2Q 2017 Results Conference Call

August 3, 2017 at 15:00 CET

Good afternoon everyone. I am Linda László, Magyar Telekom's Head of Investor Relations. I would like to welcome you to our second quarter 2017 results conference call. Please note that our presentation can be accessed via the link within the conference call invitation, and is also available in the Investor Relations section of our website.

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.

Today we have Mr. Christopher Mattheisen, our CEO, and Mr. János Szabó, our CFO, who will take you through the presentation and answer any questions you may have.

Now, it is my pleasure to turn the call to Chris to open the presentation.

Christopher Mattheisen:

Thank you, Linda. Good afternoon everybody.

First, let me briefly summarise our financial achievements at Group level, important business developments and where we stand in regards to the fulfilment of our targets for the year.

Group revenues continued to grow strongly in the second quarter of 2017, up by 9% compared to the same period last year, excluding contribution from Crnogorski Telekom. The majority of the growth results from strong performance of our System Integration and IT segment in Hungary, coupled with increased mobile service revenues and equipment sales. We have almost doubled our System Integration and IT revenues, primarily driven by the material uptick in the number of EU funded projects, which tend to be hardware and software heavy contracts, albeit at significantly lower profit margins.

Consequently, EBITDA declined by 2%, as successfully implemented cost saving measures did not fully offset gross profit pressures driven by the changing revenue composition.

Moving on to **Slide 3**, there are a number of notable strategic achievements in the period that I would like to bring to your attention.

In Hungary, our **new postpaid mobile portfolio**, launched at the end of March, has been well received by the market. Over 300 thousand subscribers have migrated over to this new plan. Amongst these early movers, we have witnessed significantly higher data allowance subscriptions that have helped to drive average data usage levels up by around 50%, leading to an increase in overall ARPU.

Regarding **mandatory prepaid registration**, thanks to our proactive approach and multi-channel distribution, our performance exceeded our original expectations and we managed to secure over 95% of prepaid revenues.

During the quarter, we continued the **rollout of our high-speed internet network**, that now reaches over 2.9 million Hungarian households. As a direct consequence of various initiatives introduced to increase fixed service subscriber numbers and capitalize on our upgraded network, we now have over 600 thousand customers connected to our high-speed internet network, whilst 42% of our total customer base subscribes to all three of our fixed line products.

One example of such an initiative is the launch of a **new brand, 'Flip'**, which offers an attractively priced 3Play package, available in certain areas in Hungary where Magyar Telekom is typically not the preferred choice. The package involves a simplified, online and self-care focused customer service.

We continued to focus heavily on extending our **4Play customer base,** capitalizing on our position as the only integrated operator in Hungary. Our flagship, Magenta 1 package attracted over 140 thousand customers by the end of the second quarter, while overall we had 280 thousand FMC subscribers. The increase was strongly supported by the new postpaid portfolio as 25% of those who have subscribed for the new tariff plan also have a fixed double or triple play contract.

In **Macedonia**, overall revenues declined by 4%, mostly due to the significant decline in System integration and IT revenues due to recent political uncertainty resulting in delayed government projects. However, positive trends witnessed in other areas continued. Mobile revenues increased, driven by growth in mobile internet usage coupled with improvement in the customer base. EBITDA, stripping out the impact of the severance expense, remained flat, thanks to stabilization of gross profit, despite the mobile termination rate cut.

Moving to our 2017 financial results and targets on **Slide 4.**, we have increased our **revenue guidance** for the year, to around 580 billion forint. This is based on strong trends in the first half of the year, including performance of the Hungarian System Integration and IT segment and increasing mobile service revenues, as well as high demand for fixed and mobile equipment. With regards to **EBITDA**, although we recorded a 9% decline in the first half of the year, this was mostly driven by the absence of one-off profits from the sales of Origo and Infopark Building G, as well as the TV content fee introduced last July, and increased rental costs. Going forward, we expect EBITDA to improve year-on-year, as the factors distorting the comparison will have no further impact in the second half of the year, and we also aim to achieve further savings thanks to our cost control measures. These measures also include the reorganization of the corporate structure, announced today. We believe that we will be able to service the client bases within the residential and the enterprise segments more effectively through building upon the already strong positions in the SoHo and SMB segments that we have established over the past few years. With regards to **Capex**, we are on track to reach the target of around 85 billion forints. We also expect to fulfil our **free cash flow guidance**, in line with expected higher EBITDA and improved working capital trends in the second half of the year.

I will now hand over to János to provide you with further detail on the performance of our business segments.

Thank you, Chris. Good afternoon.

Let me start with **Hungary** on **Slide 5**. Overall revenues increased by approximately 10% in the second quarter, due to significant growth in System Integration and IT, coupled with growth in mobile data and equipment revenues.

Mobile service revenues increased, driven by continued growth in mobile data revenues resulting from higher subscriber numbers and usage. This compensated for the decline in voice revenues, driven by competitive pressures, mainly in the SMB and Enterprise segments. Fixed line revenues declined slightly, as growth in TV and equipment revenues could not offset lower voice and broadband revenues. Revenues from energy services also decreased, due to the expiry of the last remaining universal gas contracts coupled with fewer electricity customers. As announced a couple of days ago, the Company will exit the residential segment of the electricity market with effect from the beginning of November, 2017.

EBITDA fell by 4% year-on-year, driven by a decline in gross profit and higher employee related expenses, partly offset by lower other operating expenses. The gross profit decline reflects the shift from high margin voice to low margin System Integration and IT services and increased cost of equipment sales, coupled with the new TV content fee introduced in July 2016. Employee-related expenses increased due to higher employee numbers. The improvement in other operating expenses resulted from successfully implemented cost saving measures.

Slide 6 shows developments in the Hungarian **mobile market.** Thanks to increased retention activities in relation to prepaid registration, further supported by our flexible new postpaid mobile portfolio, we managed to significantly improve our postpaid ratio, which now stands at 62% compared to 58% at the end of June 2016. This, together with an increased demand for higher data packages and data boosters had a positive impact on our blended mobile ARPU, which increased by 2% despite competitive pressure in the business segment. The popularity of flat tariff plans offering unlimited voice to customers remained high, leading to a 5% growth in Minutes of Usage. The number of net adds significantly increased during the quarter, following Magyar Telekom's win of the public procurement tender, to provide mobile voice and internet service to government institutions. This agreement was signed in the first quarter of 2017 and is valid for 39 months, during which Magyar Telekom remains the primary governmental mobile service provider. Although the margin generated from these services is low, there is potential to further increase our subscriber base and improve margin by acquiring closely related customers. Mobile data usage continued to significantly increase during the quarter with 82% of total traffic generated on our 4G network.

As can be seen on **Slide 7**, our **fixed broadband and TV** customer base continued to increase in the second quarter of 2017. Despite an increased number of subscribers, broadband retail revenues declined by 3%, as intense competition negatively affected tariff levels. TV revenues increased, underpinned by improving ARPU, due to price increases which reflect the content fee introduced in July 2016, as well as the new TV portfolio. Although fixed voice revenues declined due to falling tariff levels, we are pleased to report that the churn rate for our fixed voice customer base improved further to 1% thanks to our effective bundling strategy. Our efforts in service **bundling** reflect improvements in the 3Play customer base and fixed household ARPU levels, which increased 4% year-on-year. These achievements were also supported by the newly launched postpaid mobile tariff plan, which is aimed at further increasing the number of FMC customers, offering a 20% to 25% monthly fee discount for fixed-mobile convergence bundles. Regarding market shares, we maintained our position as market leader in both TV and fixed broadband. At the same time, we expect the recently announced Digi – Invitel transaction, if approved by the Competition Authority, to reshape the fixed landscape, with Digi becoming a strong number 2 player ahead of UPC.

The **Hungarian System Integration and IT segment** has been a very important driver of our recent performance. **Slide 8** shows the composition of our System Integration and IT revenues for the past 3 years, as well as a breakdown between the different vertical segments. Here I would like to underline the correlation between overall revenue volumes and EU fund inflows, which led to a decline in 2016, and a return to significant growth in 2017. However, as Chris highlighted, EU funded projects are typically infrastructure delivery deals, thus are low margin contracts. Consequently, in periods where there is an increase in EU funded projects, our SI/IT gross profit ratio tends to decline, as in the case of the second quarter of 2017. Apart from EU funded projects, contracts with the financial sector and healthcare system IT developments also contributed to the strong revenue growth.

Going forward, we expect further growth resulting from EU funded projects, and that these projects will be the catalysts to capturing a number of higher margin IT contracts, as we build upon newly established customer relationships and fixed asset investments.

Moving onto **Macedonia** on **Slide 9**, I am pleased to report some encouraging trends. Although the recent political headwinds negatively impacted System Integration and IT revenues, mobile revenues continued to increase, despite the mobile termination rate cut in December 2016. Total revenues at our Macedonian subsidiary declined by 4%.

In the **mobile segment**, thanks to the 4G push, significant growth in mobile broadband and equipment revenues more than offset the negative revenue impact resulting from the 30% cut in mobile termination rates. Although the total subscriber base declined slightly, the mobile revenue increase was further supported by a significant increase in the postpaid customer base. ARPU increased by 3% year-on-year in the second quarter of 2017, as we maintained our price premium despite aggressive pricing strategies from our main competitor, VIP.

In the **fixed line segment**, revenue decline was mainly driven by a decline in voice retail and wholesale revenues. The decline in wholesale revenues was driven by lower incoming international traffic volume and prices. In addition, fixed broadband revenues decreased due to lower pricing resulting from intense competition, and voice revenues declined reflecting a shrinking customer base and traffic levels. These negative impacts were partly mitigated by increasing TV revenues, supported by growth in both ARPU and subscriber base.

System Integration and IT revenues significantly decreased due to a delay in major government projects resulting from political turmoil.

EBITDA for the quarter increased by 31%, due to the comparison figure in the second quarter of 2016 being impacted by a one-time severance expense booked in relation to network outsourcing, as well as gross profit remaining stable for the quarter. Excluding the severance expense, EBITDA would have been flat year-on-year. This gives ground for optimism and we believe that Macedonia will return to delivering sustainable growth.

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)

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.