2005 FY Results Conference Call

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Conference call operator introduces call

Elek Straub remarks

Good afternoon, ladies and gentlemen and welcome to Magyar Telekom's conference call for the full year 2005 results. I am Elek Straub, Magyar Telekom's Chairman and Chief Executive Officer, and I am hosting today's call together with Dr. Klaus Hartmann, our CFO and member of the Board.

First I would like to summarize the 2005 performance of the Group. Revenues increased by over 3% year-on-year, EBITDA by 12%, and the EBITDA margin exceeded 40%. The revenue growth was driven by our acquisition in Montenegro, whose figures have been consolidated since the second quarter. Excluding the results of Telekom Montenegro, revenues were broadly flat reflecting the fierce competition in the Hungarian fixed line operations. EBITDA, on the other hand, showed an increase of almost 10% as 2004 was hit by restructuring costs of more than 20 billion forints.

In the fourth quarter of last year, we demonstrated commitment to our strategy of expanding through value accretive acquisitions. In November 2005, we announced the acquisition of Orbitel, the leading alternative service provider in Bulgaria, offering carrier selection and internet services in the country. We are also entering the Romanian retail market this year to capitalise on further revenue opportunities in the region. A further important revenue source will be the nationwide EDR service, which we will set up and operate in the coming years, as per the tender results announced last October. In addition, we strengthened our position in the Hungarian IT market by acquiring Dataplex, an IT outsourcing company, in December last year.

Thanks to this expansion strategy, we foresee revenue growth of above 3% for this and next year, creating room for further EBITDA growth in the coming years. For this year, however, we plan to maintain last year's EBITDA levels, as several of our investments and initiatives start to show tangible EBITDA contribution from next year.

With regard to capex, we target a below 15% capex to sales ratio for this year, including the UMTS network related investments, but excluding the one-time investment in the EDR system of a maximum of 22 billion forints. We aim to decrease this ratio to below 14% in 2007.

Given the strong increase in revenues and our flat EBITDA target, you can see that we are forecasting a below 40% EBITDA margin for this year. To counter revenue erosion in our traditional fixed line business, we are looking to capitalise on new revenue sources by expanding our operations into new markets. With rising demand from business clients, who require increasingly complex IT and telecommunications solutions, we see significant opportunities in the Hungarian IT market. Further revenue opportunities will come from entry into neighbouring countries as an alternative service provider. In Bulgaria and Romania, where the liberalisation process has just started, our aim is to become one of the leading alternative service providers. Although the EBITDA margin of these operations is lower than in the traditional telecommunications market, diluting our EBITDA margin to below 40%, these investments are also value accretive, given the lower investment required.

As a further step in the merger process of Magyar Telekom and T-Mobile Hungary, the Extraordinary General Meeting of the two companies approved the draft valuation balance sheets in December, concluding the decision process at Magyar Telekom. We are now awaiting Court registration, which is expected by the end of this quarter, to complete the process and legally merge the two companies.

Let me begin with the segmental analysis of the results, starting with the fixed line segment. In the Hungarian fixed line operations, we are facing increasing competition resulting in an above 4% revenue decline last year. Outgoing traffic revenues decreased by 26% last year due to the continuously decreasing traffic and lower mobile termination rates. The main drivers behind the lower traffic are the impact of mobile substitution, the lower subscriber base and the activity of alternative operators.

During last year an estimated, additional 12% of traffic was generated on Magyar Telekom's lines by alternative operators, mainly Tele2. The increased traffic of alternative operators is the main driver behind the higher incoming traffic revenues. Thanks to several promotions and the new flat-rate packages, we were able to stop Tele2's traffic expansion in the residential segment by the last quarter of 2005.

We started several initiatives in 2005 to offset the decline in traffic revenues. We entered the area of other LTOs and are offering call by call and preselection services. During last year we launched several campaigns to attract customers. As a result, Magyar Telekom generated traffic on around 8% of other LTO lines by year-end, which contributed around 2 billion forints in revenues to last year's performance. We also started to offer voice-over cable services last June. T-Kábel, our cable operator, gained around 13 thousand voice-over cable customers by the end of December. However, revenue contribution from the service was not tangible last year due to the recent introduction of the service.

With regard to T-Kábel, I would like to mention that the number of our cable customers also showed healthy growth and exceeded 400 thousand by December 2005. Cable revenues were up by 16% and reached almost 15 billion forints last year, which was the main driver behind the increase in other revenues.

With regard to our broadband program, we proceed according to plan. The number of our ADSL customers increased by 60% and the number of total broadband customers reached 358 thousand by year-end. The total number of broadband access includes the number of ADSL lines, leased line, wireless LAN and broadband cable customers. Thanks to impressive subscriber growth, data transmission revenues reached almost 42 billion forints last year. To insure further growth, we have just increased the maximum download rate of the fastest ADSL package by 50% to 6 Megabit per second, and plan to roll out the ADSL2 technology nationwide over the course of the year, which will allow us to double the highest currently available download rate.

Although we do not have exact numbers on voice over internet usage, based on some market research we estimate that around one fourth of ADSL customers are already using software such as Skype to make free Internet calls. Given the increasing broadband penetration in Hungary, we have also started to offer our own voice over internet software for residential customers, called Klip. The software offers free calls via the internet and customers can also make calls to fixed and mobile directions for a low per minute fee.

In terms of fourth quarter revenues, we see revenue growth of almost 2% due to a 3 billion forint reversal of revenue reduction related to the changes in mobile termination fees. Based on a Ministerial decree, telecom operators are required to pass on the termination fee reduction only to customers of universal packages. Given that the legal debate on mobile termination rates is still in progress, Magyar Telekom has decided not to apply the decrease retrospectively to the rest of the customers and therefore realised the difference in the fourth quarter.

Moving on to the cost side, the significant decrease in employee related expenses is due to the 17 billion forint headcount reduction related provision and expenses booked in the last quarter of 2004. We have also created a provision and expenses of less than 2 billion forints in 2005 for additional headcount reduction at our subsidiaries and rationalisation related to the merger process.

Let me now hand over to Klaus who will continue with the analysis of the international fixed line operations and the mobile segment.

Klaus Hartmann remarks

Thank you, Elek.
Good afternoon, ladies and gentlemen.

Turning to the international fixed line segment, I would like to start the analysis with the Macedonian operations.

Fixed line revenues at MakTel decreased by 6% year-on-year in forint terms, mainly as a result of mobile substitution and voice-over-IP-based competition. Besides decreasing traffic, the number of active customers is also decreasing. As a result, the company continued to dismantle disconnected lines in the fourth quarter. The decrease in voice revenues was partly offset by the increasing data revenues. Demand for ADSL remains strong, the number of ADSL connections more than tripled during the last year. MakTel is still the sole ADSL service provider in the country.

Due to the pressure on revenues, restructuring and headcount reduction remains a key focus. After the significant headcount reduction in 2004, the company booked a further 1.5 billion forints expense in the fourth quarter related to a dismissal of close to 600 employees. As a result, the company showed an impressive 26% headcount reduction throughout 2005 with the lines per employee ratio increasing to 315 by the end of last year.

Besides decreasing employee related expenses, lower payments to other network operators also helped operating profit at MakTel. The decreasing fixed to mobile and international outgoing traffic caused a 15% drop in payments to other network operators. Overall, EBITDA at MakTel increased by 12% year-on-year in local currency and the margin exceeded 42% in 2005. In the fourth quarter, due to the headcount reduction related expenses, EBITDA margin was 31%.

As for the regulatory background, liberalization in Macedonia started in 2005. This January, the first reference interconnection offer of MakTel was approved by the Regulator, which allowed alternative service providers to enter the Macedonian voice market from 2006. The approved interconnection fees are based on the fully distributed cost methodology.

Before I move on, let me mention our initiative to simplify MakTel's ownership structure. In November last year, we started the liquidation process of Stonebridge, MakTel's holding company. After we acquired the stake of SEEF Holdings and CosmoTelco in Stonebridge, increasing our ownership to 100%, there was no more need to maintain this holding company. Following the liquidation process, Magyar Telekom will directly own its 51% stake in MakTel.

Let me now turn to our fixed line operations in Montenegro. Since the consolidation, Telekom Montenegro contributed revenues of almost 14 billion forints and an EBITDA of above 2 billion to the international fixed line operations, including 1.3 billion forints of headcount reduction related expenses. The number of employees decreased by close to 20% at parent company level since the consolidation, increasing the line per employee ratio to over 200 by year-end. We aim to further increase efficiency through the integration of several functions of the fixed and mobile operations. We have already benefited from the integration of sales, network development and IT management areas, and have also introduced joint fixed-mobile business offers to the market.

In terms of a comparison with the third quarter, seasonality played a significant role. Although local traffic increased, a drop in long distance, fixed to mobile and international traffic decreased revenues by 19%. In the summer months, hundreds of thousands of tourists travel to the country boosting traffic, but causing a significant reduction in fixed line usage in the fourth and first quarters of the year.

For this year, our targets at the fixed line operations are to minimize erosion in the number of lines, significantly increase broadband penetration by introducing new offers, develop an integrated shop network and further increase headcount efficiency.

Let me now continue the segmental analysis with our Hungarian mobile operations. Penetration in Hungary was above 92% by end-2005. T-Mobile Hungary maintained its balanced focus on market share and profitability: while its market share stabilized at 45%, the EBITDA margin of the company was above 39% last year.

The high migration of customers towards more customized packages continued, further decreasing the average tariff level in the Hungarian mobile market. The increasing usage and higher portion of postpaid customers fully offset the 12% decrease in the average price level, as a result revenue per customer was stable throughout 2004. The overall revenue increase of close to 3% at the Hungarian mobile operations was driven by the 4% increase in the customer base and the strong expansion of value added service revenues. Internet access, enhanced SMS and mobile payment related services are becoming more and more popular among customers, increasing value added service revenues by 21% during last year.

On the cost side, decreased cost of equipment sales counterbalanced most of the effect of higher payments to other network operators and other operating expenses. The lower equipment prices and the decreased subsidies on equipment sales caused an almost 30% drop in the total acquisition cost. The discontinuation of the around 10 billion forints of Hungarian mobile related annual goodwill amortization, and the above 4 billion forint impairment relating to the Westel brand booked in 2004 resulted in a 29% decrease in depreciation and amortization charges last year.

Compared to the fourth quarter of 2004, the 22% increase in gross additions in the last quarter of 2005 boosted agency fees and marketing expenses, resulting in higher operating expenses. In addition, restructuring expenses were booked as part of employee related costs in the last quarter in connection with the merger process. On the other hand, payments to other network operators declined somewhat in the last quarter, reflecting the lower roaming outpayments and the decreased asymmetry in the mobile termination rates following the recent cut.

Finally, let me give you some detail on the UMTS network and the related capital expenditure. After the launch of the UMTS service in August, by the end of last year we covered the area of Budapest and the inner districts of the second largest Hungarian city, exceeding the obligation for end-2005. Going forward, we are required to cover 30% of the population by the end of next year. T-Mobile Hungary spent 9 billion forints on UMTS investments last year. However, taking also into account the 2.4 billion forint tax allowance received after this broadband investment, the asset based capex on the UMTS network amounted to 6.6 billion forints.

In terms of revenues, we still do not expect tangible revenues from the 3G service this year, due to several promotions offered to customers and the limited range of 3G handsets.

Moving on to the international mobile operations, let me start with MobiMak, our Macedonian mobile operator. Penetration levels in the Macedonian mobile market reached 61% and our mobile subsidiary had 69% market share based on the number of SIM cards at the end of 2005. Competition in the market is very strong; the two competitors are launching new offers with bundled free minutes to attract new customers, which results in a continuously decreasing price level. During last year, average revenue per minute at MobiMak decreased by 15%, which combined with the usage dilution effect resulted in a 19% drop in ARPU.

The significant price decrease was counterbalanced by the 17% growth in the customer base resulting in flat revenues. Thanks to the strict cost controls, EBITDA increased and the company showed an almost 53% EBITDA margin for the full year.

In Montenegro, penetration was close to 79%, with Monet's market share at nearly 43%. Since the consolidation, the company contributed almost 9 billion forints to this segment's revenues and above 3 billion to EBITDA.

The Montenegrin telecommunications market is characterised by strong seasonality, which is a key driver in the mobile sector. After the strong subscriber growth in the third quarter, prepaid cards used by tourists churned out in the fourth quarter, significantly decreasing the penetration level and the customer base at Monet. A drop in usage contributed to a decrease in revenues of over 30% in the fourth quarter, compared to the third quarter.

On the cost side, within depreciation and amortization charges, the increase is due to the one-time impairment charge of certain assets, related to the review of the company's books and accounting policies.

Our plan for this year is to increase Monet's market share while strengthening the postpaid ratio within the customer base. Although we expect some tariff erosion due to increasing competition, we plan to maintain current revenue per user levels by increasing usage. With regard to the EBITDA margin, we expect clear improvement due to a healthy growth in revenues on one hand, and less non-recurring items on the other.

Elek Straub remarks

(PAUSE)

That concludes the formal part of Magyar Telekom's conference call. We are 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)

This is all the time we have. If there are follow-up questions, I encourage you to contact our Investor Relations Department. The telephone number is 36-1-458-0437 or if you want to send an e-mail you can address it to investor.relations@telekom.hu. Thank you again for joining us today, and for your continued interest in Magyar Telekom.