Q4 2011 Results Conference Call

February 23, 2012 at 15:00 CET

Good afternoon, everybody, and welcome to Magyar Telekom's fourth quarter 2011 results conference call. I am Thilo Kusch, CFO and member of the Board, and I will be hosting today's call.

In 2011 the decline in revenues and underlying EBITDA were more moderate than expected and we have outperformed our previously announced guidance. While we targeted a revenue decline of 3 to 5%, revenues were only down by 2% driven by a more favourable than anticipated market environment both in the traditional telco business and SI/IT services. In fixed line, revenues were strongly supported by the energy resale business, which together with the Hoppá flat rate package and the bundling offers resulted in a significant improvement in the fixed line churn levels for 2011. The Christmas period was again very strong in terms of handset sales and upgrades, as customers' interest in higher priced smartphones in combination with a data plan remained undiminished. IPTV was also an important revenue driver as both the growth in the number of our customers as well as higher ARPU levels contributed to the strong performance. The SI/IT business in the last two quarters of 2011 also surpassed our expectations. After several quarters where results from our SI/IT segment were affected by businesses postponing investment in IT, we started to see an increase in our revenues in the second half of the year.

In terms of underlying EBITDA, we targeted a 4 to 6% drop, while we only suffered 1% decline due to our strong focus on cost efficiency, higher margins in the SI/IT business compared to the previous year and a greater contribution from our international subsidiaries, which also benefitted from the sharp deterioration of the forint towards the end of 2011. Capex, which was down by 9% in 2011 was also ahead of our anticipated reduction of 5%.

Despite our strong operational performance during 2011 where we have overcome a number of significant headwinds, to outperform our revenue and EBITDA guidance, we have had to report net losses at the Group level for 2011 for the first time in history. There are several reasons for this: the first is the financial impact of the settlement with the SEC and DOJ, which caused a 16 billion forint increase in other expenses and 6 billion forint increase in net financial expenses.

The second is the change to the corporate tax regime in Hungary, which compared to 2010, caused deferred tax expenses to be almost 30 billion forint higher in 2011. The third reason was the impairment charge booked on our Macedonian operation which caused D&A expenses to increase by 31 billion forint in the fourth quarter last year.

While you know the details behind the first two items, let me briefly explain the drivers behind the impairment charge. Competition in the Macedonian mobile market became much fiercer over the last couple of years, driven by our competitors who have brought down prices especially in the prepaid market and at the same time increased handset subsidies. Although we have stabilized our market share after several quarters of heavy declines, this was at a cost of reduced prices. Thus mobile revenues in local currency declined by 12% last year. In addition, the improvement in the economic environment in Macedonia has also been much slower than previously anticipated. Accordingly, we have reduced our 10-year revenue growth plans for the Macedonia segment by 15-25% compared to the plans prepared a year before. In addition to the decrease in expected cash flows, an increase in the applied weighted average cost of capital and reduction of the perpetual growth rate further reduced the enterprise value of the Macedonia segment. As a result we identified and recognized an impairment loss on the goodwill of the Macedonia segment.

As two of the aforementioned one-off items which contributed to the net loss reported for 2011 are non-cash, and the third item, the obligation related to the settlement with the US authorities was paid out in January this year. ree cash flow generation remained strong and even increased by 15 billion forint in 2011 compared to 2010 due to reduced capex levels and lower working capital.

Regarding the use of free cash flow, our Board of directors met this morning and will propose 50 forint per share dividend for the 2011 earnings. The annual general meeting is scheduled for April 16, and the record date for dividend payment is planned for the 8th of May 2012.

Let me also mention that Magyar Telekom has successfully deregistered from the US Securities and Exchange Commission which means we will not file a 20F for 2011. However, the Company remains committed to serving its investor base in the United States, and we will publish the annual financial statement containing similarly detailed information than we had in the 20F. We have also maintained our American Depositary Receipt program on a Level 1 basis. Our American Depositary Shares are now traded over the counter on several exchanges, while the company maintains its primary listing on the Budapest Stock Exchange.

Let me now turn to the segment analysis and start with **Telekom Hungary**, where the declining revenue trend reversed in the fourth quarter with total sales increasing by 0.5%. Although we have maintained our strong cost-cutting focus, the shift towards lower-margin non-voice services resulted in a 1 percentage point decline in the underlying EBITDA margin to 35%.

Let us take a closer look at the fourth quarter performance of the Telekom Hungary segment. Regarding the fixed voice business, we saw the outstanding results of the Hoppá package continue into the fourth quarter. While Hoppá was only introduced in January 2011, take-up has been strong. By the end of the year, a significant 28% of our fixed voice customers had subscribed to this package. Of these, almost 90% have signed a 2-year loyalty contract. Although this flat-priced package does contribute to the dilution of average revenue per access, there are huge retention benefits. While the annual churn figure dropped from 9% to 5% during last year, the comparison for the fourth quarter is even more pronounced: we have lost only 14,000 lines in the fourth quarter, which is only a third of what we lost in the same quarter in 2010. Hoppá's customer retention effects are further strengthened by its incorporation into our bundling strategy, as a growing number of subscribers ask for more of our services in order to gain discounts on their final telecom bills, and even on their energy bills. As a result, more than 52% of our fixed voice customers are currently subscribing for at least two of our services, representing a year-on-year increase of 7 percentage points.

Concerning the fixed internet business, our broadband revenues were flat as the 10% growth in the subscriber base compensated for the ARPU erosion resulting from local pricing and multi-play migration.

Turning to the TV market, the positive trends continued into the fourth quarter as revenues increased by 6% resulting mainly from an expansion of our subscriber base while ARPU also increased thanks to migration to more expensive packages. The rise in the popularity of our interactive TV services was especially visible, as the number of our IPTV customers grew by 82% to 226 thousand. Moreover, subscriptions to satellite TV increased by 11% as we are able to reach more households via this technology. I see further potential in our new Hybrid TV offer, which unites the benefits of IPTV's interactivity and satellite's better accessibility.

In the fourth quarter of 2011, other fixed line revenues were up by 30%, driven by our retail energy business. By the end of the year, the number of gas and electricity point of deliveries surpassed 35 thousand. We are glad to see that our energy business serves as a great retention tool. Customers with energy subscriptions are 80% less likely to churn from Magyar Telekom services.

Thanks to all these positive trends, total fixed line revenues increased by 2% compared to the fourth quarter of 2010, reversing the declining trend we have seen over the past 5 years.

Moving on to the mobile market, the decline in revenues slowed to 1% in the fourth quarter. While our customer base, usage, and market share increased and there was strong migration to post-paid packages, these positive developments could not offset the negative effects of the decline in the average tariff levels and falling wholesale revenues. Non-voice revenues showed more moderate growth due to lower content revenues, although mobile internet revenues were up by 15%.

2011 was the year of the smartphones in Hungary. Within the postpaid segment in the fourth quarter almost four out of five phones sold was a smartphone and an increasing amount, 70% of our new smartphone customers asked for a mobile internet package attached. The increasing popularity of smartphones continues to have a strong effect on our equipment revenues, which rose by 17% in the fourth quarter. Our overall smartphone penetration rate is still only 18%, indicating significant room for expansion in the coming years. Magyar Telekom's mobile internet market share increased by almost 2 percentage points to 49% compared to the end of the third quarter.

One of the key ingredients of maintaining our competitive edge is the continuous improvement in the quality of our network. We continued our network modernization program in the fourth quarter and now offer HSPA+ service with 21Mbps download speed in 600 locations. Furthermore, as planned, Magyar Telekom was the first to offer commercial LTE services as of 1st of January 2012. The fourth generation technology currently covers some 40% of Budapest's population, but we expect to cover the whole capital by the end of the year and will decide on further investment locations based on our experience in Budapest.

Now let's turn to T-Systems Hungary's results. Following a very strong third quarter, we had very good results in the fourth quarter, as well. We have achieved 13% growth in revenues in the fourth quarter compared to the same period in 2010 driven by the success of the SI/IT business. The results were also helped by the consolidation of Daten-Kontor Group since February last year, which is present in the Hungarian custom application development market. As well as the significant growth we have seen on the revenue side, we also managed to increase the underlying EBITDA margin by 1 percentage point to 19%. In 2010 we had to offer price allowances to customers on various services to maintain their business, but in 2011 the situation improved and margins on SI/IT reached a higher level.

In T-Systems Hungary's telecom business, fixed voice revenues declined further, driven by price pressure, continued erosion in our customer base and lower usage. Data revenues were also down due to the loss of some bigger leased line customers and significant price allowances given in 2011. The drop in mobile revenues was mainly driven by a one-off item which impacted the fourth quarter results in 2010. The negative financial impacts of the Governmental measures announced in August 2010, and booked in the third quarter, were somewhat reversed in the fourth quarter of 2010 resulting therefore in a 35% decline in other mobile revenues year-on-year.

At the same time SI/IT revenues increased by 42% as a result of several positive developments. Although the majority of the increase was driven by intra-Group service revenues, we have experienced significant external growth as well. In 2010, the majority of our corporate clients remained cost cautious and postponed their SI/IT investments, while in the second half of 2011 they started to release deferred budgets generating notable revenue streams in the third and the fourth quarter.

Nevertheless public orders remained subdued, and the restrictive measures imposed by the government are still blocking any new public IT deals. Looking ahead, as Hungary is still in the early phase regarding IT developments, I am confident that this market has significant growth potential in the long term; however, I am very cautious on the short-term projections due to the prevailing economic and political uncertainties.

Moving on to the analysis of our international subsidiaries, total revenues in **Macedonia** increased by 1% in the fourth quarter of 2011 compared to 2010. This result reflects a 9% weakening of the forint against the denar. Excluding the positive FX impact, revenues were down by 8% mainly driven by the strong mobile competition which continued into the fourth quarter. However, despite the pressures on our profitability, thanks to the significant saving in employee related expenses we managed to maintain the underlying EBITDA margin of 49%.

In the Macedonian fixed line segment, revenues in local currency were down by 9%. The main reason is the decline in retail voice revenues driven by the intensifying competition from the cable operators and mobile substitution. Regarding the broadband market, we are still seeing some single digit growth in our ADSL figures; however, these upward sales trends are starting to level off and the market seems to be nearing saturation with broadband penetration now exceeding 44%. On the other hand, thanks to our continued focus on TV services and double and triple play packages, these subscriptions are still steadily increasing.

Turning to the mobile segment, mobile revenues were down by 7% in the fourth quarter driven by significantly lower retail voice revenues as intense competition, especially in the pre-paid and the business segments places continued pressure on tariff levels. The higher usage levels could not offset the 6% decline in ARPU and the decrease in revenue producing customers. However, despite the fierce competition, T-Mobile Macedonia remained the clear market leader with a 50% market share.

Similarly to Macedonia, our Montenegrin subsidiary's fourth quarter results were inflated by a 9% year-on-year positive foreign exchange effect. In local currency, total revenues declined by 5%, while reported EBITDA fell by 6% in the fourth quarter of 2011 compared to the same period in 2010. Underlying EBITDA, however, showed 2% growth in the fourth quarter, as cost-cutting efforts continue to be strong in Montenegro and a 0.8mn Euro severance expense was accounted for in the fourth quarter of 2011. The underlying EBITDA margin was 35%.

Fixed line revenues decreased by 2%, as broadband and IPTV revenues which rose by over 11% could not wholly offset the negative effects of losses in voice revenues. Although we are still the only significant player in the fixed voice market, fixed-to-mobile substitution cuts deep into our revenues especially at the lower usage levels. In the fixed broadband business, we managed to increase our subscriber base by 14%, while maintaining our 85% market share. We strengthened our leading position in the pay-TV market as the number of our IPTV customers increased by 22% and our market share rose by 4 percentage points to 41%.

Mobile revenues in Montenegro declined by 8% in Euro terms. Voice revenues decreased by 11%, mainly due to the negative effect of falling interconnection fees and declining incoming minutes on wholesale revenues. Our retail voice revenues decreased, by 8% compared to the same period in 2010 due to the declining price levels especially in the pre-paid segment. We have been trying to shift resources away from the less profitable and more volatile pre-paid businesses to expand within the post-paid segment. As a result, we became the leader in the post-paid market by the end of the year, which should help to stabilize our voice revenues in the future. Within the non-voice segment, growth remained strong and we see further potential as ongoing network modernisation to HSPA+ enables higher download speed.

With that, I conclude the analysis of the 2011 results. Looking forward, expectations for a deteriorating economic environment potentially leading to a recession in Hungary are strengthening, together with fears over the level of declines in disposable income. Although we expect revenues to stabilise this year thanks to the new revenue sources, these new revenue streams have lower profitability and are expected to have an impact on our profit margins. Consequently, while we foresee revenues to be in the range of flat to a maximum decline of 2% year-on-year, we expect underlying EBITDA to deteriorate by 4-6% in 2012. CAPEX, not including any spectrum acquisitions, is expected to remain flat to support our ongoing network modernisation and internal projects to improve efficiency.

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)

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 would like 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.