 2008 is due to churn of low value CS customers.

The number of our Mass Market broadband DSL customers has increased from approximately 122,000 as of December 31, 2007 to approximately 131,000 as of June 30, 2008.

In the Business segment, as of June 30, 2008, we had approximately 48,000 voice telephone lines within our historical concession areas compared to approximately 47,000 lines at 2007 year end. Outside our historical concession areas, we had approximately 59,000 direct access voice telephone lines and approximately 12,000 indirect access voice telephone lines as of June 30, 2008, compared to approximately 58,000 direct access voice telephone lines and approximately 13,000 indirect access voice telephone lines as of December 31, 2007. As of June 30, 2008, we had approximately 17,000 DSL lines and approximately 14,000 leased lines compared to approximately 16,000 DSL lines and approximately 12,000 leased lines at 2007 year end.

In the Wholesale market, we had over 570 customers as of June 30, 2008, which customers include telecommunication services providers from Western Europe and the United States, incumbent telecommunications services providers, alternative fixed line telecommunications services providers, mobile operators, cable television operators and Internet Service Providers.

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## Part I. Financial Information

## HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARIES

Our goal is to provide customers with good value telecommunications services coupled with exceptional service and to be a cost efficient telecommunications service provider. Our primary risk is our ability to retain existing customers and attract new customers in a competitive market. Our success depends upon our operating and marketing strategies, as well as market acceptance of our telecommunications services within Hungary and the region.

We will continue to explore other strategic merger, acquisition or alliance opportunities. In addition, we will also continuously review our service portfolio to identify service opportunities that can enhance our competitive position.

**Comparison of the Three Months Ended June 30, 2008 and Three Months Ended June 30, 2007**

The functional currency of our Hungarian subsidiaries is the Hungarian forint, the functional currency of Memorex and Memorex's subsidiaries is the euro and the functional currency of our other subsidiaries outside Hungary is the applicable local currency. The average U.S. dollar/Hungarian forint exchange rate for the three months ended June 30, 2008 was 158.64, compared to an average U.S. dollar/Hungarian forint exchange rate for the three months ended June 30, 2007 of 184.29. The average euro/U.S. dollar exchange rate for the three months ended June 30, 2008 was 1.56, compared to an average euro/U.S. dollar exchange rate for the three months ended June 30, 2007 of 1.35. When comparing the three months ended June 30, 2008 to the three months ended June 30, 2007, you should note that U.S. dollar reported amounts have been affected by the 16% appreciation of the Hungarian forint against the U.S. dollar and the 14% appreciation of the euro against the U.S. dollar. Certain amounts in functional currency terms have been reported in U.S. dollars using a fixed exchange rate for comparative purposes.

Our results have also been affected by the inclusion of Invitel's results since April 27, 2007, the date of the Invitel Acquisition; the results of Tele2 Hungary since October 18, 2007, the date of the Tele2 Hungary Acquisition; and the results of Memorex from March 5, 2008, the date of the Memorex Acquisition. Our results for the three months ended June 30, 2007 include the results of Invitel and do not include the results of Tele2 Hungary and Memorex.

*Revenue*

| (dollars in millions) | Three Months<br>Ended June 30, |             | % change   |
|-----------------------|--------------------------------|-------------|------------|
|                       | 2008                           | 2007        |            |
| Mass Market Voice     | \$ 43.7                        | \$ 25.4     | 72%        |
| Business              | 39.1                           | 28.6        | 37%        |
| Mass Market Internet  | 14.7                           | 8.4         | 75%        |
| Wholesale             | 50.6                           | 30.4        | 66%        |
| <b>Total Revenue</b>  | <b>148.1</b>                   | <b>92.8</b> | <b>59%</b> |

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HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARIES

Our revenue in U.S. dollar terms increased by \$55.3 million, or 59% for the three months ended June 30, 2008 compared to the three months ended June 30, 2007. In functional currency terms, revenue increased by 39%. This increase is attributable to the factors described below.

***Mass Market Voice***

Our Mass Market Voice revenue for the three months ended June 30, 2008 was \$43.7 million compared to \$25.4 million for the three months ended June 30, 2007, representing an increase of \$18.3 million or 72%. This increase is mainly due to: (i) the addition of Tele2 Hungary; (ii) the fact that for the three months ended June 30, 2008 Invitel's Mass Market Voice revenue was included for the entire period, compared to the period of the three months ended June 30, 2007, when Invitel's Mass Market Voice revenue was included for only two months; and (iii) the 16% appreciation of the Hungarian forint against the U.S. dollar during the three months ended June 30, 2008 compared to the prior year.

The number of Mass Market Voice telephone lines within our historical concession areas was approximately 395,000 as of June 30, 2008 compared to 419,000 as of June 30, 2007 and the number of Carrier Selection (CS) and Carrier Pre-Selection (CPS) customers that represents our customer base outside our historical concession areas was approximately 572,000 as of June 30, 2008 compared to 211,000 as of June 30, 2007.

***Business***

Our Business revenue for the three months ended June 30, 2008 was \$39.1 million compared to \$28.6 million for the three months ended June 30, 2007, representing a \$10.5 million or 37% increase. This increase was primarily due to: (i) the fact that for the three months ended June 30, 2008 Invitel's Business revenue was included for the entire period, compared to the period of the three months ended June 30, 2007, when Invitel's Business revenue was included for only two months; and (ii) the 16% appreciation of the Hungarian forint against the U.S. dollar.

The number of Business voice telephone lines inside our historical concession areas was approximately 48,000 both as of June 30, 2008 and 2007. The number of direct access Business voice telephone lines outside our historical concession areas was approximately 59,000 as of June 30, 2008 compared to 55,000 as of June 30, 2007 and the number of indirect access Business voice telephone lines outside our historical concession areas was approximately 12,000 as of June 30, 2008 compared to approximately 14,000 as of June 30, 2007. In addition, we had approximately 17,000 DSL lines and approximately 14,000 leased lines as of June 30, 2008 compared to approximately 14,000 DSL lines and approximately 13,000 leased lines as of June 30, 2007.

***Mass Market Internet***

Our Mass Market Internet revenue increased by \$6.3 million, or 75% from \$8.4 million for the three months ended June 30, 2007 to \$14.7 million for the three months ended June 30, 2008. This increase is primarily due to: (i) the fact that for the three months ended June 30, 2008

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## HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARIES

Invitel's Mass Market Internet revenue was included for the entire period, compared to the period of the three months ended June 30, 2007, when Invitel's Mass Market Internet revenue was included for only two months; and (ii) the 16% appreciation of the Hungarian forint against the U.S. dollar.

As of June 30, 2008 we had approximately 131,000 broadband DSL customers compared to approximately 109,000 broadband DSL customers as of June 30, 2007, which represents a 20% increase.

**Wholesale**

Our Wholesale revenue increased by \$20.2 million, or 66% from \$30.4 million for the three months ended June 30, 2007 to \$50.6 million for the three months ended June 30, 2008. This increase is primarily attributable to: (i) the fact that for the three months ended June 30, 2008 Invitel's Wholesale revenue was included for the entire period, compared to the period of the three months ended June 30, 2007, when Invitel's Wholesale revenue was included for only two months; (ii) the inclusion of Memorex's Wholesale revenue, which resulted in an additional \$14.7 million in Wholesale revenue and (iii) the 16% appreciation of the Hungarian forint against the U.S. dollar.

*Cost of Sales*

| (dollars in millions) | Three Months Ended June 30, |         |
|-----------------------|-----------------------------|---------|
|                       | 2008                        | 2007    |
| Segment cost of sales | \$ 41.6                     | \$ 30.0 |

Cost of sales, at the segment level, was \$41.6 million for the three months ended June 30, 2008 and \$30.0 million for the three months ended June 30, 2007, which represents an increase of \$11.6 million or 39%. This increase is mainly attributable to: (i) the fact that for the three months ended June 30, 2008 Invitel's cost of sales was included for the entire period, compared to the period of the three months ended June 30, 2007, when Invitel's cost of sales was included for only two months; (ii) the inclusion of Memorex's cost of sales, which resulted in additional cost of sales of \$1.8 million and (iii) the 16% appreciation of the Hungarian forint against the U.S. dollar.

The following table presents a reconciliation of segment cost of sales to cost of sales as per our Condensed Consolidated Statement of Operations and Comprehensive Income (Loss) for the three months ended June 30, 2008 and 2007:

| (dollars in millions)      | Three Months Ended June 30, |                |
|----------------------------|-----------------------------|----------------|
|                            | 2008                        | 2007           |
| Segment cost of sales      | \$ 41.6                     | \$ 30.0        |
| Backbone rental expenses   | 6.1                         | 4.3            |
| Network operating expenses | 6.5                         | 4.0            |
| Direct personnel expenses  | 5.4                         | 3.4            |
| <b>Total cost of sales</b> | <b>\$ 59.6</b>              | <b>\$ 41.7</b> |



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## Part I. Financial Information

## HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARIES

The change in the amounts of reconciling items is primarily due to the Invitel Acquisition and the Memorex Acquisition.

*Gross Margin*

| (dollars in millions)       | Three Months Ended June 30, |             | % change   |
|-----------------------------|-----------------------------|-------------|------------|
|                             | 2008                        | 2007        |            |
| Mass Market Voice           | \$ 34.7                     | \$ 20.9     | 66%        |
| Business                    | 29.5                        | 20.6        | 43%        |
| Mass Market Internet        | 12.2                        | 7.0         | 74%        |
| Wholesale                   | 30.0                        | 14.3        | 110%       |
| <b>Segment Gross Margin</b> | <b>106.4</b>                | <b>62.8</b> | <b>69%</b> |
| Segment Gross Margin %      | 71.9%                       | 67.7%       |            |

Our segment gross margin increased from \$62.8 million for the three months ended June 30, 2007 to \$106.4 million for the three months ended June 30, 2008, an increase of \$43.6 million or 69%. This increase is attributable to the factors described below.

Our segment gross margin percentage increased from 67.7% in the three months ended June 30, 2007 to 71.9% in the three months ended June 30, 2008. This improvement in gross margin percentage is due to the fact that Invitel has a higher gross margin percentage than we had prior to the Invitel Acquisition.

In addition to the segment gross margin, consolidated gross margin includes backbone rental expenses, network operating expenses and direct personnel expenses, which increased as a result of the inclusion of Invitel and Memorex.

*Mass Market Voice*

Our Mass Market Voice gross margin for the three months ended June 30, 2008 was \$34.7 million compared to \$20.9 million for the three months ended June 30, 2007, representing an increase of \$13.8 million or 66%. This increase is mainly due to: (i) the addition of Tele2 Hungary; (ii) the fact that for the three months ended June 30, 2008 Invitel's Mass Market Voice gross margin was included for the entire period, compared to the period of the three months ended June 30, 2007, when Invitel's Mass Market Voice gross margin was included for only two months; and (iii) the 16% appreciation of the Hungarian forint against of the U.S. dollar.

The gross margin for the three months ended June 30, 2008 compared to the three months ended June 30, 2007 was also affected by: (i) the decrease in Mass Market Voice revenue inside our historical concession areas; offset by (ii) the increase in Mass Market voice revenue outside our historical concession areas and (iii) the reduction in interconnect charges, which resulted in lower cost of sales for the three months ended June 30, 2008 than in the prior year.

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## Part I. Financial Information

## HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARIES

**Business**

Our Business gross margin for the three months ended June 30, 2008 was \$29.5 million compared to \$20.6 million for the three months ended June 30, 2007, representing an \$8.9 million or 43% increase. The increase was primarily due to: (i) the fact that for the three months ended June 30, 2008 Invitel's Business gross margin was included for the entire period, compared to the period of the three months ended June 30, 2007, when Invitel's Business gross margin was included for only two months; and (ii) the 16% appreciation of the Hungarian forint against the U.S. dollar.

**Mass Market Internet**

Our Mass Market Internet gross margin increased by \$5.2 million, or 74% from \$7.0 million for the three months ended June 30, 2007 to \$12.2 million for the three months ended June 30, 2008. This increase is primarily due to: (i) the fact that for the three months ended June 30, 2008 Invitel's Mass Market Internet gross margin was included for the entire period, compared to the period of the three months ended June 30, 2007, when Invitel's Mass Market Internet gross margin was included for only two months; and (ii) the 16% appreciation of the Hungarian forint against the U.S. dollar.

**Wholesale**

Our Wholesale gross margin increased by \$15.7 million, or 110% from \$14.3 million for the three months ended June 30, 2007 to \$30.0 million for the three months ended June 30, 2008. This increase is primarily attributable to (i) the fact that for the three months ended June 30, 2008 Invitel's Wholesale gross margin was included for the entire period, compared to the period of the three months ended June 30, 2007, when Invitel's Wholesale gross margin was included for only two months; (ii) the inclusion of Memorex's Wholesale gross margin, which resulted in an additional gross margin of \$13.0 million; and (iii) the 16% appreciation of the Hungarian forint against the U.S. dollar.

**Selling, General and Administrative**

| (dollars in millions)                       | Three Months Ended June 30, |         |
|---|-----------------------------|---------|
|   | 2008                        | 2007    |
| Segment selling, general and administrative | \$ 52.8                     | \$ 35.4 |

Our selling, general and administrative expenses at the segment level, increased by \$17.4 million from \$35.4 million for the three months ended June 30, 2007 to \$52.8 million for the three months ended June 30, 2008. This increase is mainly attributable to: (i) the fact that for the three months ended June 30, 2008 Invitel's selling, general and administrative expenses were included for the entire period, compared to the period of the three months ended June 30, 2007, when Invitel's selling, general and administrative expenses were included for only two months; (ii) the inclusion of Memorex's selling, general and administrative expenses, which resulted in an increase of \$8.6 million; and (iii) the 16% appreciation of the Hungarian forint against the U.S. dollar.

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## HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARIES

The following table presents a reconciliation of segment selling, general and administrative expenses to selling, general and administrative expenses as per our Condensed Consolidated Statement of Operations and Comprehensive Income (Loss) for the three months ended June 30, 2008 and 2007:

| (dollars in millions)                            | Three Months Ended June 30, |                |
|--|-----------------------------|----------------|
|  | 2008                        | 2007           |
| Segment selling, general and administrative      | \$ 52.8                     | \$ 35.4        |
| Backbone rental expenses                         | (6.1)                       | (4.3)          |
| Network operating expenses                       | (6.5)                       | (4.0)          |
| Direct personnel expenses                        | (5.4)                       | (3.4)          |
| <b>Total selling, general and administrative</b> | <b>\$ 34.8</b>              | <b>\$ 23.7</b> |

The change in the amounts of reconciling items is primarily due to the Invitel Acquisition and the Memorex Acquisition.

*Depreciation and Amortization*

| (dollars in millions)         | Three Months Ended June 30, |         |
|-------------------------------|-----------------------------|---------|
|                               | 2008                        | 2007    |
| Depreciation and amortization | \$ 32.3                     | \$ 18.0 |

Depreciation and amortization increased by \$14.3 million from \$18.0 million for the three months ended June 30, 2007 to \$32.3 million for the three months ended June 30, 2008. This increase is mainly due to: (i) the fact that for the three months ended June 30, 2008 Invitel's depreciation and amortization expense was included for the entire period, compared to the period of the three months ended June 30, 2007, when Invitel's depreciation and amortization expense was included for only two months; (ii) the inclusion of Memorex's depreciation and amortization charges, which resulted in additional depreciation and amortization expense of \$5.3 million; and (iii) the 16% appreciation of the Hungarian forint against the U.S. dollar.

*Income from Operations*

| (dollars in millions)  | Three Months Ended June 30, |        |
|------------------------|-----------------------------|--------|
|                        | 2008                        | 2007   |
| Income from operations | \$ 21.4                     | \$ 9.5 |

As a result of the factors described above our income from operations increased by \$11.9 million from \$9.5 million for the three months ended June 30, 2007 to \$21.4 million for the three months ended June 30, 2008.

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## HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARIES

*Foreign Exchange Gains / (Losses), Net*

| <b>(dollars in millions)</b>         | <b>Three Months Ended June 30,</b> |             |
|--------------------------------------|------------------------------------|-------------|
|                                      | <b>2008</b>                        | <b>2007</b> |
| Foreign exchange gains (losses), net | \$ 47.3                            | \$ 3.5      |

Our foreign exchange gains of \$47.3 million for the three months ended June 30, 2008 resulted primarily from unrealized gains relating to the revaluation of our euro denominated debt at period end as a result of the strengthening of the Hungarian forint against the euro during the three months ended June 30, 2008 compared to our foreign exchange gains of \$3.5 million for the three months ended June 30, 2007 resulted primarily from unrealized gains relating to the revaluation of our euro denominated debt at period end as a result of the strengthening of the Hungarian forint against the euro during the three months ended June 30, 2007. The increase in our foreign exchange gains is due to the increase in our debt and the significant strengthening of the Hungarian forint against the euro during the three months ended June 30, 2008 compared to 2007.

*Interest Expense*

| <b>(dollars in millions)</b> | <b>Three Months Ended June 30,</b> |             |
|------------------------------|------------------------------------|-------------|
|                              | <b>2008</b>                        | <b>2007</b> |
| Interest expense             | \$ 30.3                            | \$ 14.4     |

Interest expense increased by \$15.9 million from \$14.4 million for the three months ended June 30, 2007 to \$30.3 million for the three months ended June 30, 2008. This increase is mainly due to: (i) the inclusion of the interest expense attributable to our assumed debt from the Invitel Acquisition for the three months ended June 30, 2008, which resulted in an additional \$16.3 million of interest expense; (ii) the additional interest expense of \$6.1 million as a result of the issuance of the 2007 Notes in connection with the Invitel Acquisition; (iii) interest expense on the Bridge Loans of \$4.5 million relating to the Memorex Acquisition; and (iv) the 16% appreciation of the Hungarian forint against the U.S. dollar.

*Interest Income*

| <b>(dollars in millions)</b> | <b>Three Months Ended June 30,</b> |             |
|------------------------------|------------------------------------|-------------|
|                              | <b>2008</b>                        | <b>2007</b> |
| Interest income              | \$ 0.4                             | \$ 0.2      |

Our interest income was \$0.4 million for the three months ended June 30, 2008 and \$0.2 million for the three months ended June 30, 2007. Interest income was realized on our cash balance during these periods.

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## HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARIES

*Gains / (Losses) from Fair Value Changes of Derivative Financial Instruments*

| (dollars in millions)  | Three Months Ended June 30, |           |
|--|-----------------------------|-----------|
|  | 2008                        | 2007      |
| Gains / (losses) from fair value changes of derivative financial instruments | \$ (66.7)                   | \$ (21.8) |

The \$66.7 million loss on the fair value changes of derivative financial instruments for the three months ended June 30, 2008 and the \$21.8 million loss on the fair value changes of derivative financial instruments for the three months ended June 30, 2007 is primarily due to the changes in the unrealized fair value of the hedges entered into in connection with the debt assumed as part of the Intel Acquisition. See Item 3 Quantitative and Qualitative Disclosures about Market Risk .

*Income Tax Benefit / (Expense)*

| (dollars in millions)                | Three Months Ended June 30, |        |
|--------------------------------------|-----------------------------|--------|
|                                      | 2008                        | 2007   |
| Corporate tax                        | 0.1                         | 1.0    |
| Local business tax                   | (2.1)                       | (2.0)  |
| Current tax benefit / (expense)      | (2.0)                       | (1.0)  |
| Deferred tax benefit / (expense)     | 3.4                         | 10.8   |
| Total income tax benefit / (expense) | \$ 1.4                      | \$ 9.8 |

Our income tax changed from a benefit of \$9.8 million for the three months ended June 30, 2007 to a benefit of \$1.4 million for the three months ended June 30, 2008, primarily due to the reduction in pretax profit and continued reserve on our tax losses in the United States and Netherlands.

*Net Income / (Loss) Attributable to Common Stockholders*

| (dollars in millions)                                   | Three Months Ended June 30, |           |
|---|-----------------------------|-----------|
|   | 2008                        | 2007      |
| Net income / (loss) attributable to common stockholders | \$ (27.8)                   | \$ (16.2) |

As a result of the factors discussed above, we recorded a net loss attributable to common stockholders of \$27.8 million, or \$1.69 per basic share and \$1.69 per share on a diluted basis, for the three months ended June 30, 2008 compared to a net loss attributable to common stockholders of \$16.2 million, or \$1.00 per basic share and \$1.00 per share on a diluted basis, for the three months ended June 30, 2007.

**Comparison of the Six Months Ended June 30, 2008 and Six Months Ended June 30, 2007**

The functional currency of our Hungarian subsidiaries is the Hungarian forint, the functional currency of Memorex and Memorex's subsidiaries is the euro and the functional

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## HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARIES

currency of our other subsidiaries outside Hungary is the applicable local currency. The average U.S. dollar/Hungarian forint exchange rate for the six months ended June 30, 2008 was 165.99, compared to an average U.S. dollar/Hungarian forint exchange rate for the six months ended June 30, 2007 of 188.53. The average euro/U.S. dollar exchange rate for the six months ended June 30, 2008 was 1.53, compared to an average euro/U.S. dollar exchange rate for the six months ended June 30, 2007 of 1.33. When comparing the six months ended June 30, 2008 to the six months ended June 30, 2007, you should note that U.S. dollar reported amounts have been affected by the 14% appreciation of the Hungarian forint against the U.S. dollar and the 13% appreciation of the euro against the U.S. dollar. Certain amounts in functional currency terms have been reported in U.S. dollars using a fixed exchange rate for comparative purposes.

Our results have also been affected by the inclusion of Invitel's results since April 27, 2007, the date of the Invitel Acquisition; the results of Tele2 Hungary since October 18, 2007, the date of the Tele2 Hungary Acquisition; and the results of Memorex from March 5, 2008, the date of the Memorex Acquisition. Our results for the six months ended June 30, 2007 include the results of Invitel for two months and do not include the results of Tele2 Hungary and Memorex.

*Revenue*

| (dollars in millions) | Six Months Ended June 30, |              | % change   |
|-----------------------|---------------------------|--------------|------------|
|                       | 2008                      | 2007         |            |
| Mass Market Voice     | \$ 85.6                   | \$ 34.3      | 150%       |
| Business              | 76.3                      | 43.3         | 76%        |
| Mass Market Internet  | 28.2                      | 9.5          | 197%       |
| Wholesale             | 89.4                      | 54.9         | 63%        |
| <b>Total Revenue</b>  | <b>279.5</b>              | <b>142.0</b> | <b>97%</b> |

Our revenue in U.S. dollar terms increased by \$137.5 million, or 97% for the six months ended June 30, 2008 compared to the six months ended June 30, 2007. In functional currency terms, revenue increased by 73%. This increase is attributable to the factors described below.

*Mass Market Voice*

Our Mass Market Voice revenue for the six months ended June 30, 2008 was \$85.6 million compared to \$34.3 million for the six months ended June 30, 2007, representing an increase of \$51.3 million or 150%. This increase is mainly due to: (i) the addition of Tele2 Hungary; (ii) the fact that for the six months ended June 30, 2008 Invitel's Mass Market Voice revenue was included for the entire period, compared to the period of the six months ended June 30, 2007, when Invitel's Mass Market Voice revenue was included for only two months; and (iii) the 14% appreciation of the Hungarian forint against the U.S. dollar compared to the prior year.

The number of Mass Market Voice telephone lines within our historical concession areas was approximately 395,000 as of June 30, 2008 compared to 419,000 as of June 30, 2007 and the number of Carrier Selection (CS) and Carrier Pre-Selection (CPS) customers that represents our customer base outside our historical concession areas was approximately 572,000 as of June 30, 2008 compared to 211,000 as of June 30, 2007.

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HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARIES

***Business***

Our Business revenue for the six months ended June 30, 2008 was \$76.3 million compared to \$43.3 million for the six months ended June 30, 2007, representing a \$33.0 million or 76% increase. The increase was primarily due to (i) the fact that for the six months ended June 30, 2008 Invitel's Business revenue was included for the entire period, compared to the period of the six months ended June 30, 2007, when Invitel's Business revenue was included for only two months; and (ii) the 14% appreciation of the Hungarian forint against the U.S. dollar.

The number of Business voice telephone lines inside our historical concession areas was approximately 48,000 both as of June 30, 2008 and 2007. The number of direct access Business voice telephone lines outside our historical concession areas was approximately 59,000 as of June 30, 2008 compared to 55,000 as of June 30, 2007 and the number of indirect access Business voice telephone lines outside our historical concession areas was approximately 12,000 as of June 30, 2008 compared to approximately 14,000 as of June 30, 2007. In addition, we had approximately 17,000 DSL lines and approximately 14,000 leased lines as of June 30, 2008 compared to approximately 14,000 DSL lines and approximately 13,000 leased lines as of June 30, 2007.

***Mass Market Internet***

Our Mass Market Internet revenue increased by \$18.7 million from \$9.5 million for the six months ended June 30, 2007 to \$28.2 million for the six months ended June 30, 2008. This increase is primarily due to: (i) the fact that for the six months ended June 30, 2008 Invitel's Mass Market Internet revenue was included for the entire period, compared to the period of the six months ended June 30, 2007, when Invitel's Mass Market Internet revenue was included for only two months; and (ii) the 14% appreciation of the Hungarian forint against the U.S. dollar.

As of June 30, 2008 we had approximately 131,000 broadband DSL customers compared to approximately 109,000 broadband DSL customers as of June 30, 2007, which represents a 20% increase.

***Wholesale***

Our Wholesale revenue increased by \$34.5 million, or 63% from \$54.9 million for the six months ended June 30, 2007 to \$89.4 million for the six months ended June 30, 2008. This increase is primarily attributable to: (i) the fact that for the six months ended June 30, 2008 Invitel's Wholesale revenue was included for the entire period, compared to the period of the six months ended June 30, 2007, when Invitel's Wholesale revenue was included for only two months; (ii) the inclusion of Memorex's Wholesale revenue, which resulted in an additional \$19.7 million in revenue and (iii) the 14% appreciation of the Hungarian forint against the U.S. dollar.

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## Part I. Financial Information

## HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARIES

*Cost of Sales*

| (dollars in millions) | Six Months Ended June 30, |         |
|-----------------------|---------------------------|---------|
|                       | 2008                      | 2007    |
| Segment cost of sales | \$ 81.8                   | \$ 48.7 |

Cost of sales, at the segment level, totaled \$81.8 million for the six months ended June 30, 2008 and \$48.7 million for the six months ended June 30, 2007, representing an increase of \$33.1 million or 68%. This increase is mainly attributable to: (i) the fact that for the six months ended June 30, 2008 Invitel's cost of sales was included for the entire period, compared to the period of the six months ended June 30, 2007, when Invitel's cost of sales was included for only two months; (ii) the inclusion of Memorex's cost of sales, which resulted in additional cost of sales of \$2.5 million and (iii) the 14% appreciation of the Hungarian forint against the U.S. dollar.

The following table presents a reconciliation of segment cost of sales to cost of sales as per our Condensed Consolidated Statement of Operations and Comprehensive Income (Loss) for the six months ended June 30, 2008 and 2007:

| (dollars in millions)      | Six Months Ended June 30, |         |
|----------------------------|---------------------------|---------|
|                            | 2008                      | 2007    |
| Segment cost of sales      | \$ 81.8                   | \$ 48.7 |
| Backbone rental expenses   | 10.8                      | 7.2     |
| Network operating expenses | 12.5                      | 5.6     |
| Direct personnel expenses  | 10.1                      | 5.4     |
| Total cost of sales        | \$ 115.2                  | \$ 66.9 |

The change in the amounts of reconciling items is primarily due to the Invitel Acquisition and the Memorex Acquisition.

*Gross Margin*

| (dollars in millions)  | Six Months Ended June 30, |         | % change |
|------------------------|---------------------------|---------|----------|
|                        | 2008                      | 2007    |          |
| Mass Market Voice      | \$ 67.5                   | \$ 27.9 | 142%     |
| Business               | 58.1                      | 30.7    | 89%      |
| Mass Market Internet   | 23.3                      | 8.0     | 191%     |
| Wholesale              | 48.8                      | 26.7    | 83%      |
| Segment Gross Margin   | 197.7                     | 93.3    | 112%     |
| Segment Gross Margin % | 70.7%                     | 65.8%   |          |



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Our segment gross margin changed from \$93.3 million for the six months ended June 30, 2007 to \$197.7 million for the six months ended June 30, 2008, representing an increase of \$104.4 million or 112%. This increase is attributable to the factors described below.

Our segment gross margin percentage increased from 65.8% in the three months ended June 30, 2007 to 70.7% in the three months ended June 30, 2008. This improvement in gross margin percentage is due to the fact that Invitel has a higher gross margin percentage than we had prior to the Invitel Acquisition.

In addition to the segment gross margin, consolidated gross margin includes backbone rental expenses, network operating expenses and direct personnel expenses, which increased as a result of the inclusion of Invitel and Memorex.

***Mass Market Voice***

Our Mass Market Voice gross margin for the six months ended June 30, 2008 was \$67.5 million compared to \$27.9 million for the six months ended June 30, 2007, representing an increase of \$39.6 million or 142%. This increase is mainly due to (i) the addition of Tele2 Hungary; (ii) the fact that for the six months ended June 30, 2008 Invitel's Mass Market Voice gross margin was included for the entire period, compared to the period of the six months ended June 30, 2007, when Invitel's Mass Market Voice gross margin was included for only two months; and (iii) the 14% appreciation of the Hungarian forint against of the U.S. dollar.

The gross margin for the six months ended June 30, 2008 compared to the six months ended June 30, 2007 was also impacted by: (i) the decrease in Mass Market Voice revenue inside our historical concession areas; offset by (ii) the increase in Mass Market voice revenue outside our historical concession areas and (iii) the reduction in interconnect charges, which resulted in lower cost of sales for the six months ended June 30, 2008 than in the prior year.

***Business***

Our Business gross margin for the six months ended June 30, 2008 was \$58.1 million compared to \$30.7 million for the six months ended June 30, 2007, representing a \$27.4 million or 89% increase. The increase was primarily due to (i) the fact that for the six months ended June 30, 2008 Invitel's Business gross margin was included for the entire period, compared to the period of the six months ended June 30, 2007, when Invitel's Business gross margin was included for only two months; and (ii) the 14% appreciation of the Hungarian forint against the U.S. dollar.

***Mass Market Internet***

Our Mass Market Internet gross margin increased by \$15.3 million from \$8.0 million for the six months ended June 30, 2007 to \$23.3 million for the six months ended June 30, 2008. This increase is primarily due to: (i) the fact that for the six months ended June 30, 2008 Invitel's Mass Market Internet gross margin was included for the entire period, compared to the period of the six months ended June 30, 2007, when Invitel's Mass Market Internet gross margin was included for only two months; and (ii) the 14% appreciation of the Hungarian forint against the U.S. dollar.

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## HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARIES

**Wholesale**

Our Wholesale gross margin increased by \$22.1 million or 83% from \$26.7 million for the Six Months Ended June 30, 2007 to \$48.8 million for the Six Months Ended June 30, 2008. This increase is primarily attributable to (i) the fact that for the six months ended June 30, 2008 Invitel's Wholesale gross margin was included for the entire period, compared to the period of the six months ended June 30, 2007, when Invitel's Wholesale gross margin was included for only two months; (ii) the inclusion of Memorex's Wholesale gross margin, which resulted in an additional gross margin of \$17.2 million; and (iii) the 14% appreciation of the Hungarian forint against the U.S. dollar.

**Selling, General and Administrative**

| (dollars in millions)                       | Six Months Ended June 30, |         |
|---|---------------------------|---------|
|   | 2008                      | 2007    |
| Segment selling, general and administrative | \$ 94.9                   | \$ 51.8 |

Our selling, general and administrative expenses at the segment level, increased by \$43.1 million from \$51.8 million for the six months ended June 30, 2007 to \$94.9 million for the six months ended June 30, 2008. This increase is mainly attributable to: (i) the fact that for the six months ended June 30, 2008 Invitel's selling, general and administrative expenses were included for the entire period, compared to the period of the six months ended June 30, 2007, when Invitel's selling, general and administrative expenses were included for only two months; (ii) the inclusion of four months of Memorex's selling, general and administrative expenses which resulted in an increase of \$14.2 million; and (iii) the 14% appreciation of the Hungarian forint against the U.S. dollar.

The following table presents a reconciliation of segment selling, general and administrative expenses to selling, general and administrative expenses as per our Condensed Consolidated Statement of Operations and Comprehensive Income (Loss) for the six months ended June 30, 2008 and 2007:

| (dollars in millions)                       | Six Months Ended June 30, |         |
|---|---------------------------|---------|
|   | 2008                      | 2007    |
| Segment selling, general and administrative | \$ 94.9                   | \$ 51.8 |
| Backbone rental expenses                    | (10.8)                    | (7.2)   |
| Network operating expenses                  | (12.5)                    | (5.6)   |
| Direct personnel expenses                   | (10.1)                    | (5.4)   |
| Total selling, general and administrative   | \$ 61.5                   | \$ 33.6 |

The change in the amounts of reconciling items is primarily due to the Invitel Acquisition and the Memorex Acquisition.

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## HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARIES

*Depreciation and Amortization*

| (dollars in millions)         | Six Months Ended June 30, |         |
|-------------------------------|---------------------------|---------|
|                               | 2008                      | 2007    |
| Depreciation and amortization | \$ 58.9                   | \$ 25.4 |

Depreciation and amortization increased by \$33.5 million from \$25.4 million for the six months ended June 30, 2007 to \$58.9 million for the six months ended June 30, 2008. This increase is mainly due to: (i) the fact that for the six months ended June 30, 2008 Invitel's depreciation and amortization expense was included for the entire period, compared to the period of the six months ended June 30, 2007, when Invitel's depreciation and amortization expense was included for only two months; (ii) the inclusion of four months of Memorex's depreciation and amortization expense, which resulted in additional depreciation and amortization expense of \$6.6 million; and (iii) the 14% appreciation of the Hungarian forint against the U.S. dollar.

*Income from Operations*

| (dollars in millions)  | Six Months Ended June 30, |         |
|------------------------|---------------------------|---------|
|                        | 2008                      | 2007    |
| Income from operations | \$ 43.9                   | \$ 16.2 |

As a result of the factors described above, income from operations increased by \$27.7 million from \$16.2 million for the six months ended June 30, 2007 to \$43.9 million for the six months ended June 30, 2008.

*Foreign Exchange Gains / (Losses), Net*

| (dollars in millions)                | Six Months Ended June 30, |        |
|--------------------------------------|---------------------------|--------|
|                                      | 2008                      | 2007   |
| Foreign exchange gains (losses), net | \$ 34.1                   | \$ 6.5 |

Our foreign exchange gains of \$34.1 million for the six months ended June 30, 2008 resulted primarily from unrealized gains due to the revaluation of our euro denominated debt at period end as a result of the strengthening of the Hungarian forint against the euro during the six months ended June 30, 2008.

Our foreign exchange gains of \$6.5 million for the six months ended June 30, 2007 resulted primarily from the strengthening of the Hungarian forint against the euro on our euro denominated debt outstanding during the period.

*Interest Expense*

| (dollars in millions) | Six Months Ended June 30, |         |
|-----------------------|---------------------------|---------|
|                       | 2008                      | 2007    |
| Interest expense      | \$ 57.9                   | \$ 18.2 |

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Our interest expense increased by \$39.7 million from \$18.2 million for the six months ended June 30, 2007 to \$57.9 million for the six months ended June 30, 2008. This increase is mainly due to: (i) the inclusion of the interest expense attributable to our assumed debt from the Invitel Acquisition for the six months ended June 30, 2008, which resulted in an additional \$31.7 million of interest expense; (ii) the additional interest expense of \$11.7 million as a result of the issuance of the 2007 Notes in connection with the Invitel Acquisition; (iii) interest expense on the Bridge Loan of \$5.8 million relating to the Memorex Acquisition; and (iv) the 14% appreciation of the Hungarian forint against the U.S. dollar.

*Interest Income*

| (dollars in millions) | Six Months Ended June 30, |        |
|-----------------------|---------------------------|--------|
|                       | 2008                      | 2007   |
| Interest income       | \$ 0.8                    | \$ 0.5 |

Our interest income was \$0.8 million for the six months ended June 30, 2008 and \$0.5 million for the six months ended June 30, 2007. Interest income was realized on our cash balance during these periods.

*Gains / (Losses) from Fair Value Changes of Derivative Financial Instruments*

| (dollars in millions)  | Six Months Ended June 30, |           |
|--|---------------------------|-----------|
|  | 2008                      | 2007      |
| Gains / (losses) from fair value changes of derivative financial instruments | \$ (37.6)                 | \$ (65.9) |

The \$37.6 million loss and the \$65.9 million loss on the fair value changes of derivative financial instruments for the six months ended June 30, 2008 and 2007, respectively, is primarily the result of the changes in the unrealized fair value of the hedges entered into in connection with the debt assumed as part of the Invitel Acquisition. See Item 3 Quantitative and Qualitative Disclosures about Market Risk .

*Gains / (Losses) from Fair Value Change of Warrants*

| (dollars in millions)                               | Six Months Ended June 30, |           |
|---|---------------------------|-----------|
|   | 2008                      | 2007      |
| Gains / (losses) from fair value change of warrants | \$                        | \$ (15.1) |

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## HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARIES

In May 1999, we issued notes (the *Notes*) in an aggregate amount of \$25.0 million with detachable warrants (the *Warrants*) to purchase 2,500,000 shares of our common stock at a price of \$10 per share. The Notes were canceled upon the exercise of the Warrants by TDC, our majority stockholder, on March 28, 2007. In accordance with SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, we recorded a loss of \$15.1 million upon exercise of the Warrants.

*Income Tax Benefit / (Expense)*

| (dollars in millions)                | Six Months Ended June 30, |        |
|--------------------------------------|---------------------------|--------|
|                                      | 2008                      | 2007   |
| Corporate tax                        | 0.2                       | (0.1)  |
| Local business tax                   | (4.0)                     | (3.4)  |
| Current tax benefit / (expense)      | (3.8)                     | (3.5)  |
| Deferred tax benefit / (expense)     | (1.3)                     | 11.5   |
| Total income tax benefit / (expense) | \$ (5.1)                  | \$ 8.0 |

Our income tax changed from a benefit of \$8.0 million for the six months ended June 30, 2007 to an expense of \$5.1 million for the six months ended June 30, 2008, primarily due to our deferred tax expense as a result of reserving our tax losses in the United States and Netherlands.

*Net Income / (Loss) Attributable to Common Stockholders*

| (dollars in millions)                                   | Six Months Ended June 30, |           |
|---|---------------------------|-----------|
|   | 2008                      | 2007      |
| Net income / (loss) attributable to common stockholders | \$ (23.8)                 | \$ (70.8) |

As a result of the factors discussed above, we recorded a net loss attributable to common stockholders of \$23.8 million or \$1.45 per basic share and \$1.45 per share on a diluted basis, for the Six Months Ended June 30, 2008 compared to a net loss attributable to common stockholders of \$70.8 million, or \$4.87 per basic share and \$4.87 per share on a diluted basis, for the six months ended June 30, 2007.

**Liquidity and Capital Resources**

Net cash provided by operating activities totalled \$55.6 million for the six months ended June 30, 2008, compared to \$39.7 million for the six months ended June 30, 2007. This increase is mainly due to additional cash generated due to the Intel Acquisition and the Memorex Acquisition.

Net cash used in investing activities was \$114.6 million for the six months ended June 30, 2008, and includes the acquisition of Memorex in the amount of \$49.3 million, capital expenditure of \$52.9 million and the settlement of derivative financial instruments of \$12.9 million. Net cash used in investing activities of \$126.3 million for the six months ended June 30,

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## HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARIES

2007, which includes the acquisition of Invitel in the amount of \$107.5 million, capital expenditures of \$17.8 million and the settlement of derivative financial instruments of \$2.2 million.

Financing activities provided net cash of \$65.7 million for the six months ended June 30, 2008 compared to \$111.7 million for the six months ended June 30, 2007. Cash flows from financing activities for the six months ended June 30, 2008 mainly resulted from the draw down of the Bridge Loan relating to the Memorex Acquisition in the amount of \$151.8 million and the draw down of \$14.7 million from our Amended Facilities Agreement offset by the repayment of Memorex's debt of \$90.6 million, payment under capital lease obligations of \$2.8 million and refinancing costs of \$7.5 million.

We have historically funded our capital requirements primarily through a combination of debt, equity and vendor financing. For a description of our financing arrangements and current debt structure, see Note 4 in the Notes to the Condensed Consolidated Financial Statements.

Our major contractual cash obligations as of June 30, 2008 (at June 30, 2008 exchange rates) are as follows:

## Cash Payments Due by Period

(\$ in thousands)

| Obligation                                       | Total               | 1 Year or<br>Less | 2 3 Years         | 4-5 Years           | After 5<br>Years  |
|--|---------------------|-------------------|-------------------|---------------------|-------------------|
| Long Term Debt (1)                               | \$ 1,615,466        | \$ 151,228        | \$ 236,363        | \$ 1,039,266        | \$ 188,609        |
| Interest Rate Swap Agreements                    | 68,392              | 28,041            | 40,352            |                     |                   |
| Lease Commitments to Telecommunication Providers | 137,109             | 12,174            | 23,349            | 22,314              | 79,273            |
| Other Operating Leases                           | 19,120              | 6,020             | 10,453            | 2,595               | 52                |
| Capital Leases                                   | 18,145              | 8,661             | 9,394             | 91                  |                   |
| <b>Total</b>                                     | <b>\$ 1,858,232</b> | <b>\$ 206,124</b> | <b>\$ 319,911</b> | <b>\$ 1,064,266</b> | <b>\$ 267,934</b> |

- (1) Long-term debt includes interest payment obligations calculated by rates of interest for the respective debt arrangements as follows: 9.0% for the HUF tranche of the Amended Facilities Agreement, 6.0% for the EUR tranche of the Amended Facilities Agreement, 7.5% for the 2007 Notes, 12.75% for the 2006 PIK Notes, 10.75% for the 2004 Notes and 11.5% for the Bridge Loans.

We believe that cash provided by our operating activities and our financing activities will provide adequate resources to satisfy our working capital requirements, scheduled principal and interest payments on debt and anticipated capital expenditure requirements.

We intend to either refinance our Bridge Loan or, if we choose not to or the market conditions make a refinancing prohibitive, convert the Bridge Loan to term loans maturing in 2016, which conversion right is permitted, subject to certain conditions, pursuant to the Bridge Loan Agreement. Our 2004 Notes mature in 2012 and our 2006 PIK Notes and 2007 Notes mature in 2013. We will continue to evaluate our capital structure and the capital markets in the future in making our capital financing decisions.

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HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARIES

**Inflation and Foreign Currency**

During the six months ended June 30, 2008, the Hungarian forint appreciated both against the euro and the U.S. dollar compared to the same period in 2007.

Overall, this resulted in a net foreign exchange gain of \$34.1 million for the six months ended June 30, 2008 compared to a net foreign exchange gain of \$6.5 million for the six months ended June 30, 2007.

Approximately 78% of our total revenue is denominated in Hungarian forint and our operating and other expenses, including capital expenditures, are predominantly in Hungarian forint but also in U.S. dollars and euros. In addition, certain items in the balance sheet accounts are denominated in currencies other than the functional currencies of the operating subsidiaries. Accordingly, when such accounts are translated into the functional currency, we are subject to foreign exchange gains and losses which are reflected as a component of earnings. When the subsidiaries financial statements are translated into U.S. dollars for financial reporting purposes, we are subject to translation adjustments, the effect of which is reflected as a component of stockholders' equity.

While we have the ability to increase some of the prices we charge for our services generally commensurate with increases in the Hungarian Consumer Price Index (CPI) pursuant to our licenses from the Hungarian government, and as regulated by the government, we may choose not to implement the full amount of the increase permitted due to competitive and other concerns. In addition, the rate of increase in the Hungarian CPI may not be sufficient to offset potential negative exchange rate movements and, as a result, we may be unable to generate cash flows to the degree necessary to meet our obligations in currencies other than the Hungarian forint. See Item 3 Quantitative and Qualitative Disclosures about Market Risk (Market Risk Exposure below).

**Unaudited pro-forma consolidated financial information of Matel**

In connection with the Invitel Acquisition on April 27, 2007, our subsidiary, HTCC Holdco II B.V. (Holdco II) issued Floating Rate Senior Notes (the 2007 Notes) in the amount of EUR 200 million due 2013 (as described in Note 4 in the Notes to the Condensed Consolidated Financial Statements). All liabilities and obligations relating to the 2007 Notes were transferred to our subsidiary Matel after the consummation of the Invitel Acquisition. Matel is the direct parent company of Invitel and the indirect parent of our other operating subsidiaries. We use Matel as a financing entity.

Matel is required to furnish to the holders of the 2007 Notes and the 2004 Notes all annual and quarterly reports required to be filed with the U.S. Securities and Exchange Commission, which reports are required to contain certain financial information, including certain non-GAAP financial information. We believe that the 2007 Notes and the 2004 Notes are a key component of our capital structure and any non-compliance with the 2007 Notes Indenture or the 2004 Notes Indenture could have a material impact on our financial condition and liquidity.

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## Part I. Financial Information

## HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARIES

The following table presents unaudited summarized pro-forma consolidated financial information of Matel, on a pro-forma basis, as though the combination of Invitel, Euroweb Romania, Invitel Technocom, Tele2 Hungary and Memorex had occurred at the beginning of the respective periods:

|  | Three months ended<br>June 30, |                   | Six months ended<br>June 30, |                   |
|--|--------------------------------|-------------------|------------------------------|-------------------|
|  | 2008<br>Pro-forma              | 2007<br>Pro-forma | 2008<br>Pro-forma            | 2007<br>Pro-forma |
|  | (in thousands)                 |                   |                              |                   |
| Revenue  | \$ 148,060                     | \$ 135,043        | \$ 289,716                   | \$ 270,236        |
| Adjusted EBITDA (1)  | 65,717                         | 50,251            | 124,568                      | 99,763            |
| Net income (loss)  | (20,674)                       | (14,740)          | (14,329)                     | (67,892)          |
| Depreciation and amortization                              | (32,246)                       | (35,271)          | (61,273)                     | (57,387)          |
| Net interest expense (2)                                   | (18,465)                       | (18,080)          | (38,116)                     | (35,503)          |
| Capital expenditure (3)                                    |                                |                   | 60,015                       | 56,421            |
| Net cash flow provided by (used in) operating activities * |                                |                   | 55,632                       | 38,187            |

  

|                           | June 30,<br>2008 | December 31,<br>2007 |
|---------------------------|------------------|----------------------|
|                           | (in thousands)   |                      |
| Cash and cash equivalents | \$ 31,185        | \$ 53,057            |
| Third party debt (4)      | 885,282          | 820,077              |
| Net third party debt (5)  | 854,097          | 767,020              |
| Total liabilities         | 1,205,630        | 1,075,523            |

(\*) Consolidated net cash flow provided by operating activities as per our cash flow statement for the six months ended June 30, 2008. The above unaudited pro-forma consolidated financial information is intended for informational purposes only and is not indicative of Matel's results of operations had the combination of Invitel, Euroweb Romania, Invitel Technocom, Tele2 Hungary and Memorex occurred at the beginning of the respective periods. The unaudited pro-forma consolidated financial information does not include potential cost savings from operating efficiencies or synergies.

The pro-forma financial information in Note 3 of Notes to the Condensed Consolidated Financial Statements differs from the pro-forma financial information presented above because the pro-forma financial information in Note 3 is prepared for HTCC, the parent company, while the pro-forma financial information presented here is for Matel, a subsidiary of HTCC.

The unaudited pro-forma consolidated financial information for the three and six months ended June 30, 2008 included in the above table was calculated by using a U.S. dollar/Hungarian forint exchange rate of 158.64 and 165.99, respectively, which was the average exchange rate for the three and six months ended June 30, 2008. The unaudited pro-forma consolidated financial information for the three and six months ended June 30, 2007 included in the above table was calculated by using a U.S. dollar/Hungarian forint exchange rate of 184.29 and 188.53, respectively, which was the average exchange rate for the three and six months ended June 30, 2007.



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## Part I. Financial Information

## HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARIES

- (1) We define EBITDA as net profit/(loss) plus income taxes, net financial expenses and depreciation and amortization. Adjusted EBITDA is EBITDA plus the cost of restructuring, due diligence expenses, non-cash share-based compensation and other non-recurring items. Other companies in our industry may calculate Adjusted EBITDA in a different manner. Adjusted EBITDA is not a measurement of financial performance under U.S. GAAP and should not be considered as an alternative to net gain or to cash flow from operating, investing or financing activities, as a measure of liquidity or an indicator of our operating performance or any other measures of performance derived in accordance with U.S. GAAP. Although depreciation and amortization are non-cash charges, the assets being depreciated and amortized will often have to be replaced in the future, and Adjusted EBITDA does not reflect any cash requirements for such replacements. In addition, Adjusted EBITDA does not reflect our cash expenditures or future requirements for capital expenditures or contractual commitments.

Adjusted EBITDA is reconciled to net income as follows:

|                                       | Three months ended<br>June 30, |                    | Six months ended<br>June 30, |                    |
|---------------------------------------|--------------------------------|--------------------|------------------------------|--------------------|
|                                       | 2008<br>Pro-forma              | 2007<br>Pro-Forma  | 2008<br>Pro-forma            | 2007<br>Pro-Forma  |
|                                       | (in thousands)                 |                    |                              |                    |
| Adjusted EBITDA                       | \$ 65,717                      | \$ 50,251          | \$ 124,568                   | \$ 99,763          |
| Cost of restructuring and integration | (6,053)                        | (6,929)            | (11,842)                     | (7,428)            |
| Due diligence expenses                | (647)                          | (65)               | (1,297)                      | (213)              |
| SEC related expenses                  | (912)                          | (522)              | (610)                        | (1,020)            |
| Provision for unused vacation         | (615)                          | (1,553)            | (1,235)                      | (1,590)            |
| One-off provision for bad debts       | 23                             | (1,934)            | (394)                        | (1,960)            |
| Turkey start-up expenses              | (741)                          | (1,082)            | (1,894)                      | (1,357)            |
| Other                                 | (1,375)                        | (583)              | (1,662)                      | (2,002)            |
| <b>EBITDA</b>                         | <b>\$ 55,396</b>               | <b>\$ 37,583</b>   | <b>\$ 105,634</b>            | <b>\$ 84,193</b>   |
| Income taxes                          | 1,729                          | 14,118             | (4,475)                      | 10,439             |
| Minority interest                     | 2                              | 3                  | (3)                          | 2                  |
| Financing expenses, net               | (26,429)                       | (17,030)           | (48,964)                     | (37,632)           |
| Foreign exchange gains (losses), net  | 47,546                         | 6,876              | 32,338                       | 12,547             |
| Gains (losses) on derivatives         | (66,672)                       | (21,019)           | (37,586)                     | (64,979)           |
| Gains (losses) on warrants            |                                |                    |                              | (15,075)           |
| Depreciation and amortization         | (32,246)                       | (35,271)           | (61,273)                     | (57,387)           |
| <b>Net income (loss)</b>              | <b>\$ (20,674)</b>             | <b>\$ (14,740)</b> | <b>\$ (14,329)</b>           | <b>\$ (67,892)</b> |

- (2) Net interest expense equals interest expense (excluding interest on subordinated shareholder loans) less interest income. The pro-forma adjustment to net interest expense is the additional net interest expense due to the Invitel Acquisition and the Memorex Acquisition.
- (3) Capital expenditure represents acquisition of telecommunications network equipment and other intangibles from our cash-flow statement.
- (4) Third party debt excludes related party subordinated loans, liabilities from capital lease obligations and liabilities relating to derivative financial instruments.
- (5) Net third party debt equals third party debt less cash and cash equivalents.

**Recently Adopted Accounting Pronouncements**

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements ( SFAS 157 ), which defines fair value, establishes a framework for measuring fair value in GAAP, and enhances disclosures about fair value measurements. SFAS 157 applies when other accounting pronouncements require fair value measurements; it does not require new fair value



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Part I. Financial Information

HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARIES

measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those years. In February 2008 the FASB issued a Staff Position that delays the effective date of SFAS 157. Delayed application of SFAS 157 is permitted for non-financial assets and non-financial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually), until fiscal years beginning after November 15, 2008, and interim periods within those fiscal years. We adopted SFAS 157 as of January 1, 2008 for financial assets and liabilities. The adoption of SFAS 157 has not had a material effect on our financial position or results of operations.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities – Including an amendment of FASB Statement No. 115 ( SFAS 159 )*, which permits entities to choose to measure many financial instruments and certain warranty and insurance contracts at fair value on a contract-by-contract basis. SFAS 159 applies to all reporting entities, including not-for-profit organizations, and contains financial statement presentation and disclosure requirements for assets and liabilities reported at fair value as a consequence of the election. SFAS 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. We adopted SFAS 159 as of January 1, 2008. The adoption of SFAS 159 has not had a material effect on our financial position or results of operations.

**Recently Issued Accounting Pronouncements**

In March 2008, the FASB issued FASB Statement No. 161, *Disclosures about Derivative Instruments and Hedging Activities*, an amendment of FASB Statement No. 133 ( SFAS 161 ). SFAS 161 changes disclosure requirements for derivative instruments and hedging activities. The Statement requires enhanced disclosures about (a) how and why derivative instruments are used, (b) how derivative and related hedged items are accounted for under FASB Statement No. 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect financial position, financial performance, and cash flows. We are currently assessing the impact of SFAS 161.

**Item 3. Quantitative and Qualitative Disclosures about Market Risk**  
**Market Risk Exposure**

*Foreign Currency Exchange Rate Risks*

We are exposed to various types of risk in the normal course of our business, including the risk from foreign currency exchange rate fluctuations. Our operations, including approximately 78% of our gross revenue and approximately 82% of our operating expenses, are Hungarian forint based. Therefore, we are subject to currency exchange rate risk with respect to our non-Hungarian forint denominated expenses, primarily euros and U.S. dollars, due to the variability between the Hungarian forint and the euro and U.S. dollar. Due to our limited exposure with respect to non-Hungarian forint denominated expenses, we have not entered into any agreements to manage our foreign currency risks related to such expenses but we continue to monitor the currency exchange rate risk related to such expenses.

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## Part I. Financial Information

## HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARIES

We are also exposed to exchange rate risk since the majority of our debt obligations are in euros. If the Hungarian forint weakens in the currency exchange markets versus the euro, we would have to generate more revenue in Hungarian forint to settle such debt obligations. The Hungarian forint/euro exchange rate changed from 253.35 as of December 31, 2007 to 237.03 as of June 30, 2008, an approximate 7% appreciation in the value of the Hungarian forint versus the euro. Given our euro-denominated debt obligations, exchange rate fluctuations can have a significant impact on our financial statements in connection with foreign exchange gains/losses and the resulting debt balances. The sensitivity of our future cash-flows to foreign exchange rate changes related to our debt service, including all hedging in place, is detailed in the table under the section Derivative Financial Instruments .

*Interest Rate Risks*

We are exposed to interest rate risks because our outstanding euro denominated debt and Hungarian forint denominated debt obligations primarily accrue interest at variable rates tied to market interest rates. The interest rates on the euro and Hungarian forint denominated obligations are based on EURIBOR and BUBOR, respectively. We evaluate market interest rates and the costs of interest rate hedging instruments by reviewing historical variances between market rates and rates offered by lending institutions on hedging instruments, as well as market expectations of future interest rates. The sensitivity of our future cash-flows to interest rate changes related to our debt service, including all hedging in place, is detailed in the table under the section Derivative Financial Instruments .

*Derivative Financial Instruments*

During 2007, in order to reduce our exposure to foreign currency exchange rate risk and interest rate changes, we implemented a major hedging program as part of which we hedged the interest rate and foreign currency exchange rate risks on a substantial portion of our debt. The following table summarizes the notional amounts and respective fair values of our financial instruments, which mature at varying dates, as of June 30, 2008:

| Asset / (Liability)                | Notional Amount   | Fair Market Value<br>(in thousands) | Fair Value Change  |
|------------------------------------|-------------------|-------------------------------------|--------------------|
| Cross currency interest rate swaps | \$ 650,906        | \$ (68,472)                         | \$ (30,818)        |
| FX forward contracts               |                   |                                     | (22)               |
| Interest rate swaps                | 23,178            | 80                                  | 926                |
| <b>Total</b>                       | <b>\$ 674,084</b> | <b>\$ (68,392)</b>                  | <b>\$ (29,914)</b> |

The notional principal amount provides one measure of the transaction volume outstanding as of the end of the period, and does not represent the amount of our exposure to market loss. The estimated fair values represent the estimated amounts that we would pay or receive to terminate the contracts as of June 30, 2008. The amounts ultimately realized upon settlement of these financial instruments, together with the gains and losses on the underlying exposures, will depend on actual market conditions during the remaining life of the instruments.

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## Part I. Financial Information

## HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARIES

*Sensitivity Analysis*

The following table shows the sensitivity of our debt instruments and the related hedge transactions to foreign currency exchange rate and interest rate changes as of June 30, 2008:

| Instrument  | 1% p.a. increase in interest rates     |  |                            | 10% p.a. increase in HUF/EUR rate      |  |                            |
|---|--|--|----------------------------|--|--|----------------------------|
|   | Cash Flow<br>impact on debt<br>service | Cash<br>Flow<br>impact on<br>underlying<br>hedge | Net Cash<br>Flow<br>impact | Cash Flow<br>impact on<br>debt service | Cash<br>Flow<br>impact on<br>underlying<br>hedge | Net Cash<br>Flow<br>impact |
|   | (in thousands)                         |  |                            |  |  |                            |
| Amended Facilities Agreement HUF tranche <sup>(1)</sup> | \$ (188)                               | \$ 206   | \$ 18                      | \$                                     | \$   | \$                         |
| Amended Facilities Agreement EUR tranche <sup>(1)</sup> | (931)                                  | 1,020  | 89                         | (4,220)                                | 4,190  | (30)                       |
| 2007 Notes  | (3,165)                                | 3,112  | (53)                       | (2,460)                                | 2,460  |                            |
| 2004 Notes  | (2,247)                                | 2,247  |                            | (2,420)                                | 2,420  |                            |
| 2006 PIK Notes <sup>(2)</sup>                           | (2,547)                                |  | (2,547)                    | (4,170)                                |  | (4,170)                    |
| <b>Total</b>  | <b>\$ (9,078)</b>                      | <b>\$ 6,585</b>                                  | <b>\$ (2,493)</b>          | <b>\$ (13,270)</b>                     | <b>\$ 9,070</b>                                  | <b>\$ (4,200)</b>          |

(1) Calculation based on actual outstanding notional amounts per repayment/hedging schedule

(2) The issuer can select the interest to be paid in cash or in kind (i.e. issue of new bonds)

The above table shows the impact of a 1% increase in interest rates (e.g. BUBOR and EURIBOR) and in the Hungarian forint/euro exchange rate on our debt service related cash flow due in the next 12 months.

In the ordinary course of business we enter into contractual agreements to provide and receive telephone and other services. Certain of these agreements are denominated in currencies other than the functional currency of any of the parties, mainly in euros, and are required to be accounted for separately as embedded derivatives. The impact of a 10% strengthening or weakening of the Hungarian forint against other currencies would result in a change in the amount of embedded derivatives by \$5.4 million.

**Item 4. Controls and Procedures**

Our management, with the participation of our Chief Executive and Chief Financial Officers, has evaluated the effectiveness of our disclosure controls and procedures (as defined in Securities Exchange Act of 1934, as amended, Rules 13a-15(e) and 15d-15(e)) as of the end of the period covered by this report. Based upon and as of the date of that evaluation, our Chief Executive and Chief Financial Officers concluded that our disclosure controls and procedures were effective to ensure that information required to be disclosed in the reports we file and submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive and Chief Financial Officers, as appropriate, to allow timely decisions regarding required disclosure.

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Part I. Financial Information

HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARIES

We should note that any system of disclosure controls and procedures, however well designed and operated, can provide only reasonable, and not absolute, assurance that the objectives of the system are met. In addition, the design of any system of disclosure controls and procedures is based in part upon assumptions about the likelihood of future events. Due to these and other inherent limitations of any such system, there can be no assurance that any design will always succeed in achieving its stated goals under all conditions.

There were no changes in our control over financial reporting during the quarter ended June 30, 2008 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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Part II. Other Information

HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARIES

**Item 1. Legal Proceedings**

As reported in our 2007 Annual Report on Form 10-K, several Hungarian municipalities initiated court proceedings against us in the Metropolitan Court of Budapest seeking payment in connection with an ambiguous provision in some of our concession contracts regarding the payment of local municipal taxes. On May 15, 2008, the Metropolitan Court ruled on our behalf and denied the claims of the municipalities. The municipalities have appealed this ruling and the first hearing is scheduled for October 2008.

**Item 1A. Risk Factors**

In our report on Form 10-K for 2007, we disclosed certain risk factors contingent on the closing of the Memorex Acquisition. On March 5, 2008, we completed the Memorex Acquisition.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

None.

**Item 3. Defaults Upon Senior Securities**

(a) None.

(b) In 1999 we issued 30,000 shares of Preferred Stock Series A with a liquidation value of \$70 per share. At the end of the second quarter 2008, the preferred shares were held by TDC A/S. Any holder of such Preferred Shares is entitled to receive cumulative cash dividends payable in arrears at the annual rate of 5%, compounded annually, on the liquidation value. As of June 30, 2008, the total arrearage on the Preferred Shares was \$908,000.

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

(a) Our Annual Meeting of Stockholders was held on May 23, 2008.

(b) Not Applicable.

(c) First Matter Voted on at our Annual Meeting of Stockholders:  
Election of Directors

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|                        | <b>Votes Cast<br/>For</b> | <b>Votes<br/>Withheld</b> |
|------------------------|---------------------------|---------------------------|
| Ole Steen Andersen     | 14,731,518                | 23,104                    |
| Robert R. Dogonowski   | 14,605,853                | 148,769                   |
| Jesper Theill Eriksen  | 14,605,853                | 148,769                   |
| Peter Feiner           | 14,738,739                | 15,883                    |
| Jens Due Olsen         | 14,738,739                | 15,883                    |
| Carsten Dyrup Revsbech | 14,605,853                | 148,769                   |
| Henrik Scheinemann     | 14,605,853                | 148,769                   |



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Part II. Other Information

HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARIES

Second Matter Voted on at our Annual Meeting of Stockholders:

Ratification of the appointment of PricewaterhouseCoopers Kft. as auditors of the Registrant for the fiscal year ending December 31, 2008.

| <b>For</b> | <b>Against</b> | <b>Abstain</b> |
|------------|----------------|----------------|
| 14,736,279 | 3,881          | 14,462         |

(d) Not Applicable.

**Item 5. Other Information**

None.

**Item 6. Exhibits**

- 31.1 Certification of Martin Lea, President and Chief Executive Officer, required by Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934
- 31.2 Certification of Robert Bowker, Chief Financial Officer, required by Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934
- 32.1 Certification of Martin Lea, President and Chief Executive Officer, required by Rule 13a-14(b) or Rule 15d-14(b) of the Securities Exchange Act of 1934 and Section 906 of the Sarbanes-Oxley Act of 2002, 18 U.S.C. 1350
- 32.2 Certification of Robert Bowker, Chief Financial Officer, required by Rule 13a-14(b) or Rule 15d-14(b) of the Securities Exchange Act of 1934 and Section 906 of the Sarbanes-Oxley Act of 2002, 18 U.S.C. 1350

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Part II. Other Information

HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARIES

Signatures

Pursuant to the requirements 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.

Hungarian Telephone and Cable Corp.

August 8, 2008

By: /s/ Martin Lea  
Martin Lea  
President and Chief Executive Officer

August 8, 2008

By: /s/ Robert Bowker  
Robert Bowker  
Chief Financial Officer (Principal Accounting Officer, Principal  
Financial Officer)

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**HUNGARIAN TELEPHONE AND CABLE CORP.**

Index to Exhibits

| <b>Exhibit No.</b> | <b>Description</b>  |
|--------------------|---|
| 31.1               | Certification of Principal Executive Officer pursuant to Rule 13a-14 of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2               | Certification of Principal Financial Officer pursuant to Rule 13a-14 of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1               | Certification of Principal 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 Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002                             |