Q4 2013 Results Conference Call

February 27, 2014 at 16:00 CET

Good afternoon, everybody, and welcome to Magyar Telekom's fourth quarter 2013 results conference call. I am Chris Mattheisen, Magyar Telekom's Chief Executive Officer, and I will be hosting today's call with János Szabó, our CFO.

Although 2013 was a challenging year, plagued by uncertain macroeconomic and market conditions, I am pleased to report that the Group still managed to increase revenues, improve customer retention and deliver strong customer volume figures.

During 2013 we achieved revenue growth of 5% driven by an increasing contribution from non-core telecom businesses, such as retail gas and electricity, system integration/IT services and equipment sales.

At the same time, better operational performance in Hungary allowed us to marginally beat our EBITDA guidance, realizing only an 8% decline, rather than the 9% to12% decline that was originally anticipated.

Capex for 2013 totaled 87.5 billion forint excluding spectrum acquisitions and annual frequency fee capitalizations, in line with the 5% reduction the Group had guided towards.

Turning to the free cash flow, let me first highlight that we have modified the definition of our free cash flow to better reflect the real cash generation of the Company. Due to a number of different financial structures being used, some operation related items are accounted for in the financing cash flow and thus were not included in free cash flow as per the earlier definition. Under the new definition we include such solutions – booked as "Repayment of other financial liabilities" – within our free cash flow.

In 2013, free cash flow based on this new definition decreased by 59 billion forint. This was primarily due to lower EBITDA, extension of the frequency usage rights in the 900 MHz and 1800 MHz frequency bands in Hungary, the acquisition of the 4G license in Macedonia, and the deterioration in working capital, while the proceeds from the sale of Pro-M improved 2012's performance.

Looking ahead to 2014, we expect lower growth in retail energy and equipment sales to lead to a decline in our revenues of up to 3% compared to 2013. Our reported EBITDA is expected to decline by 3% to 6% driven by the continued, albeit more gradual, shift in our revenue mix to lower margin services. Our Capex target for the year is around 87 billion forint, which we plan to spend on projects geared towards enhancing future levels of efficiency, such as IP migration and integrated CRM and billing systems. This target is excluding any spectrum acquisitions and annual frequency fee capitalizations.

Moving on to the segment analysis, revenues in **Telekom Hungary** grew by 3% year-on-year in the fourth quarter due to stabilization in fixed and mobile revenues coupled with increasing contribution from energy and IT services. As a result of the lower operating tax burden, EBITDA increased by a healthy 15%; however, it is worth noting that even when this impact is stripped out, EBITDA performance remained stable.

In the mobile market, we continued to see diverging trends in the residential and SMB segments. In the residential market, the priority was to market the flat rate packages on a much wider scale than in previous quarters. Here, thanks to our successful upselling efforts which led to optimization driven upward migration, we were able to mitigate the financial pressure from downward migration driven by the need to rationalize costs. At the same time, reflecting the difficult economic environment we saw a strong focus on cost reduction among our SMB customers which, coupled with competition driven price erosion, led to continued pressure on our profitability.

Nevertheless, in the fourth quarter we witnessed that overall roughly every third customer who had chosen one of our Next packages was actually willing to pay higher monthly charges than in previously, in exchange for the convenience of the flat rate that Next packages offer.

The penetration of smart devices and mobile internet continued to increase, with the sale of smartphones accounting for over 70% of total sales in the fourth quarter. In addition, the ratio of subscribers using smartphones by the end of the year rose to over 41%, from 31% a year earlier while around 85% of post-paid smartphone buyers subscribed to a data package. Reflecting these trends, in the fourth quarter 16% of our ARPU came from mobile internet usage and exhibited a 17% increase compared to the same period in 2012. Overall, ARPU levels declined by 2% as the impact of the lower termination fees outweighed the growth in non-voice revenues.

In the fixed line market, we have been able to further mitigate customer erosion whilst at the same time gaining the largest percentage of TV customers in the market largely due to our bundling strategy. As a result, we were able to stabilize fixed line revenues even without the positive contribution from IT and energy services, as the 7% growth in TV revenues and the almost doubling of equipment sales could fully compensate for the reduction in voice revenues. Within our equipment portfolio, smart TVs and tablets were the two most sought after items with revenues doubling and quadrupling, respectively, year on year.

I would also like to highlight the significant growth we recorded in the segment's IT revenues proving that our efforts to grow our IT market share in the SMB segment have been substantiated. More specifically, we see real demand for our recently launched service of providing basic hardware and software on a monthly payment structure, where no initial investment is needed and 24-hour expert support is provided. We consider this proposition a launch pad for our cloud services.

In the energy segment, as we continued with our cautious approach to customer acquisition, revenue growth slowed down, and the number of points of deliveries were flat compared to the end of the third quarter of 2013.

Looking forward to 2014, we intend to continue with our bundling strategy placing a stronger emphasis on the unique integrated offering that our company can provide to its customers. In the initial stages, we have simplified our mobile tariff structure by halving the number of available packages at the beginning of February while at the same time increasing the number of those offers that provide favorably priced mobile tariffs to our fixed line customers. I also anticipate that we will soon be able to report on the developments we have achieved in growing our 4 and 5 Play customer base.

Let me now hand over to János who will provide further details on the results of the T-Systems Hungary segment as well as the international subsidiaries.

János Szabó remarks

Thank you, Chris.

Turning to the performance of **T-Systems Hungary**, revenues for the fourth quarter decreased by 7% compared to the corresponding period in 2012. This was mainly driven by a 9% decrease in system integration and IT revenues resulting primarily from lower hardware sales and fewer outsourcing revenues. As mentioned before, the system integration and IT business can be very volatile as it is largely impacted by a small number of large contracts. However, for the full year system integration/IT revenues were up by 18%, counterbalancing the erosion of fixed and mobile telecom services.

EBITDA of T-Systems Hungary decreased by 35% and although we saw a year-on-year improvement in the direct margin in the fourth quarter of 2013, the non-deductible VAT charge recorded in November negatively affected our EBITDA performance.

Mobile revenues fell marginally by 1% year-on-year. Although competition drives tariffs down in this segment, we managed to offset the majority of the decline through the acquisition of a higher number of voice and internet customers coupled with the impact of the new, net 4 forint connection fee introduced in November 2013.

Fixed line revenues were down by 5%, as the termination of some key data contracts with customers from mainly the public sector resulted in a 14% data revenue decline.

Moving on to our international subsidiaries, on average, the Hungarian forint weakened by 5% against the Macedonian denar during the last quarter of 2013. Performance in **Macedonia** in the fourth quarter remained under pressure due to intense competition. Consequently, total revenues in local currency terms declined by 12% compared to the last quarter of 2012. EBITDA declined by 18% in denar terms, while the EBITDA margin remained at a healthy level of 39%.

Mobile revenues in local currency terms were down 15% for the quarter driven by the continued voice retail revenue decline, as the slight increase in the customer base and the 10% higher MOU could not offset the 18% decline in ARPU in denar terms. At the same time, the mobile termination rate cut which became effective as of November 2013 negatively impacted wholesale revenues. Nevertheless, we did experience increasing demand for smartphones, which comprised as much as 66% of handset sales in the fourth quarter. That said, smartphone penetration remains below 30%, and as such, we see significant upside potential in this segment. In December 2013, we became the first operator to launch a 4G service in Macedonia and we believe that we will reap the benefits of this investment, as it will give us the all-important edge over our competitors, particularly as the penetration of fourth generation devices and mobile data usage increases.

In the fixed line segment, revenues were 7% lower in denar terms. IPTV remained our flagship product with the number of subscribers increasing by 33%, to 88 thousand. Unfortunately, this uptake was unable to compensate for the negative effect of fixed voice churn. At the same time, as the first European operator, Makedonski Telekom launched a pure All IP network with all of the company's fixed lines migrated to the new platform. Among other benefits, this change enables a much faster time to market when it comes to new product or service launches, while providing a better quality of audio calls and an overall richer portfolio of multimedia services.

As with Macedonia, our **Montenegrin subsidiary**'s fourth quarter results were also positively impacted by the average 5% year-on-year weakening of the forint against the euro. Excluding this, total revenues were down by 1% in local currency terms, while EBITDA for the period decreased by 7% due to higher severance expenses related to a voluntary headcount reduction program that was implemented at the end of 2013.

Mobile revenues declined by 8% in euro terms. Voice revenues decreased by 19%, mainly due to the negative effect of the lower mobile termination rates effective as of January 2013 and the tariff pressures stemming from the economic and competitive environment. That said, there is a positive development that I would like to share with you: the SIM and IPTV subscription based tax that was introduced in July 2012 has been abolished as from January 2014.

Turning to the fixed line segment, revenues increased by 4% in local currency terms, as the decline in voice and data usage was offset by the growing contribution of TV and internet revenues. In addition, other fixed line revenues increased driven by a long term rental of dark fiber networks. Despite increasing competition from cable operators, we have managed to maintain our strong leading position in all of our fixed line markets.

Chris Mattheisen remarks

Thank you very much, János. That concludes the formal part of Magyar Telekom's conference call. Now, operator, when you are ready, we will take the first question.

(Take questions)

I believe we have time for one more question.

(Take final question)

If you have any follow-up questions, please contact our Investor Relations Department. Please also note that the transcript of our conference call will shortly be available on our website. Thank you again for joining us today.