Q1 2010 Results Conference Call

May 12, 2010 at 15:00 CET

Good afternoon, ladies and gentlemen and welcome to Magyar Telekom's first quarter 2010 results conference call. I am Thilo Kusch, Magyar Telekom's Chief Financial Officer and member of the Board and it is my pleasure to host today's conference call.

Before going onto analyze the first quarter's financial performance, let me first briefly outline two important developments that have recently happened.

In order to enhance further Magyar Telekom's effectiveness and speed in reacting to the changes in the market place and the wider economy, the Board of Directors has decided on a number of important changes to the management structure. From 1st of July 2010, there will be eight chief officers with functional responsibilities in charge of the day-to-day operations of the company, instead of the current six. These changes will help to enhance co-operation between the marketing, sales and technology areas, and will ensure the company's transition from a traditional fixed and mobile service provider to a more innovative communications, entertainment and information services company.

Going more into the details of some key organizational changes: the Consumer Services Business Unit will no longer function as a separate business unit and all mass market product management, communications, market research and branding competencies, that were previously distributed across different areas of the company, will now be consolidated and will report into a single Chief Marketing Officer, a newly created position. Together with a new marketing and branding approach, this will help us to ensure a continuous stream of attractive products and services for our customers. A Chief Sales Officer position will also be created to help ensure a seamless end-to-end service for Magyar Telekom's mass market customers. This Chief Officer will be responsible for sales, customer service, provisioning and logistics for customer premise equipment. As a result of these changes, it is expected that Magyar Telekom will become more attuned to our customers' needs and more responsive to the changes we are facing in the market.

Let me also highlight that Magyar Telekom has held its Annual General Meeting at the beginning of April where shareholders approved the 2009 audited annual financial statements and a dividend payment of 74 forints per share.

Furthermore, the shareholders gave authorization for the Board of Directors to buy back Magyar Telekom equity, up to 10% of the Company's share capital. However, I should stress that we continue to believe that dividend payment should remain the main method for shareholder remuneration in the future as well.

Turning to the first quarter financials, total revenues declined by 7.5% as the substantial headwinds of previous quarters emanating from strong competition, saturated core markets and the wider economic downturn continued to put pressure on our business performance. As a consequence, both fixed line and mobile voice revenues continued to decline and could only partly be offset by higher TV and mobile internet revenues. Furthermore, in the first quarter, we also experienced a decline in System Integration / IT revenues as the economic and political uncertainty continued to have a negative impact on the number of projects tendered. In addition, the strengthening of the Hungarian forint compared to last year, had an adverse impact on the contributions from our foreign subsidiaries on their translation and consolidation into the Group.

EBITDA excluding special influences decreased by 11% as the lower level of voice related payments, reflecting lower voice usage and the cut in the Hungarian mobile termination rates, and the decrease in other operating expenses driven by our cost cutting initiatives could only partly offset the increase in bad debt levels and the decline in high-margin voice revenues.

At the same time, we are on track to reach the 5% decline in our annual CAPEX spending. In the first quarter CAPEX decreased by 4 billion forint compared to the same period last year, reflecting our strong focus on free cash flow generation.

Despite the unfavorable market conditions seen in the first quarter, we remain confident in our ability to improve our financial performance once the economic indicators, which drive demand for our services, start to show signs of recovery. This is expected towards the end of the year.

Now, let me start the business unit analysis with the results of our **Consumer Services Business Unit or CBU**. Driven by the continuing intense competition and depressed household consumption, our residential business remained under significant pressure. As a result, total CBU revenues decreased by 4% in the first quarter compared to the same period of last year.

Due to lower revenues, EBITDA declined by 5%, as our disciplined approach to cost management could only partially offset the negative impacts of the decline in high margin voice revenues on EBITDA.

In the residential fixed line market, we continued to execute our strategy aimed at positioning Magyar Telekom as the leading triple play operator with a focus on TV services. As a result of this strategy, the number of our customers who subscribe for bundled fixed line services continued to increase. The ratio of multiple-play CBU subscribers increased from 30% to 37% by the end of this quarter compared to the same period last year. In addition, CBU successfully managed to increase further its satellite and IPTV subscriber base. Thanks to these favorable trends, Magyar Telekom is now the second largest pay TV service provider in Hungary, with a market share in excess of 26%, and it is our intention to become the number one player in time. At the same time, traditional fixed line voice customer churn remained high in the first quarter of 2010, due to the continuing structural factors at play: namely, a high level of mobile substitution and migration to cheaper IP- and cable-based voice services.

We continue to execute our strategy of replacing falling fixed line voice service revenues with internet and TV revenues. In the first quarter, TV revenues increased by 18% to 6 billion forint. At the same time, broadband internet revenues were flat because the 12% increase in broadband subscriber base was offset by lower ARPU levels. Broadband ARPU remained under pressure as customers continued to migrate to lower priced packages in what remains a fiercely competitive market.

Regarding the fiber rollout, our coverage exceeded 190,000 households and we are on target to reach 220,000 households with fiber connection by the end of the year. At the same time, the weighting of fiber subscribers continued to increase steadily, reaching 8% penetration by the quarter's end. Half of these fiber customers are new to Magyar Telekom and close to two thirds of them have chosen triple play packages.

Turning to the residential mobile market, business performance was negatively affected by the depressed consumer demand, significant tariff erosion and the 16% cut in mobile termination rates with effect from January 2010. Consequently, driven by lower retail and wholesale voice revenues, total CBU mobile revenues decreased by 3% in the first quarter. However, the mobile internet market continued to expand and we witnessed a rapid increase in both our subscriber base and revenues.

The number of T-Mobile's internet subscribers increased by 65% compared to the same period last year.

Overall in the mobile business, we are focusing on maintaining our strong market positions supported by our high quality network, innovative services and attractive branding. In the first quarter of 2010, we managed to maintain our clear market leading position in voice with a market share of over 44%, amongst active customers. Furthermore, we even managed to increase our market share slightly in mobile broadband to 49% among traffic generating subscribers.

Looking ahead, we expect our residential business to remain under pressure until the macro-economic environment improves, in particular with respect to the labor market and the household consumption in Hungary.

Let us now continue with the results of our **Business Services Business Unit, or BBU**. The difficult macroeconomic environment, coupled with the uncertain political and economic outlook, continued to put significant pressure on our business performance in this unit, thereby impacting the majority of our services.

Revenues at BBU in the first quarter of 2010 declined by 8% compared to the same period of last year, driven by the combined impacts of declining retail voice revenues both in the fixed and mobile segments and lower System Integration / IT revenues. However, thanks to the considerable efforts we have made on the cost side, to mitigate the negative macro environment, EBITDA margin for this segment was kept stable at 47%.

Looking at the underlying trends in this segment, we see that on the fixed line side the revenue decline accelerated further primarily driven by customer erosion, both on the voice and data sides. At the same time, mobile voice revenues are also under pressure, as intense competition is continuing to drive tariffs down whilst the 16% mobile termination rate cut at the beginning of the year also negatively impacted wholesale revenues.

System Integration / IT revenue was down by almost 7% but it should be emphasized that this is very much a project driven business, implying that there can be significant fluctuations in revenues from one quarter to the next. For instance, last year's first quarter results were boosted by higher outsourcing revenues, derived mainly from a one-off sale of assets in a finance lease transaction.

This year by comparison was on a smaller scale where we completed a project with the Hungarian Tax Authority in which we sold licenses and data warehouse applications to them. However, although of a smaller size financially, it does enhance our credentials for further similar projects in the public sector going forward.

It should also be highlighted that due to the current economic and political uncertainty, many customers in both the public and private sectors have deferred their project investment decisions. Once visibility starts to improve, particularly with the new government and clarification of its economic policies, we expect that project tenders and orders will speed up. Furthermore, in conjunction, we also expect the usage of EU funds to accelerate towards the end of the year: both of these developments should positively impact our results going forward.

Continuing with the analysis of the performance of our international subsidiaries, let me draw your attention to the considerable strengthening of the forint in the first quarter compared to the same period last year. This resulted in lower contributions from these subsidiaries when translated, since both the Macedonian Denar and the Euro weakened by 8% compared to the forint in the period. As a result, to better reflect the underlying business performance in these countries, we are presenting the analysis in local currency terms.

Total revenues **in Macedonia** declined by 4% in the first quarter compared to the same period last year, while EBITDA suffered a 23% drop driven by a one-off provision of 600 million forint relating to a legal case. Furthermore, EBITDA was also negatively impacted by a one-off charge of 900 million forint of other expenses relating to the implications of the finalization of the internal investigation. Excluding these items, EBITDA declined by 8%, reflecting the fierce competition that has continued to erode margins in both the fixed and mobile segments.

In the <u>fixed line segment,</u> competition intensified further with mobile, alternative and cable companies all negatively impacting our voice revenues. As a result, despite our continuous efforts to increase customer retention, the churn rate remained relatively high at 11%. In addition, usage declined further, also due to the unfavorable economic environment. However, thanks to the initiatives we launched last year to counter these negative factors, which included the introduction of the 2Play and 3Play packages, both internet and TV revenues increased.

On the mobile segment side, overall revenues increased by 2%, driven by the significant improvement in our customer mix. Although the overall customer base slightly declined, we recorded a 12% increase in our post-paid customer base, increasing the post-paid ratio to 32%. As a consequence, blended MOU grew by 21%, however ARPU increased only by 5%, reflecting the significant price pressure driven by the intense competition.

Looking ahead, since no major improvement is foreseen in the economic environment in Macedonia nor is the intense competition expected to ease, both at least in the short term, we forecast the current business trends to prevail for the remainder of 2010.

Let us continue with our **Montenegrin subsidiary**. In local currency terms, total revenues declined by 2% in the first quarter compared to the same period last year, while EBITDA dropped by 30%, due principally to one-off severance payments of 900 million forint related to headcount reduction accounted for in the first quarter of 2010. Excluding this item, EBITDA increased by 4% reflecting the strict cost control measures taken: in particular, savings on materials and maintenance as well as marketing expenses. Consequently, the underlying EBITDA margin increased from 34% to 36% year-on-year.

In the fixed line business, the high level of mobile substitution resulted in a retail voice revenue decline; while lower international traffic volume led to a decrease in wholesale revenues. These impacts continued to put pressure on our traditional voice revenues. In contrast with the deterioration in the traditional fixed voice business, we still saw healthy demand for our broadband internet and IPTV products, with total connections increasing by 30% year-on-year. At the same time, our initiatives in bundling products also give grounds for optimism, as the demand for double and triple play offers continues to grow: 29% of our customers now subscribe to such packages.

Turning to the Montenegrin mobile market, competition remained extremely fierce while the challenging economic environment also negatively impacted our mobile operations. The decline in average tariff levels could not be offset by the 15% higher usage, resulting in 2% lower overall mobile revenues. T-Mobile Montenegro continued to focus on the post-paid segment which resulted in 7% growth in the post-paid customer base, allowing us to maintain our market leading position in this segment.

Looking ahead, we expect mobile competition to stay intense, while competitors' traffic re-routing through Serbia will also continue to put pressure on the Montenegrin revenues.

That concludes the formal part of Magyar Telekom's conference call. I am now happy to open the floor for questions. 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 there are follow-up questions, I encourage you to contact our Investor Relations Department. The telephone number is 36-1-458-0424 or if you want to send an e-mail you can address it to investor.relations@telekom.hu. I would like to inform you that the transcript of our conference call will be available on our official website. Thank you again for joining us today, and for your continued interest in Magyar Telekom.

Figures prepared in accordance with IFRS, Magyar Telekom also presents non-GAAP financial performance measures, including, among others, EBITDA, EBITDA margin, underlying EBITDA, underlying EBITDA margin and net debt. These non-GAAP measures should be considered in addition to, but not as a substitute for, the information prepared in accordance with IFRS. Non-GAAP financial performance measures are not subject to IFRS or any other generally accepted accounting principles. Other companies may define these terms in different ways. For further information relevant to the interpretation of these terms, please refer to the chapter "Reconciliation of pro forma figures", which is posted on Magyar Telekom's Investor Relations webpage at www.telekom.hu/investor_relations.