2Q 2016 Results Conference Call

Aug 5, 2016 at 15:00 CET

Good afternoon everyone and good morning to those of you calling from the Americas. I am Marton Lennert, Magyar Telekom's Head of Investor Relations. On behalf of the Company, I would like to welcome you to our second quarter 2016 conference call. If you have not received our presentation by email, please note that this is available in the Investor Relations section of our website and it can also be reached if you click on the link within the conference call invitation.

Before we get started, I would like to draw your attention to the disclaimer on the last slide. Information in this presentation contains statements about expected future events and financial results that are forward-looking and subject to risks and uncertainties.

Unfortunately, Mr. Christopher Mattheisen, our Chief Executive Officer is unable to join our call today but we have with us Mr. János Szabó, our CFO, who will take you through the quarterly results and answer any questions you may have. And now it is my pleasure to turn the call to János.

János Szabó:

Thank you, Marton. Good afternoon everybody.

Let's start today's call with a brief summary of what we have achieved operationally in the second quarter of this year and what it means financially at Group level for the first half of 2016. Then, as usual, I will give you an update on the performance of our three segments – MT Hungary, Macedonia and Montenegro.

I am pleased to report that the positive trends in our KPIs seen during the past few quarters have continued into the second quarter of this year. Although our headline revenue witnessed a 6.5% decline compared to the second quarter of 2015, as you can see **on Slide 2**, this was primarily due to our decisions with respect to the energy business and lower Systems Integration and IT revenues resulting from a temporary slowdown in EU fund inflows. Excluding these, our core telco revenues continued to grow by 2.2% driven by growth in mobile data and equipment coupled with fixed broadband and TV revenue uplift. On the other hand, Group EBITDA for the quarter declined by 2.0% year-on-year as higher other operating expenses offset gross profit growth and lower employee related expenses.

On Slide 3, you can see our half year **group financials**. Our Group **revenues** decreased by 7.0% compared to the first half of last year primarily driven by the decline in energy and SI/IT revenues which was partly mitigated by increasing telco revenues. Thanks to investments in 4G networks across our footprints, our Group mobile broadband and equipment revenues increased significantly whilst voice revenues declined. Following the fixed access network upgrades, we were also able to further grow our fixed broadband and TV customer bases at higher ARPUs in Hungary. Group-wide rollout of Magenta1, our quad-play proposition based on the integrated Telekom brand, has helped too in promoting our brand and services.

Our **EBITDA** performance improved by 5.0% year-on-year in the first half of this year. It was achieved not only through gross margin growth, but also thanks to significant savings in employee related expenses and one-off gains in the first quarter. Group Capex for the first half of 2016 was virtually unchanged compared to last year, resulting in a steadily increasing **Free Cash Flow.** Group FCF for the half year exceeded 20 billion forints, despite the incremental severance payout, loan repayment and a higher settlement of capex creditors. The net debt to total capital ratio improved from 42.9% at the end of 2015 to 42.4% driven by a reduction in both short- and long-term borrowings. There is a slight increase in our leverage compared to the previous quarter due to the dividend payout in May 2016, but we expect our net debt ratio to further decline in the second half of this year. Our performance so far this year has been in-line with our expectations and I am pleased to reiterate our **guidance** targets; for the avoidance of doubt, the one-off gains recorded in the first quarter were as expected and have been incorporated into our outlook.

On Slide 4, you can see how **different segments** contributed to our revenue and EBITDA performance. The revenue drop was principally driven by the Hungary segment due to the absence of energy revenues and the slowdown in SI/IT. MT-Hungary segment's EBITDA was up by 1.6% due to gross profit growth and lower employee related expenses, mitigated by higher other operating expenses. I am also very pleased to report that the revenue turnaround in Macedonia continued into the second quarter this year following 5 years of decline, driven by growth in mobile and SI/IT revenues. The sharp EBITDA decline in Macedonia was mostly due to one-off employee related expenses following an outsourcing deal. Excluding severance payments, EBITDA was down by only 1.3% year-on-year in the second quarter. The 9% revenue decline in Montenegro was due to intense competition in both fixed line and mobile, while we continued to face regulatory pressure on fixed voice and broadband pricing. Montenegrin EBITDA was also down significantly driven by sustained pressure on margins and higher OPEX, mostly due to a one-off relating to the reversal of former years' tax expense accruals in the second quarter of 2015.

Let me now turn to the segmental analysis **on Slide 5**, starting with **MT Hungary**, where revenues declined by 7% during the second quarter compared to the same period in 2015 due to a significant fall in energy and SI/IT revenues. We are proud of the fact that with the MTR cut behind us, our mobile revenues in Q2 improved by 4%. We were able to increase our fixed revenues driven by broadband and TV thanks to a growing customer base and ARPUs. EBITDA in the MT Hungary segment increased by almost 2% due to an improvement in gross profit and lower employee related expenses, partly offset by higher other operating expenses. The underlying growth was driven by an increase in gross profit whilst telco taxes declined slightly owing to a lower subscribers base and changing calling habits. Gross profit rose by 2 billion forints due to improved telco margins driven by higher ARPUs in mobile, fixed BB and TV. Employee-related expenses improved by circa 2 billion forints due to the headcount reduction program implemented in 2014 and 2015, partly offset by wage and cafeteria benefit increases and a smaller proportion of project related employee related expenses which were capitalized in the quarter. On the other hand, other operating expenses increased by 3 billion forints due to higher marketing, sponsorship and advisory fees, as well as increased rental fees, higher network maintenance and IT costs due to the parallel operation of legacy and next generation platforms.

On Slide 6 you can see a 2% increase in our postpaid customer base thanks to prepaid to postpaid migration driven by strong demand for data. Our postpaid ratio is at 58% in Hungary and continues to grow. We are pleased to report that our blended **mobile** ARPU also improved by 3%. The popularity of the flat tariff plans offering unlimited voice and messaging to customers remained high leading to 7% growth in the Minutes of Usage. Thanks to our attractive device portfolio, smartphone sales represented over 90% of postpaid handsets driving mobile equipment revenues. The retail mobile market remained relatively stable due to the muted impact of UPC as the only MVNO and we do not expect Digi to enter the market before the fourth quarter of this year. Nevertheless, we continue to witness very strong price competition in the business mobile market targeting our higher than average market shares in both the SMB and enterprise segments.

Following the High Speed Internet network upgrade and roll-outs, the favorable trends experienced in **fixed** broadband and TV in the previous quarters have continued, resulting in a customer base growth of 4% and 3%, respectively, as shown **on Slide 7.** We maintained our market leader positions in both market segments and already have more than a million fixed broadband subscribers in Hungary with an increasing share of high bandwidth tariff plans. We have also maintained our focus on IPTV sales to offer greater value to our customers in return for a higher blended TV ARPU. Other fixed line revenues benefitted from increased date payment charges and Video on Demand usage boosted by the European Football Championships. On the other hand, competition in the business sub-segment remained intense.

We are pleased to report **on Slide 8,** that the churn rate in our **fixed voice** customer base has remained stable at 2% thanks to our effective bundling strategy. Our continued focus on efficiency is reflected in the progress achieved in IP based migration, which we aim to complete by the end of this year. The Minutes of Usage remained roughly stable in Q2, while ARPU declined by 4% due to competitive pressures coming from the cable operators.

Turning to our **energy business**, following the transfer of most of our B2B clients into the joint venture in January 2016, as well as the exit from the residential gas market last summer, our revenues declined compared to the same period last year. We now only operate in the residential electricity market, whilst awaiting the expected changes.

On Slide 9, let me draw your attention to the results of our efforts made in **bundling our services**, which is a cornerstone of our strategy. In line with our focus on targeting households, the percentage of our fixed line multiplay customers who have taken up triple-play packages has continued to increase, while the number of households with at least one Telekom fixed line service has remained stable. We witness lower churn among our double- and triple-play customers compared to customers who are provided a single service. Furthermore, our blended household fixed line ARPU increased by 3%, mostly due to successful cross-selling activities. With an integrated IP network and Telekom brand, we continued to market our Magenta1 quad-play offer. By the end of the second quarter, we have more than 73 thousand M1 customers in Hungary, which helped maximize our share of household spending on telecommunications services.

If we turn to **Slide 10**, you can see IDC's independent growth estimates for the **System Integration and IT** services market for the next few years, driven by the significant opportunities in application development and integration services. According to IDC's research, we are by far the market leader with 14% market share. This is slightly lower than the previously communicated figure due to a change in their methodology according to which the total market now also includes services provided by global vendors from their headquarters, not only through local offices which are often not directly involved in the delivery. This change has increased the size of the IT services market by 9%.

In the second quarter of 2016 our SI/IT **revenues** declined by 23% compared to the same period last year driven by a temporary slowdown of EU fund inflows. As mentioned earlier, the timing of our future SI/IT projects is very much dependant on the receipt of these funds by Hungary, and we see further downside risk in this respect for the second half of this year. On the other hand, both our SI/IT margins and gross profit increased. Looking ahead, we still believe that SI/IT will be among our key growth drivers and expect 2017 to be a stronger year in this sense. At the same time, despite the revenue decline, we saw significant margin growth in the second quarter of 2016 thanks to the successful sales mix shift towards system integration projects, which have higher added value.

Moving on to our foreign subsidiaries, starting with Macedonia **on Slide 11**, I am very pleased to report that we were able to sustain the **revenue** turnaround thanks to continued growth in mobile and SI/IT revenues. Following the merger of VIP and One, the new company started offering quad-play bundles under the VIP brand in May. Despite this development, we managed to increase our **mobile** market share to above 48% by the end of June 2016 thanks to strong Magenta1 sales and focus on the postpaid segment. The 3% mobile revenue increase was also supported by the significant growth in mobile broadband revenues thanks to our 4G push. In the **fixed line segment**, revenues fell by 4% compared to the same period last year due to lower voice revenues coupled with lower sales of equipment, such as TV sets and IT equipment. This fall was partly offset by an improvement in fixed broadband revenues due to higher ARPU. At the same time, I'm happy to report an excellent performance in **SI/IT**, where revenues more than doubled thanks to some major project wins. The 26% decline in **EBITDA** was mainly driven by a one-time severance expense booked in relation to a network outsourcing project impacting 20% of total employees. As of July 2016, Ericsson, as a managed services partner, has taken responsibility for network operations, field operations, passive networks, as well as infrastructure maintenance services both for fixed and mobile networks. Excluding this one-off, EBITDA would have declined by only 1% compared to the second quarter of 2015, which I believe is a great achievement. Looking forward, we believe in the sustainability of the revenue turnaround which is expected to lead to higher margins, and ultimately, a growth in EBITDA.

At our **Montenegrin subsidiary**, **total revenues** declined by 9% compared to the second quarter of 2015 due to competitive and regulatory pressures that continued to be felt across all major revenue lines as shown **on Slide 12**. **Mobile** revenues continued to decrease primarily due to lower voice ARPU coupled with a decline in SMSs driven by higher OTT penetration. At the same time, the launch of Magenta1 continued to have a positive impact on subscriber growth, and we saw a significant increase in our postpaid ratio: at the end of June 51% of our mobile customers had subscribed for a postpaid package compared to 44% a year ago. **Fixed line** revenues declined by 12% as fixed voice and broadband revenues were heavily affected by the regulatory price caps and more aggressive competition from cable companies offering 3Play packages. **SI/IT** revenues declined by 29%, reflecting a different dynamic in the execution of ICT deals. Despite savings in employee related expenses, Montenegrin **EBITDA** was also down significantly driven by sustained pressure on margins and higher OPEX. It's important to note that the OPEX figure in Q2 2015 was positively affected by a one-off relating to the reversal of former years' tax expense accruals following a favourable court decision.

Looking ahead, we believe that with fixed and mobile services continuing to converge, our Magenta1 offer will make us more resilient to the competitive and regulatory headwinds, by reinforcing our ability to defend the strong market share that we have in fixed line voice and to grow our mobile subscriber base.

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)

(Take questions)

I believe we have time for one more question.

(Take final question)

If you have any follow-up questions, please do 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 and your continued interest in Magyar Telekom.