Q2 2014 Results Conference Call

August 7, 2014 at 15:00 CET

Good afternoon, everybody, and welcome to Magyar Telekom's second quarter 2014 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.

Before summarizing our second quarter performance and results, I would like to give you a quick overview and status update on the initiatives that were discussed at the Investor Day held last September.

Over the past year, we successfully continued our transformation by integrating further our core, near core and beyond core services in order to provide a unique customer experience that helps to optimise value for both the Company and our subscribers.

We are delighted to see an increasing number of customers choosing us, both in the residential and business segments. Churn among residential fixed voice customers declined even further, and we managed to steadily increase our fixed broadband, TV and mobile subscriber bases. At the same time, both the number of average services and average revenue per household increased by around 2%, a figure I strongly believe will be improved further by the launch of digital home services in the coming months.

Additional efforts to enhance customer experience include the introduction of simplified product offerings and discount systems, both in our mobile and fixed portfolios. Our aim continues to be focused on leveraging further our special integrated capabilities, with one of the first initiatives being the introduction of a unique, multi screen TV product and also started to offer fixed-mobile bundles with special discount schemes.

Throughout the period, we also continued to take advantage of the opportunities that are being made available through our partnerships in the customer relations and business development spaces. We have been reshaping our sales focus and fine tuning our service portfolio in both the SMB and enterprise segments in order to become the ICT service partner of choice to our clients. Given that small and mid-sized Hungarian enterprises are still limited in terms of both financial and human resources, as well as the necessary technological know-how, at the moment our focus areas in this segment are horizontal products and basic hardware, software, and service offerings. We are already beginning to see results of these initiatives and expect IT revenues in this segment to almost double this year.

Amongst our T-Systems customer base, we are trying to strengthen customer relationships through becoming a transformation partner. We are focusing on the acquisition of industry specific knowledge, especially in the healthcare and transportation sectors, while retaining public institutions as one of our main target groups. By developing a competitive vertical portfolio with integrated solutions and improving our sales efforts, we believe that we are able to provide a superior customer experience; and as a consequence, to turn around the current declines in margin trends by next year.

Due to ongoing changes in the industry, which demand maximum resource optimization and stronger cooperation amongst participants to achieve economies of scale, developing appropriate partnerships is perhaps becoming ever more critical to the success of business development. This trend is key for us, and thanks to different Group-wide initiatives, we are able to utilize global partnerships while drawing upon specific local knowledge to meet local demand where required. Consequently, we can capitalize on know-how and share risk while simultaneously improving our efficiency of resource allocation. I believe these elements will be vital when we venture into new markets quite different from our core telecommunications industry in many ways; markets such as energy servicing, media, and finance. Therefore going forward, in order to optimize resources while continuing the expansion of our service portfolio, we plan to strengthen our relationships with partners and engage in further partnering solutions when exploring new business opportunities.

In our international operations, we continue to see challenges ahead. In Macedonia, competitive pressure remains, though we do see considerable scope to execute simplifications on an operational level. In Montenegro, our financials are stable and margins remain strong despite the depressed economic situation. However we do expect competition to intensify, resulting in some deterioration in performance. Our primary focus at both operations is to strengthen our market positions and continue to manage margin pressure.

Finally, let me say a few words about the planned 2015-2016 headcount reduction program, a major manifestation of our emphasis on efficiency improvements. As you know, we plan to reduce the Parent Company workforce by around 25% that is made possible by the encompassing simplification projects we are running. These include increasing the role of online and automated processes both internally and at the front end.

In short, I strongly believe we are on the right track to achieve all our goals that were set out when we originally embarked on this robust transformation process.

Moving on to second quarter performance, Group revenues declined by 3% compared to the same period in 2013, due to lower energy revenues, driven predominantly by the lower regulated retail prices and lower equipment sales, a reflection of what we believe to be a temporary saturation in the segments targeted. Persistent competitive challenges in Macedonia and the regulatory and competitive headwinds in Montenegro also negatively impacted revenue performance.

Despite lower revenues, our gross margin improved in the quarter as a result of improvements in the energy and SI/IT margin, while EBITDA was supported further by lower employee costs, reflecting last year's efficiency enhancing measures.

Looking ahead to the rest of this year, we expect revenue and Capex to be in line with our previously stated guidance, and EBITDA to be better than expected. The raising of EBITDA guidance is predominantly driven by our efforts to improve the gross margin, together with the slight improvement that we are witnessing in Hungarian household spending power, that lends support to our upsell efforts and demand for higher margin services such as mobile voice and TV. Consequently, we now expect EBITDA to decline by no more than 3% compared to the 2013 level. While we anticipate continued pressure on our free cash flow during the remainder of 2014, we hope to see significant improvement in this respect from 2015 onwards.

I will now hand over to János who will provide an analysis of the results on a segment by segment basis.

János Szabó remarks

Thank you, Chris.

In the **Telekom Hungary** segment revenues decreased by 3% during the second quarter compared to the same period in 2013. This was driven by lower energy revenues due to the cut in regulated prices, and the decline in voice and equipment revenues. These lower revenue streams could not however be fully offset by increasing TV and fixed and mobile broadband services.

EBITDA for the period increased by 3%, largely as a result of an improvement in gross margins both in energy and mobile services. Savings in other operating expenses were mainly driven by lower fees and levies following the capitalization of annual frequency fees last year.

In the mobile market, we recorded a further increase in the total number of subscribers, with the share made up by the faster-growing postpaid segment increasing to over 49%. This trend, coupled with stable termination rates and a strong increase in mobile internet usage, led to a 3% increase in mobile ARPU over the same period last year.

In the fixed segment, the 4% revenue decline was mostly driven by lower voice revenues as although churn was still below 2%, heavy competition-driven price pressure, as well as multi-play migration, resulted in a 7% decline in ARPU for the quarter. Both TV and broadband revenues, on the other hand, increased, with growth in the relevant customer base compensating for ongoing price pressures.

In the energy segment, revenues declined by 13%. This was largely driven by the 11% cut in regulated retail prices, effective from November 2013, and a further 6.5% cut in the regulated gas prices effective from April this year.

Let me now continue with the performance of **T-Systems Hungary** where revenues decreased by 7% in the second quarter, compared to the same period last year. This was due to a 7% decline in traditional fixed revenues coupled with a 10% decline in System Integration and IT revenues, however mobile revenues increased during the same period. Although EBITDA decreased by 6%, mainly due to the higher operating tax burden, the gross margin improvement recognized in the first quarter of 2014 continued into the second quarter. This is in line with our efforts to focus on service-intensive projects where we can add real value as an effective service and transformation partner.

Mobile revenues increased by 1% compared to the same period last year. Although competition is putting pressure on tariffs, we successfully mitigated any decline through the acquisition of new customers, while the mobile connection fee introduced in November 2013 also supported our results.

Fixed revenues decreased by 7%, due to a relatively small voice ARPU loss of 1% and a 4% loss in the number of subscribers. In addition, the decline in data revenue continued due to the termination of some contracts.

Turning to the international subsidiaries, the unfavorable impacts of competitor driven disruptive pricing on the market continued to weigh heavily on the **Macedonian** results. Revenues in Forint terms declined by 12% in the second quarter of the year compared to the same periodr of 2013. At the same time, EBITDA declined by 23%, reflecting competition driven margin erosion, higher marketing spend, and the increase in frequency fees and a one-time effect of a legal case. As the forint weakened by 3% compared to the Denar, the underlying revenue decline, i.e. in local currency terms was 14% while EBITDA was 25% weaker than a year earlier.

Mobile revenues in denar terms declined by 15%, driven by a 13% drop in retail voice revenues due to significant pricing pressures and a decline in the customer base. Wholesale voice revenue was 36% lower compared to the same period last year, as a result of the cut in mobile termination rates, effective from November 2013. Non-voice revenues declined by 5%, as an increase in mobile internet usage could not fully compensate for the fallout in SMS revenues. Consequently, APRU in the second quarter was 18% lower compared to the same period last year.

In the fixed line segment, revenues declined by 12% partly driven by a significant drop in equipment sales revenues, due to a major one-off sale in the second quarter of 2013.

In addition, voice revenues continued to decline further and could not be fully counterbalanced by the increase in TV revenues.

Going forward, we do not expect a significant improvement in the current challenging environment, particularly because following the acquisition of the number 2 cable operator, Blizoo, by Telekom Austria, both of the country's other mobile operators are now able to offer fixed voice, broadband and TV services as well.

At our **Montenegrin subsidiary** revenues declined by 2% in the second quarter in Forint terms while EBITDA increased by 2%. However, in local currency terms EBITDA decreased by 1% as efficiency improvements resulting in lower material, maintenance and marketing costs and lower employee related expenses which were driven by the

2013 voluntary headcount reduction program could not fully offset the decline in gross margin stemming from the revenue mix change.

Mobile revenues were down 9% in euro terms as higher equipment revenues driven by improving smartphone sales could only partly mitigate the decline in voice revenues. The decrease in voice revenues can be attributed to a decline in the prepaid customer base, the 7% lower ARPU driven by high tariff pressure (especially in the postpaid segment), and the negative impact of lower mobile termination rates effective from March 2014. In addition, this year's tourist season did not start as strongly as the previous year's, negatively impacting our voice visitor revenues.

Fixed line revenues in local currency terms slightly decreased, as growing IPTV and ADSL customer figures, together with increasing equipment revenues from the sale of laptops and TV sets could not fully offset the decline in voice revenues. The pressure on voice revenues increased further in the second quarter due to the introduction of retail price regulation in the fixed voice market effective from April 2014.

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.