2Q 2015 Results Conference Call

Aug 6, 2015 at 15:00 CET

Good afternoon everyone and good morning to those of you calling from the Americas. I am Marton Lennert, Magyar Telekom's Head of Investor Relations. On behalf of the Company, I would like to welcome you to our second quarter 2015 conference call. If you have not received our presentation by email, please note that this is also available on our Investor Relations 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.

Now, let me introduce today's speakers who will take you through the presentation and answer any questions you may have. I am pleased to introduce Mr. Christopher Mattheisen, the Chief Executive Officer of Magyar Telekom; and Mr. János Szabó, our CFO.

And now it is my pleasure to turn the call to Chris to open the presentation.

Christopher Mattheisen:

Thank you, Marton. Good afternoon everybody.

Let's start today's call with a brief summary of what we have achieved financially at Group level during the first half of 2015. Then, as always, we will go through the quarterly results of our four segments – T-Hungary, T-Systems, Macedonia and Montenegro. Slides 2 and 3 provide a summary of our strategic achievements and our market shares across the various segments of the Hungarian telco market.

I am pleased to report that the positive trends in our operations achieved during 2014 have continued into the first half of 2015. Let me first give you a summary of our half year performance in terms of revenue, EBITDA and CAPEX <u>on Slide 4</u>. Our **Group revenues**

increased by 3.9% compared to the first half of last year, driven by continued improvement in all of our major revenue streams. Our **mobile** revenue is up by an overall 2% following the Group-wide 4G push that has resulted in our mobile data and equipment revenues more than compensating for the loss in mobile voice. We saw a slight increase in **fixed line** revenues due to our continued focus on triple play customers, with the network improvement across our footprint allowing us to offer services of a higher quality. **System integration and IT** revenues grew by 11% in line with our strategy. Our **Hungarian energy** revenues grew by 26% in the first half of this year, reflecting our conscious decision to place greater focus on the more profitable B2B segment. Our original guidance for the full year 2015 anticipated roughly stable revenues compared to 2014 and we maintain this guidance target in spite of exceptionally low mobile termination rates.

Our **EBITDA performance improved by 5%** year on year in the first half of this year. It was achieved not only through increasing the gross margin, but also through achieving significant savings in employee related expenses. However, let me please remind you that the planned cut in FTEs this year will lead to a one-off severance expense of approximately 8 billion forints, most of which will be booked in the third quarter. This special one-off item is the principal reason why we are maintaining our EBITDA guidance, on a reported basis, to be up to a 3% decline for the full year 2015 compared to 2014.

The **Group Capex** for the first half of 2015 was over 35 billion forints which, despite the commencement of the Hungarian fixed High Speed Internet roll-out program, is only 5% higher compared to capex for the first half of 2014. The vast majority of the planned investment is still ahead of us and we expect a significant pick-up from this level in the second half of this year. In the meantime, we have speeded up PSTN replacement, both in Hungary and in Montenegro, in order to increase the efficiency that IP networks can offer, and we have spent less on Hungarian mobile networks than expected thanks to the network sharing agreement with Telenor. Our Capex guidance for this year remains at 105 billion forints and to be clear, this does include an element of spend on the extensive High Speed Internet roll-out program, which will be accelerated in the second half of this year.

On Slide 5 you can see the breakdown, by sector, **of our revenue and EBITDA** performance. Both Hungarian segments increased their revenues despite the 76% cut in mobile termination rates effective from the 1st of April. To put this into context, revenues at Telekom Hungary for the second quarter were up by almost 5 billion forints, which is a 4% increase, driven by a strong fixed line performance and a significant increase in energy revenues. The resultant higher gross margins and lower employee related expenses also contributed to a 9% increase in EBITDA in the second quarter this year. Moreover, these very good results in the residential and SME segments were coupled with a 3% revenue increase at T-Systems. A couple of large projects were won within the government and healthcare segments, resulting in an increase in system integration and IT revenues in excess of 2 billion forints, which helped to more than offset revenue weakness in telco, which was principally for regulatory reasons. In the meantime, however, EBITDA pressures remained within the enterprise segment.

After the successful approval of the merger of T-Mobile Macedonia and Makedonski Telekom, we are proud to announce that following the integration of operations over a number of years, we are finally able to serve our customers in Macedonia through one legal entity. As the mobile market continues to show signs of stabilization, the competition office has approved the merger of our two mobile competitors which helps to create a strong integrated player as both of them have fixed line assets. Overall, revenues fell by less than 5% at our Macedonian subsidiary with EBITDA declining at a slower rate due to cautious cost control within operational expenses. In Montenegro, a steep increase in system integration and IT revenues almost offset the decline in messaging and prepaid mobile revenues, along with continuing regulatory pressures within fixed voice and broadband, which resulted in a marginal decline of 1% in overall revenue.

Let me now turn to the segmental analysis on Slide 7, starting with **Telekom Hungary**, where revenues increased by more than 4% during the second quarter compared to the same period in 2014. We are pleased to announce that within mobile, our strong broadband and equipment sales, handsets and wearable accessories, were almost enough to compensate for the sharp MTR cut which alone was responsible for a loss to revenue of 5 billion forints. We managed to achieve significant growth in both fixed broadband and TV revenues thanks to the ever larger customer bases and higher ARPUs in each of the two areas. Higher fixed wholesale and data revenues were largely a reflection of the GTS acquisition, whilst energy revenues benefited from our greater focus on the higher margin B2B sub-segment.

With an improvement in the gross margin and further savings in employee-related expenses following the FTE cuts in 2014, along with seeking other operational efficiencies, EBITDA for the second quarter increased by 9% year on year, by 3.4 billion forints. We are very pleased that after many years of decline we have finally achieved margin expansion amongst our small and medium business customers, helped by the tailwind of a general economic recovery.

On Slide 8 you can see that we were able to increase further our **mobile** customer base by 1% in the second quarter of 2015 compared to last year and the postpaid ratio has now grown to 51%, thanks to 104 thousand postpaid net adds. The 4% increase in our contracted mobile RPC was driven by lower churn and higher prepaid to postpaid migration underpinned by strong demand for mobile data. Year on year, average minutes of use is 9% higher which is consistent with the growth in our flat rate subscriber base that is centered on the high end segments of our residential, and small and medium business customers. The prepaid ARPU declined significantly due to the MTR cut to 1.71 forints per minute. On the other hand, this regulatory effect was almost fully compensated by increased mobile data spending among our contract subscribers. The average postpaid revenue per customer increased by 2% compared to last year when you exclude the negative impact of the MTR cuts. Magyar Telekom's 4G outdoor population coverage in Hungary has now surpassed 90% penetration which puts us ahead of many of our European peers. We are pleased to report that more than 640 thousand of our customers now actively use our 4G network, enjoying the unique experience it provides. This is equivalent to around 30% of the total mobile broadband customer base, implying there is ample scope for further expansion. Our growth in mobile data revenue has mostly been due to the increasing small screen internet penetration, which is up by 17% year on year. Besides offering a reliable and high quality network, and value for money plans, we have continued to focus on device sales. Our smartphone sales account for over 90% of postpaid handsets and we have maintained our leading market position within the high end device segment.

We have continued the restructuring of our customer base and revenue mix within our **fixed line** operations in the residential and SME segment. As shown on Slide 9, we had 84 thousand **broadband** and 33 thousand **TV** net adds compared to the second quarter of 2014 which helped us to maintain our market leadership positions. Our focus has remained to offer quality home services on superior networks as we initiated our extensive High Speed Internet network roll-out program. The increasing ratio of higher bandwidth packages due to upselling activities was driven by last year's network upgrades. We have continued to push IPTV sales to offer greater value to our customers. Half of our TV subscriber base already enjoys the benefits of the interactive television service in return for a higher monthly fee. We are proud to report that our successful migration activity and the price increase implemented last year helped us to achieve ARPU growth for TV and for broadband of 7% and 6%, respectively, compared to the second quarter of 2014.

We are pleased to announce on Slide 10 that erosion in our **fixed voice** customer base has decreased to less than 1% this quarter thanks to the smart bundling strategy we have executed. As mentioned earlier, we are working intensively on PSTN migration as we plan to shut down this legacy platform at the end of next year. However, our areas of primary focus are not only on offering a richer telephony service to our customers along with attaining higher levels of operational efficiency, but also without losing any fixed voice customers in the migration process. Moreover, the 2.5% decline in fixed voice ARPU is the lowest it's been in recent years, undoubtedly supported by our focus on triple-play which has helped to increase the average revenue generated per household. Furthermore, we have witnessed much lower churn levels among customers subscribing to package bundles.

The main reason behind the 29% growth in **energy** sales is the revenue increase from the business sub-segment. We tripled the number of our B2B electricity customers and we were able to increase the gas sales among our business customers as well year on year. Not surprisingly though, we lost some of our residential customers ahead of our exit from the residential gas market on 1 August due to unfavorable developments in the regulatory environment.

I will now hand over to János who will talk in more detail about the performance of T-Systems Hungary as well as our foreign operations.

János Szabó remarks

Thank you, Chris.

Let me please continue on Slide 11 with the performance of **T-Systems Hungary.** I am proud to announce that after several quarters of decline, the segment **revenue** increased by 3% in the second quarter of 2015, compared to the same period last year. The growth was driven by the material increase of 14% in SI/IT revenues, in excess of 2 billion forints, that was partially offset by lower mobile voice revenues, lower revenues from fixed voice and retail data. Although it is evident that certain one-off large IT projects have had a significant positive effect on revenue in the second quarter of 2015, we are confident that expansion of the SI/IT business line will continue for the rest of the year. The gross margin of the segment declined by 5%, partly due to a 10% increase in the total direct costs driven by higher SI/IT related costs but also due to the loss of many telco subscribers to the state owned operator at the beginning of 2015, as previously reported. Higher level of bad debt that derived from a change in the ageing structure of certain outstanding receivables and also the MTR cut from 1st of April that was reflected in a significant fall of mobile wholesale voice revenues and interconnection costs contributed further to the 10% decline in **EBITDA** for the second quarter. However, the increase in the total revenue gives us confidence that strong foundations are in place for a return to growth in the second half of 2015.

Mobile revenues declined by 7% as the improvement in mobile data and mass messaging revenues could only partly balance the fall in mobile retail and wholesale voice revenues. At the same time, despite the intense competition, we successfully increased our mobile voice and broadband customer base by more than 6% and 9%, respectively. However, the level of mobile voice traffic decreased and we witnessed further mobile voice and broadband ARPU erosion due to the fierce competition, principally from Vodafone.

Fixed line revenues declined by 14% due to the significantly lower voice and retail data revenues. On the voice side, we continued to experience high churn levels coupled with ARPU erosion. Similar to the first quarter of 2015, the significant churn of our fixed broadband customers compared to the same quarter last year is a result of the presence of the state-owned operator among government related fixed data and broadband customers. Fixed data revenues fell by 19%, contributing to more than half of the overall fixed line revenue decline. At the same time, blended fixed broadband ARPU improved by more than 6% compared to the same period of last year.

Moving on to our foreign operations, starting with **Macedonia** on Slide 12, we are pleased to announce that the approval of the merger of T-Mobile Macedonia and Makedonski Telekom, known as Maktel, happened in the second quarter. Having one, rather than two legal entities to serve households with both fixed and mobile offerings along with seeking further cost efficiencies are the main drivers behind this integration. Following the approval of the merger between VIP and One in July 2015 and the recent acquisition of Albafone by VIP, we lost our market leadership in mobile and TV segments against the combined operation but maintained our leading positions in the fixed voice and broadband segments; however, VIP and ONE are still marketed as separate brands. There is no doubt that Maktel will face great competitive challenges following this merger as both mobile operators had previously acquired fixed cable assets but we have outstanding brand perception and by consolidating into one entity, this will provide further valuable cross-sell opportunities in the market. Due to the shrinkage of the mobile market in Macedonia to now only two players, we expect that the regulator at some point will encourage entry by MVNOs; however, these details are still under discussion.

The market in general has become rather static due to the recent political uncertainties as witnessed by the lower churn rate and lower gross adds in both mobile and fixed line operation. However, the political turmoil does seem to be coming to an end now, with new elections due to take place next April. We continue to see positive signs with a slowdown in total revenue decline, at -5% during the second quarter of 2015 compared to -13% for the same period of last year.

Mobile revenues declined by 5%, continuing on the stabilizing trend that we saw in the first quarter of this year. The 21% increase in equipment sales and 30% improvement in data revenues offset to a degree the significant revenue decline from SMS, and somewhat smaller ones in retail and wholesale voice. The blended mobile ARPU decreased by 9% which is very encouraging when compared against the 18% drop we witnessed for the same period a year earlier.

In the **fixed line** segment, revenues fell by 8% compared to the same period last year, which is also a great improvement from the 12% decline in the second quarter of 2014. The decrease is due to lower retail and wholesale voice revenues, partially mitigated by the 24% increase in

TV revenues, derived from growth of 5% in IPTV customers numbers and 18% higher TV ARPU. We are pleased to report an outstanding SI/IT performance through major project wins in the government and transport segments. Maktel managed to triple its **SI/IT** revenues and the good performance is set to continue during the second half of the year.

Moreover, EBITDA fell by 5% in local currency in line with revenue, so maintaining margin. Gross margins contracted slightly and SI/IT and employee related expenses were higher, yet these were offset by lower other operating expenses resulting from lower provisions and frequency costs, as well from efficiency improvements.

At our **Montenegrin** subsidiary, revenues declined only by 1% in the second quarter of 2015 and EBITDA declined by 7% as shown on Slide 13. The FX impact related to the strengthening of the Forint was not significant.

Mobile revenues decreased by 7%, mainly driven by revenue falls in prepaid mobile voice, wholesale and SMS in line with lower traffic. The decline was partly offset by higher data revenues reflecting the rise in handset internet users. **Fixed line** revenues were heavily affected by the regulatory price cap that resulted in lower fixed voice and broadband ARPUs. This fall in fixed revenues was partially offset by an improvement in fixed equipment revenues.

SI/IT revenues almost doubled compared to the same period of last year driven by an increased number of ICT customers and one-off projects – the flip-side of this is that related SI/IT service costs increased significantly too, with total direct costs increasing by 13% mainly due to the higher cost of equipment sales related to mobile handsets and accessories. This led to a 6% decline in the gross margin compared to the second quarter of 2014. Other operating expenses decreased by 17% due to the reversal of accruals related to a favorable court case.

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)

(Take questions)

I believe we have time for one more question.

(Take final question)

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 continues interest in Magyar Telekom.