Magyar Telekom

Q1-Q3 2005 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 first nine months of 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.

Let me start with a short summary of the performance of the Group. Revenues increased by over 2%, EBITDA by nearly 5% year-on-year, and EBITDA margin reached 41.7%. Looking at the results excluding Telekom Montenegro, whose figures have only been consolidated since the second quarter, revenues decreased by 1%, EBITDA increased by 2.3% and EBITDA margin was 42% for the reported period. The decrease in organic revenue is primarily due to the strengthening competition in the Hungarian wireline operations, which could only be partially offset by expanding internet revenues and a slight increase in Hungarian mobile revenues.

The maturing Hungarian mobile market is now entering a new phase, where operators are expected to focus more on protecting market share and increasing cost efficiencies. Customers' needs are also turning to unified and bundled telecommunications services for more favourable prices. This changing environment is driving the need for greater business integration between Hungarian fixed and mobile operations. On October 6, the Board of Directors therefore made a proposal to merge T-Mobile Hungary with the parent company. The Extraordinary General Meeting held on November 7 discussed the Board's proposal and approved the merger. A second General Meeting will also be needed to approve the draft balance sheets prepared by the auditor for the merger. Finally the Court is expected to register the transaction and end the legal process around the end of the first quarter 2006. The merger is expected to produce significant, positive effects on our financial performance through four main items.

Firstly, we expect to achieve operational cost savings from the rationalization and elimination of parallel activities. Currently, the two companies have full scale corporate functions, which should be shared where it is possible. We see several opportunities in the procurement area or in the integration of the IT platform, as well as in the back office functions, such as the introduction of a common billing system, joint SAP and CRM systems, as well as shared data centers. Integrating the real estate and car fleet management would result in further cost savings through purchasing and other operational synergies.

We have just signed an outsourcing contract for fleet management services, according to which the more than two thousand vehicles used by Magyar Telekom will be operated by the same outsourcing partner that already operates the fleet of T-Mobile Hungary. In parallel, it takes over more than 80 employees from Magyar Telekom who managed the transportation services within the company. We expect the outsourcing to result in about 20% improvement in the efficiency of the transportation-related activities due to the integration.

The second item is the optimization of our investments. The integrated development of the IP-based next generation network will result in a more efficient asset base, creating opportunities for further investment and cost savings.

The next opportunity lies in marketing and sales activities. Building on our competitive advantage of being an integrated service provider, we will introduce new bundled fixed-mobile packages. Also, sales channels are going to be integrated under the common "T" brand. As a result, we expect to achieve further improvements in our revenues despite strengthening competition.

The fourth item is financial benefits. We can exploit further opportunities in harmonizing treasury processes and achieve savings in working capital. In addition, as the merger improves the financial performance of the Group, we will be able to utilize the tax credit on broadband investments and the tax losses of the parent company sooner.

As a result, we expect an annual financial benefit of several tens of billions forints following the full implementation of the integration, which will take at least two years. While we also expect positive effect on our revenues and EBITDA, improved cash flow generation will be the most obvious benefit from the merger.

Before continuing with the segmental analysis, let me mention one additional important project. The consortium of T-Mobile Hungary and Magyar Telekom has won the tender to build and operate the nation-wide Unified Digital Radio

Network system in Hungary and signed the contract with the Government at the end of October. The rollout of the so-called EDR system is planned for 2006 and 2007. The full investment required for the system is not anticipated to exceed 25 billion forints, with the majority incurring in 2006. The Government will start paying the service fee from 2007 with equal annual payments of 9.3 billion forints until 2015. EDR will be constructed with TETRA technology, which represents a highly developed digital radio communication technology and ensures outstanding voice quality and availability.

Now please let me turn to the segmental analysis of our quarterly performance. First I would like to start with the Hungarian wireline operations.

The segment witnessed an almost 7% revenue drop in a year-on-year comparison, as competition is getting fiercer from all directions. However, as we were able to almost offset the negative revenue trend by strict cost control, the segment's EBITDA margin slightly increased and reached almost 37%.

Looking at the quarterly financial performance, we see a lower EBITDA margin of 35%. This was also due to the one-time effect related to the Universal Telecommunications Support Fund. Receivables after the contribution made years ago were written off following a Court decision in September 2005, increasing operating expenses with 0.8 billion forints in the third quarter at the fixed line segment.

The negative impact on revenues is mainly coming from the intensifying competition in the highly saturated mobile market and the effect of the reduced mobile termination charges. Due to continuously decreasing mobile prices, substitution remains strong. Alternative and cable operators are also targeting our fixed line customer base. While unbundling still does not play a tangible role in Hungary, carrier selection and preselection services of other local telecom and alternative operators are having a significantly negative effect on our traffic. In the first three quarters this year, other operators generated traffic of around 10% of our fixed line minutes by using around 25% of Magyar Telekom's lines.

Thus both fixed line erosion and traffic loss remained strong in the third quarter. The cumulative line loss reached 110,000 by the end of September, and outgoing traffic revenues decreased by 29% compared to the first nine months of last year.

In order to mitigate the effects of the intensifying competition, T-Com is further customizing its tariff packages to concentrate more on access revenues. The so-called 'Favourite' tariff packages, which were introduced in June in the framework of the rebranding campaign, already accounted for more than 190,000 subscribers by the end of September.

In line with our strategic target to increase broadband penetration in Hungary, we are focusing on the ADSL rollout. By the end of the third quarter the number of wholesale ADSL lines reached 280,000 and the number of total broadband customers, including cable broadband, leased line and wireless LAN customers, exceeded 300,000. As a result, data transmission revenues increased by 34%, partially offsetting the decrease in traffic revenues.

In terms of the headcount reduction program we announced last year, we are progressing according to plan. By the end of September the lines per employee ratio reached 461 at the parent company, and 10 billion forints of the total 13 billion provisioned in the fourth quarter last year for headcount reduction at the parent company were used up. As a result, employee-related expenses show an impressive decrease of 8% year-on-year at the Hungarian fixed line segment.

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.

International fixed line operations include Telekom Montenegro since the second quarter, therefore I would like to analyse the Macedonian and Montenegrin operations separately.

Our Macedonian operations are still constrained by the weak macroeconomic environment. While the recent arrangement with the IMF assumes a stable currency for the next three years, the low GDP growth and the high unemployment rate limit top-line growth opportunities at the MakTel Group. The strengthening of the forint compared to the Macedonian denar also had a negative impact of around 2% year-on-year on the figures in forint terms.

Fixed line revenues at MakTel decreased by 8% year-on-year in forint terms. Mobile substitution has a significantly negative effect on both traffic and customer numbers. As mobile penetration is growing, the number of inactive and non-paying customers in the fixed line segment is increasing. As a result, we decided in the third quarter to disassemble 23,000 inactive customers, which is reflected in the reported customer base.

Traffic decrease was partly offset by the price adjustment steps introduced last July and this year in August. While the nominal per minute prices were not changed in August except for the decrease in fixed to mobile tariffs, we increased the billing increment to minute-based and also increased the monthly subscription fee, bundling it with 100 free minutes for residential customers. In addition, internet revenues show a healthy growth, partly offsetting decreasing usage revenues. Demand for ADSL service is strong, while MakTel is still the sole ADSL service provider and continues to have a strong leading position in the dial-up market.

Due to the limited revenue growth potential, efficient cost control and headcount reduction is still a key focus. While the significant decrease in the employee-related expenses also reflect the provision created in the third quarter last year for the headcount rationalization, the already implemented headcount reduction further decreased the employee-related expenses by 18% at the parent company. Other operating expenses were also trimmed; as a result, EBITDA margin of MakTel was above 46% in the first three quarters.

As for the regulatory background, the new Telecom Act came into force on the 5th of March, creating the framework for future competition in the fixed line segment. MakTel submitted the reference interconnection and unbundling offers to the Communications Agency in August and September and is awaiting approval.

Turning to Montenegro, first I would like to mention the Group level performance of the last two quarters. The TCG Group posted revenues of over 14 billion forints and an EBITDA of 4.4 billion forints for the second and third quarters. This also includes the 1.2 billion forints severance expense for headcount rationalization at the parent company. Without this item, EBITDA margin of the TCG Group would almost reach 39% for the two quarters.

In terms of the fixed line operations in Montenegro, margin since consolidation reached 28% without the severance expense. While the summer tourist season mainly increases the customer base and traffic of the mobile operations, fixed line revenues also benefited from the higher international traffic. In addition, the headcount reduction program, which was announced in the second quarter, has already produced positive effects on profitability. The headcount of the parent company decreased by 18% in the third quarter, reducing the employee-related expenses and improving the efficiency at the fixed line operations.

In order to maximise operational synergies within the TCG Group and further increase efficiency, the company announced in October the integration of the fixed and mobile operations, in line with the strategic organisational changes proposed for Magyar Telekom Group. The integration will provide greater strategic opportunities compared to separately run organizational and business lines and will help in the preparation for the liberalization of the telecommunications sector.

Let me now continue the segmental analysis with our Hungarian mobile operations. Penetration reached 90% by the end of September in Hungary, which clearly shows that the market penetration keeps growing moderately with further potential mainly in voice usage and data cards. The market share of T-Mobile Hungary slightly decreased to 45% but the company maintained its clear leadership position with more than a 10 percentage points advantage over the second operator.

The market can be further characterized by high migration of customers towards more favourable packages which leads to a continuously decreasing average tariff level. The year-on-year average tariff decrease was around 10% by the end of September, which was almost fully offset by the increasing usage. Due to the high mobile substitution and the increasing price elasticity of customers, monthly usage per user increased by 9% year-over-year.

The migration of customers also results in positive customer-mix change: prepaid users are more and more migrating towards postpaid packages; as a result the ratio of postpaid customers continues to increase and reached 31% by the end of September. Thanks to the higher usage and the increasing postpaid ratio, revenue per user remained flat at T-Mobile Hungary.

On the cost side, the growing role of flat rate tariff packages increased the portion of outgoing calls. As a result, payments to other network operators grew by 10% year-on-year at T-Mobile Hungary. On the other hand, mobile operators could decrease the handset subsidies due to the differentiated offers and lower equipment prices. Acquisition cost of new customers decreased by 35% on a year-on-year basis. The decrease was even higher in the prepaid segment, at almost 48%.

Before moving on, let me mention our progress in the 3G roll-out. At the end of August, T-Mobile Hungary launched the commercial service of the 3G network, thereby becoming the first company to offer UMTS services in Hungary. The current coverage is around three quarters of Budapest and by the end of the year nearly the whole capital will be covered. The UMTS services currently available include video conferencing, fast data and music download as well as mobile broadcasting. While we spent 5.5 billion forints in cash on the UMTS network in the first three quarters, taking into account the tax allowance which we receive after broadband investments, the asset-based capex spent on UMTS was 4.6 billion forints.

Moving to the international mobile operations, here I would also like to speak separately about our Macedonian and Montenegrin subsidiaries.

The Macedonian mobile market is still characterized by fierce competition for market share. At a penetration level of above 59% our mobile subsidiary had 69% market share based on SIM cards. Our revenue-based market share is even stronger due to the higher proportion of postpaid customers, however Cosmofon, the competitor is targeting MobiMak's customer base to increase its own market share.

Due to the decreasing mobile tariffs and the relatively high penetration level, growth in customer base does not automatically result in similar revenue growth. Mobile revenues in forint terms were flat, however in local currency terms they show some improvement. Due to the strict cost control, EBITDA margin of MobiMak actually increased compared to the same period of last year, and almost reached 54% during the reported period.

Now I would also like to say a few words on the Montenegrin mobile market.

As we already indicated for the fixed line operations, seasonality caused by the summer tourist season is extremely strong in the Montenegrin mobile market. The penetration level, which suddenly jumped to 99% in the third quarter, is a clear sign of this. The majority of the tourists usually buy a prepaid card, or re-activate the one bought last year, increasing the penetration level significantly in the summer months. However, these prepaid cards will churn out in the fourth quarter, after a three-month inactive period.

The high number of tourists significantly increased usage of the mobile operators in the third quarter. Mobile revenues of Monet increased by more than 50% compared to the second quarter and EBITDA was also positively influenced. However, we would like to note that in the fourth quarter this seasonal trend is expected to turn around, as the last quarter of the year used to be the weakest in terms of usage.

Regarding competition, we were able to slightly increase our market share which now stands at 44%. While the increase was mainly prepaid driven, we have also tried to improve our postpaid customer base through new promotions and new package offers.

While we should not forget that the third quarter performance of the Montenegrin operations includes considerable seasonal impacts, we can see from the reported results that the company is already benefiting from the restructuring efforts made by our management team and confirm our view that the transaction will be value-enhancing.

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. I would also 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.