First Nine Months 2006 Results Conference Call

November 9, 2006 at 16:00 CET

Conference call operator introduces call

Elek Straub remarks

Good afternoon, ladies and gentlemen and welcome to Magyar Telekom's first nine months 2006 results conference call. I am Elek Straub, Magyar Telekom's Chairman and Chief Executive Officer. With me today is Thilo Kusch, our new CFO, who joined us from Deutsche Telekom's IR department in September.

Before going through the analysis of the results, let me say few words on the forthcoming General Meeting scheduled for November 15 and summarize the most important events of the third quarter and give you an update on our fixed-mobile merger and our public targets.

As we announced on 2nd of November, in spite of the fact that Magyar Telekom is committed to complying fully with the requirements and requests of the authorities that have jurisdiction over it and is seeking to have its annual results and dividend proposal approved as promptly as reasonable practicable, Magyar Telekom's management was not in a position to disclose the proposed resolutions as the submissions for the General Meeting were not available.

Turning to our business, we have continued to expand our service portfolio, capitalizing on opportunities created by the convergence between telecommunication and IT markets. Following the approval of the Hungarian Competition Authority, we have completed the acquisition of KFKI, Hungary's leading ITC service provider. At the same time, we have further rationalized our portfolio, with the sale of non-core assets. The disposal of our Montenegrin subsidiary's stake in CKB bank was followed by the sale of Cardnet, a Point of Sales terminals company.

Turning to the merger, the first effects from the integration in terms of sales and customer retention are becoming visible. These were, however, offset by initial costs in the first nine months of 2006, therefore the EBITDA impact for the period is not significant, while investment needs were financed within the full year budget.
In the next three years, we expect to see significant positive impact, with net present value of these benefits currently estimated to be around 60 billion forints in the period of 2007-2009, roughly evenly distributed over the three years. We expect contribution from tax savings for all three years, accompanied by the increasing importance of cost synergies both in terms of operating and capital expenditures. Looking at top line opportunities, we see good retention potential compared to our business case before the impact of the integration.

Despite the positive contribution of the integration, we have not changed our EBITDA guidance for 2007, which is growth in forint terms over 2005 performance, for a number of reasons. In 2007, the cash savings from utilization of tax benefits will play an important role whilst EBITDA impact of the integration will accumulate gradually over the subsequent years. In addition, the Hungarian austerity package will negatively affect our profitability through increased wage taxes, higher costs due to strengthening inflationary pressure and decreased disposable income, most certainly limiting top line opportunities. Furthermore, reassessed treatment of the EDR project will also result in a lower EBITDA. As a result of the reassessment, we are also modifying our 2006-2007 revenue growth target from above 3% per annum to a compounded average growth rate of at least 3% in these two years. At the same time, we confirm our targeted gross addition to tangible and intangible assets to sales ratio of less than 15% this year and less than 14% in 2007.

Now looking at the **Group performance**, revenue grew by over 7% in the first nine months of 2006 compared to the same period last year, whereas EBITDA increased by almost 1%. Weakening of the forint supported the performance of our international subsidiaries in forint terms, while the consolidation impact of our Montenegrin subsidiary also helped the year-on-year improvement. On the other hand, the 3.1 billion forint cost incurred related to the investigation negatively impacted the EBITDA resulting in a lower EBITDA margin. In addition, a technical factor, the reassessment of the EDR project to financial lease, although raising the revenues in the Hungarian mobile segment by nearly 10 billion forint, at the same time put further pressure on the EBITDA margin.

As for the **third quarter results**, aforementioned factors were also helped by the strong underlying performance especially at our international operations, leading to an almost 12% revenue and 1% EBITDA growth.

Starting the segmental analysis with the **Hungarian fixed line** operations, we see a revenue increase of over 2% in the third quarter reflecting the rise in internet related income as well as the growing importance of IT and system integration activities. In addition, as more and more customers sign up for some type of flat-rate package with one-year loyalty period, subscription revenues have also seen an upward trend. Our newly-introduced tariff packages aim to further support this positive development. Although owing to these offers average usage per customer increased, and this led to broadly stable domestic traffic volume, due to price discounts and higher portion of free, bundled minutes, traffic revenues decreased partially offsetting the aforementioned positive impacts on fixed line revenues.

Looking at the competitive landscape in the voice market, the situation remains largely unchanged, in both residential and business segments, mobile and alternative operators still pose the highest risk. Nonetheless, we are trying to mitigate these effects through more pronounced presence in other LTO territories by providing carrier selection via interconnection to the local incumbents and voice over cable services via our cable operator, T-Kábel.

Overall revenue contribution from the internet segment was over 11 billion forint in the third quarter, an above 20% increase compared to 2005. Migration from dial-up to broadband solutions continued, with permanent emergence of new or lower priced products. In the third quarter some competitors capitalized on full unbundling to introduce naked ADSL in Budapest. However, according to our estimates, these offers were not met with significant demand yet. At the same time, to encourage usage and provide an attractive entertainment package, T-Online is starting to offer IPTV. Apart from traditional TV services, this T-Home solution also offers further interactivity and content via services such as video on demand, personal video recording, electronic program listing, time shift or child lock functions.

The number and the content of the available channels are similar to that of the cable TV, with 25-50 channels depending on the package chosen, with the online video database offering further choices.

In terms of the IT and system integration revenues, EBITDA improvement of more than 1.5 billion forint compared to the third quarter last year is driven by the combined impacts of the stable revenue stream from our complex outsourcing contracts concluded earlier, some further revenue recognition from the electronic tax return filing system mentioned in the previous quarter, which has proved much more popular than expected and finally, the consolidation impact of both Dataplex and KFKI. The server outsourcing company, Dataplex, contributed over 400 million forint to the quarterly revenues, whereas KFKI group with close to 700 million forint for the two weeks of consolidation. Saying a few words on our intentions for KFKI, I would like to highlight that in the next year we plan to focus on the additional revenue opportunities provided by the new integrated services we are capable to jointly provide. These may include IT product sales to our traditional clients, since neither the client base nor the service portfolio of the two companies have significant overlaps, they are rather complementary to each other. Accordingly, we hope to strengthen our already solid position in the IT market further, and extend those areas where we already hold key positions, such as outsourcing or network integration. In addition, from 2008 on we aim to exploit cost side synergies, such as resource optimization as well.

On the cost side, the consolidation impacts of our new subsidiaries, the cost related to the investigation and some non-recurring expenses from the merger projects put downward pressure on profitability. Consequently, EBITDA did not follow the increasing trend of the revenue, resulting in a decline in the quarterly margin of the segment.

(Pause)

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

Thilo Kusch remarks

Thank you, Elek.
Good afternoon ladies and gentlemen!
Before moving on to the financial analysis of the **international operations**, I am happy to inform you that the **rebranding** of our mobile company in Macedonia and both the mobile and the fixed operations in Montenegro was executed in the third quarter, with related expenses financed by Deutsche Telekom.
In Macedonia, the rebranding of Mobimak to T-Mobile Macedonia happened at the beginning of September, and we can already see its initial positive impact on the segment's results. We are also in the process of assessing the potential rebranding of MakTel, the fixed line operator, in spring 2007.
In Montenegro, we introduced the T-Com and T-Mobile brands for the fixed and the mobile operations at the end of September.

Now let me turn to the performance of the **international fixed segment**, where the 18% growth in revenues in the third quarter of 2006 is attributable to the favourable FX impact, the improvement in the Montenegrin fixed operations and the 1.4 billion forint contribution of our wholesale point of presence and alternative retail operations in Romania and Bulgaria. Other than these factors, the 27% EBITDA growth in the segment was also supported by further improvements at our Macedonian fixed operator, MakTel.

In the **Macedonian fixed segment**, slow economic growth and the low level of disposable income continued to limit top line opportunities. The quarter-on-quarter revenue increase of 10% is due to the further weakening of the forint, as in Macedonian denar terms revenues were broadly stable. Our successful efforts to dismantle the illegal operators providing international call terminations helped incoming traffic revenue growth, while the almost doubled broadband customer base and the still increasing number of dial-up users resulted in a major improvement in internet revenues. However, these revenue contributions were offset by the strong mobile substitution and the strengthening presence of the alternative service providers in the international call segment, resulting in a decline of overall outgoing traffic revenues.

As for the profitability of the segment, I am pleased to tell you about the further efficiency improvement in MakTel which drove the quarterly EBITDA margin to 49%. Last year's headcount rationalization program resulted in significantly lower employee-related costs, while other efforts, such as the drive to improve collecting efficiency, helped to also push other operating expenses down.

Before moving on, let me summarize shortly the expected economic changes to be introduced by the new Macedonian government that was elected in July. Most importantly they are targeting faster GDP growth, partially by boosting FDI. They aim to introduce structural reforms, lower taxes and to also provide tax and other incentives to encourage international investments. Concerning the telecommunication sector, they are strongly committed to liberalization.

As for the current status of the liberalization process, both interconnection and unbundling offers have been approved by the authorities, though none of the competitors has yet concluded an agreement with MakTel. Currently alternative operators still only provide prepaid cards for international outgoing call services based on Commercial Network Access Agreements. However, we expect some to sign reference interconnection offers shortly and to enter other market segments as well in the next one or two years. In addition, some are also likely to sign international call termination agreements, which may jeopardize part of our revenue stream.

With regards to the **Montenegrin fixed segment** results, the quarterly revenue growth of almost 20% is partially attributed to the favourable foreign exchange movements, since the forint weakened by almost 12% against the euro, nevertheless revenues in local currency terms were also up by more than 8%. The growth was strongly supported by the positive impacts of the summer season which resulted in increased international and mobile interconnection revenues, while internet related revenues were boosted by the significant addition to the number of broadband customers thanks to the summer ADSL campaigns.

Turning to the cost side we can see clear signs of improvement. The positive impacts of the reduced headcount and the lower other operating expenses resulted in an over 20% increase in EBITDA in local currency terms, while driving the margin to 38%.

Let me start the analysis of the **Hungarian mobile segment**, by giving you a more detailed picture of the reassessment in the accounting treatment of the **EDR project** and its implication on the results. Due to a recent change in IFRS, namely IFRIC 4, a significant part of the EDR activities now qualifies as construction and subsequent sale of network assets through a financial lease. Consequently, the accounting treatment has been reassessed in the third quarter. Investment in project-related equipment is now treated as purchase and construction of inventory, and subsequent sales of finished goods.
As a result of this change, in the balance sheet short term and long term receivables increased by 9.8 billion forint while gross additions to tangible and intangible assets decreased by the same amount. In the cash flow this resulted in a favorable change in the investing, and an adverse impact on the operating cash flow. At the same time, in the income statement other mobile revenues and cost of telco equipment sale were increased by the same amount. This alone has no effect on EBITDA but does lower the EBITDA margin. Furthermore, as these costs of construction are no longer considered as capital expenditure, there is no depreciation and amortization on these assets, thus year-to-date D&A decreased by 0.5 billion forint. In addition, interest income is accruing on the aforementioned finance lease receivables of 9.8 billion forint, which amounted to 0.2 billion forint in the first nine months of 2006. On top of this, 1 billion forint service revenues had been accounted in the first nine months of 2006 for network usage and access revenues.
As for the future implications, the recognition of the revenue stream is modified, but total revenue during the contracted period will not change significantly. As opposed to our earlier assumptions, revenue recognition will be higher in the investment period and consequently lower in the remaining years of the service. Additionally, a portion of the revenues is recognized as interest income and the network construction related expenses will be accounted as cost of telco equipment sale and not capital expenditure. Both of these changes will have a negative impact on the EBITDA, thus will lower the EBITDA margin throughout the whole period.

Concerning next year's impact in particular, service revenues will be reduced by two factors. Firstly, because a larger part of the revenue from the EDR activities is recognized upfront in 2006 as revenues from sale of network assets instead of service revenues that is evenly distributed over the coming years. Secondly, a portion of the revenues will be accounted as interest income. These revenue reductions will accordingly result in an EBITDA shortfall in the coming year. I would like to note, that if there is additional investment to the network and subsequent sale, revenues from sale will be accounted, but because cost of telco equipment sales would rise by a similar amount, this alone will have no impact on EBITDA level, but as mentioned before will impact the EBITDA margin.

With regard to the Hungarian mobile market, penetration continued to expand at a slower pace, reaching over 95% by the end of September, whereas the relatively calm competitive landscape remained unchanged. Although our market share slightly decreased owing to some promotional activities from Pannon, we managed to maintain our market leading position and increased our customer base by over 5%. As new additions were driven mostly by postpaid clients, customer mix improved, which positively contributed to the underlying performance. Excluding the impact of the EDR project, quarterly revenue growth was still over 4% compared to the third quarter last year. We can see steady usage increase in parallel to the tariff erosion. This in turn is partially fuelled by the accelerated migration of residential users to lower priced corporate packages as the scope of these offers continuously widens. Nevertheless, revenue per user levels remained broadly stable compared to last year, as the higher usage and the increasing role of data-related value added services offset the tariff decline.

On the cost side, the systematic decrease in subscriber acquisition cost was counterbalanced by higher payments to other network operators, reflecting the higher traffic and seasonally increased subscriber roaming activity and the initial costs of some fixed-mobile merger projects, for example the unification of the retail shop network.

Apart from these and the reassessment of the EDR project, the 1.1 billion forint reversal of the accrual created for payments into the Universal Telecommunication Support Fund following a favourable Court decision in September last year also has a one-off negative impact on the quarter on quarter comparison. Consequently, the quarterly EBITDA and margin deterioration were mostly driven by these factors, whereas the underlying results show a generally stable performance.

Continuing with the **international mobile segment**, let me start with the Macedonian mobile market.

Mobile penetration growth is slowing in **Macedonia** due to the high mobile premium and low disposable income. Penetration stood at 66% at the end of September. At the same time, the rebranding of Mobimak to T-Mobile Macedonia supported the company's efforts to slow down its market share erosion; by the end of the third quarter this had decreased only slightly to 67%. Meanwhile, the performance of the segment was extremely strong - revenue increased by 25%, and EBITDA grew by more than 36%. Apart from the positive FX impact, the revenues were also supported by the substantial rise in MOU and by the 10% increase in the customer base. These positive impacts were, however, offset to a certain degree by the declining prices driven by the intensifying competition.

Turning to the cost side, higher usage resulted in higher payments to other operators. However, due to strict cost control measures, operating costs remained broadly stable, positively impacting the EBITDA and driving the margin to over 58%. The high portion of SIM-only prepaid customers also contributed to the strong profitability. Although these clients usually buy new SIMs with more favourable offers at time of expiration driving the churn rate to relatively high levels, the subscriber acquisition cost related to these sales is very low. Consequently they are rather high EBITDA margin customers.

As for the **Montenegrin** mobile market, the quarterly performance was strongly impacted by the summer season which also led to a penetration of above 108% by the end of September. Although in the third quarter, T-Mobile Crna Gora lost some market share, it should be able to regain its position in the remaining part of the year, supported by initiatives introduced as part of the rebranding campaign. Looking at the results of the segment, we see strong revenue growth of 10% in local currency terms, which was even stronger in forints due to the aforementioned positive FX impacts. In addition to the boost in international revenues driven by the expanded number of visitors, the higher usage and increased share of postpaid customers led to a rise in ARPU, also contributing to the solid operational performance.

In terms of profitability, the improvement is even stronger as the lower equipment costs offset the increase in payments to other operators generated by higher usage. EBITDA in euro terms rose by more than 22%, while margin reached 57%.

(PAUSE)

Elek Straub remarks
That concludes the formal part of Magyar Telekom's conference call. Now we are 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. I would like to inform you that the transcripts of our conference calls will be available on our official website.
Thank you again for joining us today, and for your continued interest in Magyar Telekom.