4Q 2016 Results Conference Call

February 23, 2016 at 15:00 CET

Good afternoon everyone. I am Linda László, Magyar Telekom's Head of Investor Relations, I would like to welcome you to our fourth quarter 2016 conference call. Please note that our presentation can be accessed via the link within the conference call invitation, and is also available in the Investor Relations section of our 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. Mr. Christopher Mattheisen, our CEO, will start with an overview of our full year results and outlook for 2017. Following that, Mr. János Szabó, our CFO, will talk about the fourth quarter performance of each of our business segments.

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

Christopher Mattheisen:

Thank you, Linda. Good afternoon everybody.

Let's start today's call with a brief summary of what we have achieved financially at Group level during 2016.

I am pleased to report a strong set of financial results for the full year 2016. Revenue performance exceeded our previously announced guidance, driven by a favorable fourth quarter in Hungary, where our increased marketing activities and higher level of subsidies led to a better than anticipated sales growth of both mobile handsets and data packages. Although our total revenue witnessed an 8% decline compared to 2015, as you can see **on Slide 2**, this was primarily due to our decisions regarding the energy business, as well as a decline in Systems Integration and IT revenues following a temporary slowdown in EU fund inflows and a very strong fourth quarter 2015 comparative. EBITDA grew by 5% during the year, again outperforming our guidance. This positive result can be attributed to lower severance expenses, significant savings in employee related expenses, one off gains from the sale of Infopark building G and Origo, as well as a rise in profitability at our Systems Integration and IT services in Hungary due to a strategic focus on higher margin projects.

Capex, excluding spectrum license fees totalled close to 105 billion forints, exceeding our target of around 100 billion forints. At the same time, I am pleased to report that thanks to EBITDA growth and lower interest payments, our free cash flow increased by 87% compared to 2015, thereby reaching our target of 50 billion forint free cash flow a year earlier than expected.

On Slide 3, you can see our new **public targets** for 2017. Moving forward, competition is expected to intensify in both mobile and fixed line. Digi is expected to enter the mobile market, and prepaid and business mobile segments are likely to remain very tight. In terms of the fixed line market, increasingly competitive regional 3Play offers are undoubtedly intensified by the rollout of optical networks by Digi and UPC. Regulatory risks to growth also continue, with an ongoing obligation to register prepaid SIMs as well as further cuts in EU roaming rates. As an integrated operator, we believe that our 4Play Magenta 1 bundled offer differentiates us from our competitors and allows us to address these challenges in Hungary through maximizing the telecommunication share of the household spending wallet.

Taking into account these headwinds, as well as stripping out any contribution from our Montenegrin business, whose sale was finalised in January this year, we now expect revenues to decrease to around 560 billion forints for 2017. We expect EBITDA to remain broadly stable excluding the one-off profits from the sale of Infopark building G and Origo at around 182 billion forints due to our focus on additional operational efficiencies. Although Capex for 2016 excluding spectrum acquisitions was higher than originally guided, we still expect a decline to around 85 billion forint in 2017. Investments in programs related to our mobile network and roll out of high speed internet access will be less capital intensive than in the preceding two years. Furthermore, as we are nearing the completion of a number of efficiency enhancing projects, Capex related to the IP migration and other IT projects will also be lower. We expect free cash flow to increase to around 55 billion forints, excluding the transaction price received for the disposal of our majority ownership in Crnogorski Telekom.

Based on the current operating and regulatory environment and outlook, we expect the Company to pay 25 forint dividend per share in relation to 2017 earnings, keeping a stable dividend level compared to 2016 earnings.

Continuing with the quarterly results, **on Slide 4**, you can see contributions to revenue and EBITDA performance by segment. The revenue drop was principally driven by the Hungarian segment, due to the absence of the business energy revenues and the slowdown in EU funded System Integration and IT projects. EBITDA in Hungary improved, despite slightly lower gross profit, as a result of savings on employee-related expenses due to lower headcount and lower severance expenses. I am very pleased to report that in Macedonia, following the EBITDA improvement achieved in the third quarter, excluding severance expenses related to the headcount reduction program, EBITDA increased by more than 3% in the fourth quarter. At the same time, revenues declined by 2% driven by a decline in fixed voice retail, wholesale and ICT revenues, offsetting the strong mobile performance. In Montenegro, the slight revenue drop was due to intense competition both in fixed line and mobile, whilst regulatory pressures with regards to voice and broadband pricing continued. Montenegrin EBITDA was down by 10%, as a result of sustained pressures on margins and higher other operating expenses largely driven by the reversal of a one-off tax accrual in the previous year.

I will now hand over to János to provide you with further detail on the performance of each of our business segments.

Let me start with **MT-Hungary** on **Slide 5**. Overall revenues declined by 15% during the fourth quarter compared to the same period in 2015, driven by both a significant reduction in the contribution from energy, and a fall in System Integration and IT revenues due to a very strong fourth quarter 2015 comparative.

Mobile revenues in the quarter remained broadly stable, as increased mobile broadband revenues, significantly higher smartphone sales and increased third party export sales were offset by lower voice revenues. Fixed revenues declined, driven by lower ARPUs in voice, fixed broadband and TV segments due to tough regional 3Play competition. Annual net adds in these segments were lower compared to previous quarters in 2016 as a result of portfolio cleansing, where long-standing non-paying customers were forced to disconnect in the fourth quarter of 2016. Other fixed revenues declined due to the deconsolidation of Origo.

EBITDA in the MT-Hungary segment increased by 3%, mainly driven by a significant year on year decline in employee related expenses due to a drop in severance expenses and underlying efficiency savings resulting from the headcount reduction program carried out over the past couple of years. These savings more than offset the significantly higher other operating expenses which were driven by higher network maintenance, repairs and remedial work expenses, increased rental, marketing and sponsorship fees.

On Slide 6 you can see developments in the Hungarian **mobile market**. We witnessed a more aggressive approach by Vodafone aimed at increasing market share in both retail and business mobile markets. The retail market was affected by the introduction of low priced prepaid offers, while the business mobile market continued to face very strong price competition. Despite these headwinds, we managed to increase our postpaid ratio by 3 percentage points to 59%. This improvement in the customer mix resulted in a higher blended ARPU. Magenta 1, our flagship product, also performed very well. More than 113,000 subscribers have chosen this high-value 4Play package as of the end of December 2016 versus 28,000 at the end of 2015. The number of 4G customers continued to increase;

by the end of December 2016, 57% of our mobile broadband subscribers had a 4G package, which also led to higher usage.

As can be seen on **Slide 7**, we continued to increase our **fixed broadband and TV** customer base compared to December 2015. However, customer numbers declined compared to September 2016, driven by the forced disconnections I mentioned earlier. Despite the increasing subscriber base, broadband retail and TV revenues slightly declined, as the intense local competition resulted in slightly lower ARPUs. At the same time, we maintained our position as market leader in both segments, and increased the share of high bandwidth tariff plans; 36% of our customers now subscribe to high speed internet capable of a speed of at least 30 megabits per second. This, and the high demand for our 1000 megabits per second fixed network offer validates the intensive fixed network rollout conducted over the last two years. We currently cover 2.8 million households with high speed internet, and plan for this number to exceed 3 million by the end of 2018, with the support of EU funding. Despite fierce regional 3Play competition, mainly driven by our two biggest competitors, Digi and UPC, we aim to increase our penetration on these networks.

Turning to **Slide 8,** you can see that almost our entire fixed customer base is on an IP based network and we are very close to concluding the PSTN migration, enabling the shutdown of this legacy platform. Competitive pressures from cable operators were felt in the **fixed voice segment** as well, thus fixed voice ARPU declined by 7%. Although the fixed voice market is fully saturated and the inactivity ratio is increasing, we remain focused on mitigating revenue decline through migration of our high-end residential fixed voice customer base to our flat rate packages.

Briefly on our **energy business**, it comes as no real surprise that our revenues have declined compared to the same period last year, following the transfer of most of our B2B clients into the joint venture in January 2016. It is still our intention to exit the residential electricity business, and we now expect that this will happen sometime in Q3 2017.

Turning to **Slide 9,** let me draw your attention to the results of our efforts in **bundling our services**, which continues to be a cornerstone of our strategy. As an integrated service provider, with an integrated IP network and highly valued brand, we are in a very advantageous position to maximise the telecommunication share of household wallet spend through selling additional services to subscribers. Our Magenta 1 subscribers represent our most valuable, high-end customer base in Hungary with flat mobile and fixed plans, as well as high bandwidth fixed broadband packages. Thanks to the popularity of Magenta 1 and successful cross-selling activities, our blended household fixed line ARPU improved by 2% in the quarter.

If we turn to **Slide 10**, you can see the great opportunities in application development and integration services driven by overall market growth. We are by far the market leader with a 14% share of this highly fragmented market.

In Q4 2015 Systems Integration and IT revenues were heavily boosted by mostly low margin infrastructure projects connected to the end of the recent EU funding cycle. Since then, inflow of EU funds into Hungary has temporarily slowed, which was only partially offset by new assignments in Q4 2016, resulting in a 30% revenue decline for this segment. Exceptionally high revenues related to a governmental System Integration and IT project were not repeated in Macedonia, further contributing to the revenue fall.

At the same time, both System Integration and IT gross profit and gross margin ratio improved in the fourth quarter, thanks to major project wins in the Hungarian public sector. We believe that the Systems Integration and IT market will grow significantly in 2017, underpinned by higher EU fund inflows, and we intend to increase our market share through a greater focus on high margin system integration projects.

Moving on to our foreign subsidiaries, starting with Macedonia **on Slide 11**; I am very pleased to report that revenues for the quarter slightly declined, while EBITDA declined only due to one-off severance expenses. Mobile revenues have increased for the fourth consecutive quarter, supported by the success of our Christmas sale, the continuing popularity of our

Magenta 1 offer, and significant growth in mobile broadband and equipment revenues thanks to the 4G push. Our mobile market share continued to increase, exceeding 50% at the end of December 2016, while almost 42% of our customers subscribed to a postpaid package compared to 37% a year ago. Thanks to an improvement in postpaid ARPU and subscriber base, blended ARPU slightly increased despite the decline in the prepaid business line.

In the **fixed line segment**, revenues fell by 7% compared to the same period last year, due to lower voice revenues reflecting a shrinking customer base and usage, coupled with a decline in wholesale revenues due to lower incoming international traffic volume and prices. Excluding a technical adjustment related to the break-down of Fixed Mobile Convergence products, fixed broadband revenues marginally decreased, while TV revenues improved by 14%, driven by higher ARPUs and an increased customer base. **System Integration and IT** revenues were significantly down, due to exceptionally high revenues related to a governmental project in the fourth quarter of 2015 that were not repeated this year.

As mentioned earlier, following the **EBITDA** improvement in the previous quarter, excluding the severance expenses related to the voluntary headcount reduction program, EBITDA increased by more than 3%, driven by savings stemming from the lower headcount. At the same time, gross profit increased by 2% as a result of a significant decline in bad debt expenses, owing to a recent collection campaign and annual review of impairment rates, while other direct costs declined in line with lower sales of fixed equipment. Looking forward, we believe that stabilization in revenues and cost efficiency improvements shall soon lead to a sustainable turnaround in EBITDA.

At our **Montenegrin subsidiary**, **total revenues** declined by 2% compared to the fourth quarter of 2015, due to continuing competitive and regulatory pressures across all major revenue lines, as you can see from **Slide 12**. **Mobile** revenues increased by 11% due to higher equipment sales and data revenues, both driven by one-off events, counterbalancing the effect of lower Balkan roaming prices. Equipment revenues increased thanks to a one-time wholesale deal, while a rise in data revenues was driven by a negative technical billing correction that took place in the same period of 2015. We continued to enlarge our 4Play Magenta 1 subscriber base which had a positive impact on mobile ARPUs and subscriber growth, resulting in a 19% increase in our post-paid customer base. **Fixed line** revenues declined by 16% in Q4 due to regulatory price caps affecting fixed voice and broadband revenues, more aggressive competition from cable companies offering 3Play packages, and continued mobile substitution. Fixed wholesale revenues declined due to lower levels of incoming domestic and international traffic, while revenues from fixed equipment sales marginally increased. **Systems Integration and IT revenues** increased by 38%, due to an exceptionally low Q4 2015 comparison figure. **EBITDA** declined by 10% in the fourth quarter, as the decline in gross profit could not be offset by savings in employee-related expenses. The fall in gross profit reflects shrinking total revenues, due to ongoing competitive pressures across all business lines, coupled with higher direct costs. As announced, Magyar Telekom has disposed of its majority stake in Crnogorski Telekom, therefore, as of end-January 2017, Montenegrin operations will no longer be consolidated into Magyar Telekom Group's financials.

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)

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 continued interest in Magyar Telekom.