Conference Call Transcript

4 February 2015

QUARTERLY UPDATE

Operator

Welcome to the Vodacom Group Ltd quarterly update conference call for the period ended 31 December. Vodacom Group CEO, Shameel Joosub, will be hosting the conference call. I will read the forward looking disclaimer before handing over to Shameel Joosub.

This quarterly update for Vodacom Group Ltd for the period ended 31 December 2014 contains forward-looking statements with respect to the group's financial position, results of operations and businesses and certain of the group's plans and objectives.

In particular such forward-looking statements include statements relating to the group's future performance, future capital expenditures, acquisitions, divestitures, expenses, revenues, financial positions, dividend policy and future prospects, business and management strategies relating to the expansion and growth of the group, the effects of regulation on the group's businesses by governments in the countries in which it operates, the group's expectations as to the launch and rollout dates of products, services and technologies, expectations regarding the operating environment and market conditions, growth in customers and usage and the rate of dividend growth by the group.

If you do not have a copy of the results announcement and presentation it is available on the investor relations section on the website www.vodacom.com. If you should need any assistance during the conference then please signal an operator by pressing star and then zero. With that I would like to hand the conference over to Mr Joosub. Please go ahead.

Shameel Joosub

Thank you. Good afternoon and good morning to those in the US. Welcome to Vodacom's quarterly update conference call for the period ended 31st December 2014. I am joined by our CFO, Ivan Dittrich, and our group Executive for Investor Relations, TC Ralebitso. Please be aware that today's session is an update on our revenue performance and customer numbers for the quarter only.

We have some salient features at group level. Firstly, group revenue decreased 2.2% in constant currency to R19.9 billion with service revenue down 2.7% to R15.85 billion. Excluding the impact of the 50% cut in mobile termination rates in South Africa group revenue increased 1.5% and service revenue increased 0.6%.

Our group data revenue increased 19.9% to R4.3 billion, representing 27.4% of service revenue. Our group active customers increased 9.1% to 61.1 million, and active data customers grew 16.4% to 26.5 million customers.

Our international operation service revenue increased 7.6% to R3.9 billion, representing 25% of group service revenue. We had strong progress in our accelerated capex program with 15% of group revenue spent for the quarter to speed up LTE rollout and to expand our 3G coverage across our markets.

Let’s now look at the two important segments separately. I will start with South Africa. Our pricing strategy focussing on integrated bundles for contract customers and low-cost bundles for the prepaid segment is well advanced. We managed to reduce our blended price per minute by 21.3% to 63 cents. This further stimulated usage, increasing outgoing traffic 10.1%.

I think it is fair to say we didn’t see the same elasticity in the quarter as we saw in previous quarters. We have now migrated 74% of our contract customers to integrated plans, and 46% of our top-up customers have switched to uChoose plans. The result is that 69% of contract revenue is in bundle and we have reduced contract churn to its lowest level ever at 7.8%. Our contract transformation should be more or less complete by March this year and our hybrid plans should be more or less complete by November next year.

The number of prepaid customers using bundles increased 18.8% to 6.2 million. We sold an average of 50 million prepaid bundles per month in the quarter, up 18.8%. The improvements we have achieved have helped to counter the impact of the 50% cut in mobile termination rates in April, even weaker than expected consumer spending and intensified competition.

Our service revenue in the quarter declined 5.8% year on year. Excluding the impact of MTRs, which had a 4.2% drag on service revenue, is down 1.7%. However, on a quarter on quarter basis excluding the R325 million once-off impact in Q2, Q3 service revenue improved 1.6% over Q2. I think it is also important to remember that last year’s Q3 was our strongest quarter last year where we saw a 4% jump. And we had a number of once-offs in Q3 last year. So we were battling against a very strong Q3. The underlying result, as I just mentioned, is up 1.6% quarter on quarter so we are quite pleased with that result.

Our reported segment revenue has been skewed somewhat by a reclassification of a portion of top-up revenue from mobile prepaid customer revenue to mobile contract revenue. The change was required in order to simplify our management of the performance of each segment. This has resulted in a boost to our reported contract revenue and a weakening of our prepaid revenue in the reporting numbers, very important to bear in mind as you consider the performance of each segment.

Mobile contract revenue is up 1.5% after four successive quarters of decline. Our reported ARPU is down 1.8% year on year but flat compared to Q2. Excluding interconnect ARPU was up 1.1% year on year. As we get a further penetrated contract base and start to reach the end of the pricing transformation we do see a recovery of contract revenue.

Mobile prepaid customer revenue declined 7.6% due to a 16.3% year on year decline in APRU. However, we achieved flat ARPU from Q2. The decline in ARPU was driven in part by MTN’s aggressive summer promotion targeting multi-SIM customers and weaker than expected consumer spending. Although we have not lost share to MTN we were forced to increase our promotional activity and up the uptake of bundles to 50 million, which obviously did cause a little bit of a weakness in specifically voice revenue.

We also took action to decrease the inflow of starter packs in the market to reduce the rotation of SIM cards. You will remember we had a similar problem two years ago. We took measures to change it then. The impact of that means that we reduced the number of active customers by 1.3 million and that’s a result of when you slow down the gross connections your churn obviously does catch up with you. It does then correct itself in the following quarters. We have however seen the positive of these actions also coming through in our contribution margin where we have had the benefit of cutting the arbitrage.

Our data demand remains strong. Our data revenue is now 30% of our service revenue. Data grew 18.8% against an exceptionally strong Q3 last year where revenue grew 31%. Price per MB decreased 26.5% stimulating data traffic growth of 62%. Importantly, we have now managed to maintain stable pricing on Q2. So data pricing in the market is now for the first time in two years stable quarter on quarter.

16.8 million customers representing 53.4% of our active customers, now use data. We have also continued to drive up the number of smartphones and tablets on our network. The active devices increased 24% to 9.5 million. Our average monthly usage is up 41% to more than 350MB on smartphones.

Our new business segments are progressing well. Vodacom Business managed service revenue grew 27.6% reflecting our increased foothold in the enterprise services market. The re-launch of M-Pesa in August is progressing well with approximately 700,000 registered M-Pesa customers. Our active machine to machine collection increased 17.1% to 1.6 million customers. We have now 1.6 million SIM cards in machines.

Our accelerated capital investment programme remains on track. We doubled our LTE sites to 2,194 and increased 3G sites by 22% to 8,407. This represents LTE network population coverage of 34% and 3G network population coverage of 94% to give us a strong lead in the market and a substantial lead over our competitors. 78% of our sites are now high capacity back wall, which is helping to improve our customer experience in addition to helping us to reduce our costs.

If we now move on to our international operations, we have maintained strong customer growth, higher voice and data usage and wider M-Pesa adoption. Our international service revenue grew 7.6% to R3.9 billion to now contribute 25% of group service revenue. The slower growth in service revenue reflects the ongoing price competition and regulatory pressures in our key markets, that being Tanzania and the DRC.

Tanzania experienced severe pricing pressure since Q3 of last year, but during the course of this year pricing repair has led to more stable pricing. We have now been able to return to growth in the Tanzanian results.

Growth in the DRC reduced due to slower than anticipated network rollout, competitive pressures and some network outages due to failures on the national broadband infrastructure. Mozambique and Lesotho continue to grow strongly.

Our strategy of offering more value to customers through bundles led to an 18.6% growth in customers to increase our base to 29.7 million customers. Mobile data revenue growth grew 24.8% or 22% if we exclude M-Pesa, reflecting strong demand for mobile data services in all our markets. This was supported by an increase of 30.7% in active data customers to 9.7 million, an almost threefold increase in data traffic.

We are continuing the momentum with M-Pesa. M-Pesa revenue grew 28% contributing 9.4% of international service revenue. M-Pesa customers increased 29.7% to 7.6 million customers, reflecting strong uptake in all our markets. We continued to expand the ecosystem to drive up the volume and value of M-Pesa transactions. To give you an idea, we now move $1.5 billion a month in transactions in the Tanzanian market. This is an important next step in increasing the contribution of M-Pesa as we reach the right levels of active users.

We also now have more than 1.3 million customers using our M-Pawa savings and loan service after re-launching in September. M-Pawa has resulted in a 7% uplift in M-Pesa ARPU.

To conclude I would like to give you a view of our outlook for 2015 and an update on Neotel. We have maintained positive growth trends on a quarter on quarter basis despite some strong headwinds through the year. Data growth remains strong and we increased the contribution of the international business, including M-Pesa, to the group.

I would like to highlight the impact of the lower MTRs will last through the remainder of the year. The good news is that after this year the mobile termination rate issue becomes a very small part of our lives going forward.

The competition in South Africa seems to be stabilising. I think with the entire market being under pressure we have seen a lot more rationality in the market of late, and we are hoping that that will continue into next year.

We maintained our tight cost management to mitigate the impact of these challenges on our overall performance. We achieved further improvements in our opex and direct expenses. We are confident that the guidance that we've given for next year in terms of our medium-term guidance is still achievable.

Lastly, on Neotel, just to remind you that Neotel has not been brought into our guidance so once the deal is concluded this will be an upside to our guidance. ICASA has held public hearings on our proposed acquisition of Neotel on the 15th and 16th January. The ICASA review is ongoing, and we are still hopeful that we will gain firm direction from ICASA before the end of our financial year in March.

ICASA has committed to the date publicly and in writing, so we are confident that we now have a definitive date and can actually put a defined end to the transaction. We still await the recommendation from the Competition Commission to the Competition Tribunal. Indications are that the tribunal hearing process will not be finalised before the end of March 2015. I will now hand back to the operator to assist with any questions that you may have.

Operator
Ladies and gentlemen, at this time if you do have a question please press star and then one on your touchtone phone. Our first question comes from JP Davids from Barclays. Please go ahead.

JP Davids
Good afternoon. I've got a couple of questions. The first area is just to look at prepaid in South Africa. It is really a question around your bundling strategy, which obviously your competitors have largely replicated. Given that they have replicated a lot of what you have got out there do you find that the bundling strategy is not as effective as it used to be in helping you maintain share and manage down pricing? And related to that is just a question of why more of the base is not taking up bundles. So just looking at the first half there are just over 6 million people who had used bundles, and now 6.2 million. So bundle usage doesn't seem to be increasing much.

And then the second question is around the international business. Could you provide a little bit more commentary around what is happening with the data revenues excluding M-Pesa? It looks like growth rates there have decelerated pretty materially between the first half and the third quarter. Thank you.

Shameel Joosub
So if I could start with the prepaid question, I think what we are seeing is that the prepaid bundle uptake, we are getting more customers buying bundles more frequently through the month. So it is

really becoming institutionalised in behaviour. So we are still very confident that the bundle strategy is working. However we did see a little bit more weakness coming through specifically from voice. If we look at the prepaid segment the underlying result in prepaid is about -2% if we take the once-off movements between segments and everything out, which is a slight weakening of the trend from Q2, which is -1%. So there has been a slight weakening in trend.

I think that predominantly comes through from increased consumer pressure, and then also I would say partly from MTN increasing its competitive activity. I think we have seen a lot more rational Cell C. we have seen price-ups from Cell C. we are starting to see price-ups from MTN as well. So I think what we saw was quite a desperate MTN at the beginning of the financial year, and then very aggressive activity, and then almost starting to realise the impact of that and starting to back off a little bit.

Now, what happened in the prepaid segment was not that we lost share to MTN, what actually happened was that we had to increase the uptake of bundles to the 50 million to compensate to make sure that we didn't lose share to MTN. so we had to increase the penetration of bundles. As we penetrated lower parts of the bundles we didn't get the same elasticity that we got through the quarters. You will probably find there was a little bit of optimisation between the networks if you like in terms of the different promotional activity. A percentage of customers, a big percentage of your customers basically only use one network. And then there is a percentage of your customers that are multi-SIMers. About a third of your customers I would say are multi-SIM customers. And we also made significant gains in the last 18 months in the prepaid part. So there was a little bit of people starting to re-utilise MTN I would say, and then we had to take increased measures to push bundles a little bit faster to compensate for that.

Okay. In the financial segment the problem came through in Tanzania and the DRC. The Tanzanian part we are already starting to see the benefits of price repairs come through so we are back into growth. The price aggression started in Q3 last year. And effectively it was a result of overcooking the bundles, and there was too much value in the bundles and everybody started to realise that everyone went negative. So you are seeing three sequential price increases in the market place to basically recover the situation with more anticipated through the year. What has been happening is operators are reducing the benefit in specific integrated bundles and also shifting back to more on-net bundles. So the recovery will come through in Tanzania but it has messed up the year, is probably a fair comment.

In the DRC the situation was slightly different. We didn't get the capex into the market fast enough so we had a slower rollout. It did dampen our numbers a little bit because the growth comes from increasing customers on your existing footprint but also increasing your capacity. So we had a slower part coming through there. And then we did have increased competitive pressures and some network outages which put a damper on the numbers. Having said that we have seen some rationality come through. The operators and the regulator under the leadership of the Minister have gotten together and all agreed to a price floor. Historically once that happened, rationality returns to the market because you get taxed on the price floor. So if you go under the price floor you still get taxed at the price floor. So effectively we see a market repair coming through. Regulatory assisted market repair will come through in the DRC and effectively improve the results. The good news is that a lot of the capex will be spent in this last quarter, which effectively should give us a boost into the new year.

JP Davids

Thanks. Just one follow-up on that price floor. Does that relate to data in addition to voice, or is it only voice?

Shameel Joosub

It's voice.

Operator

Our next question comes from UBS' Chris Grundburg. Please go ahead.

Chris Grundburg

Hi guys. Just a couple of quick ones if I may. I just wondered on the data performance in South Africa if you could just give us an update. What do you now see as the sustainable data revenue growth that you think you can drive in South Africa in one to three years? And within that if you could maybe comment on what the balance is between pricing and volume, which would be helpful. And by way of a second question, on the post-paid segment in South Africa I'm curious to hear your views in terms of the competitive landscape. What are you seeing in terms of the major competitor offerings and where do you think they are gaining traction or not as the case may be? Thanks.

Shameel Joosub

Thanks Chris. Firstly on the data revenue side we still see data revenue being able to expand at just about 20% for the next few years. Essentially why we think that will happen is that we still have a lot of growth left in terms of the number of smartphone devices that we think we can put into the market. Just to put into perspective for you, we have 16.7 million customers using data. 53.4% of our customers now use data. So there is still room to expand that number, of which there are about 10.5 million data-capable devices that are in the hands of those customers. So there are still 6.2 million customers that we still have to get on a data-capable device, be it a smartphone, a tablet or a dongle. The growth that we are seeing if you put a customer onto data is extremely strong. So we are seeing a very good uplift coming through from converting customers from feature phones into smartphones. Just to give you a sense, a Symbian phone uses 34 MB and an Android device uses almost 400 MB. So you can see the difference that we get from converting customers from a feature phone into a smartphone.

We are also seeing a very good uplift as we convert customers into 4G. We have in the quarter just under a million customers using 4G services. And we have seen a nice ARPU uplift as customers convert from 3G to 4G, and also a much bigger uplift on consumption. When it comes to data revenue and effectively pricing we see a much lower decrease in pricing. So we see a stabilisation in pricing in data coming through purely because of the network investment that is required. I've said over the last year that we are more or less stable on data prices, so there has not been much aggression in data pricing. We still have the effect obviously from the previous year, but we are starting to see data pricing stabilise. In fact, it was completely flat quarter on quarter, which I think is a good indicator of what is happening. There should also be a narrowing in terms of growth in terms of volumes versus pricing.

So we saw data volumes go from 75% year on year growth at the half year to 65% year on year growth in the quarter. And obviously a more stabilised pricing part. Which is actually a good indicator because as you can narrow that gap then that will obviously ensure more of your monetising of data. We are confident with the data number growth going forward because one of the underlying factors in your data numbers is the fact that you gave customers bigger bundles to complete the price transformation. So the data transformation we did in November last year. We effectively gave customers much bigger bundles. So through this year we have suffered from MBB which constitutes almost a third of revenue growing single digits. That is included in our numbers. Obviously internet and your mobile is growing almost in the 30s to compensate. So effectively what will happen into the new year is you start to return to growth in MBB in terms of usage as people are starting to breach the bundles again. And we've done a very detailed analysis both on contract and on prepaid and on MBB of the utilisation of the bundles, how much of the bundles are utilised, when people breach the bundles and so on.

In terms of post-paid what we are seeing is effectively what happened in post-paid was we started our price transformation almost two years ago now, and by March that transformation will be completed. MTN came out in about April or May last year with their integrated offers and finally started their migration to the new bundles. So what you will find in the contract, I think you will find MTN still has to take the pain in terms of managing through their transition, whereas we will start to emerge from that transition. Cell C I think is under pressure and not too much aggression on the contract market space. I think what you are also starting to see is that A&R is being steered down. A&R Q4 over Q3 was lower, Q2 over Q3 was lower, Q1 over Q2 was lower. So there is a constant step-down there now taking a little each quarter to make sure that we manage the A&R efficiency if you like obviously to maintain margin whilst doing the last of the pricing transformation.

So also a lot more rationality on post-paid. Your gross has settled on a lower number for the entire market. And essentially we are seeing good gains in the contract market space and clearly taking market share there. But what I can only call the stupidity has started to wean out. So because prepaid promotions are more aggressive now, your on-billers, your free vouchers that go with it and all the arbitrage stuff is basically out of the contract base. The other important thing is that obviously Nashua from November is consolidated into Vodacom and we should start to see some of that benefit coming through. It will help us to better manage the transformation on that base. Churn is at 7.6% which is obviously the lowest that we've ever experienced.

Chris Grundburg
Thanks. Just one clarification if I may. Can you quantify the ARPU uplift that you have seen from 3G to 4G?

Shameel Joosub
It is still early days, but effectively we are seeing almost R35 uplift on post-paid and R100 uplift on prepaid. But I would still like to look at the prepaid number a little bit closer, to be honest.

Chris Grundburg
That's really helpful. Thanks guys.

Operator
Thank you. Our next question comes from Thato Motlanthe from Citigroup. Please go ahead.

Thato Motlanthe
Hi. Afternoon everyone. Just a quick question on clarity from me. Your statement that you've achieved further improvements in opex and direct expenses, would that mean that those expenses have gone backwards, or is it just a continuation of the cost management as such?

Ivan Dittrich
It's Ivan here. It's a continuation of the cost management programmes that we've got in place. Shameel has already touched on the direct expenses in the A&R that has been improving quarter over quarter. But from an opex perspective as you know we've had proper cost management programmes in place over the last four years or so and in the last three to six months we have intensified our efforts further to optimise costs even more.

Thato Motlanthe
That's clear. Thanks.

Operator
Thank you. Just a quick reminder, ladies and gentlemen, if you would like to ask a question please dial star one on your phone now. Our next question comes from Avior Research's David Lerche. Please go ahead.

David Lerche
Hi. Good afternoon everyone. Just a couple of quick ones from me please. Firstly, regarding M-Pesa in South Africa can you let us know how many agents you actually have selling product at the moment? And then further to that, are you at all concerned about the fact that you've slowed the rollout of SIM cards into the channel in South Africa? That has obviously squeezed your prepaid customer base. Are you worried that that is going to have a sustainable effect going forward, or should that wash out?

Shameel Joosub
On M-Pesa we've got 4,000 agents live. I think still a lot more work to be done on M-Pesa. It is early days and we will really see the benefit through the year. Every month it is getting better. We are also focussing on making sure that we can get repeat users and so on. So I think still early days, and I think we have had some lessons learned already in the early days and improvements that we are already making on the platform and on the services. We are trying to increase the services on M-Pesa, so for example electricity. We are pushing to try and launch electricity soon, which will give additional usage to the M-Pesa platform. We also see a big opportunity in B2C which is effectively trying to get the miners, the construction companies, everyone that pays out in cash in any form, to try and use the M-Pesa platform.

I think one needs to understand the issue that we have in the market currently. We do about 4 million SIM cards that we put into the market. 2 million get connected. And of that about 200,000 is probably live after three months. And that will be consistent across all the networks. Call it 200,000 to 300,000 real customers that you are gaining. Now, the wastage in SIM cards, you lose about 200 million a year in SIM card wastage just on Vodacom. In the industry you're probably losing 400 million. So effectively there is an opportunity to optimise. So what did we do? We took a couple of actions. Firstly, we improved the rules of what constitutes a connection. And so that will provide a little bit of rationality. We saw monthly connections were going up to 2.6 million. Immediately you know that the dealers are playing arbitrage games, and obviously once we start to analyse it we pick up the issue. We strengthened the rules. The second thing is we strengthened the rule of RICA and having a 72 hour rule in place. The third thing we did was we introduced a price on SIM cards. So we made the SIM card price R3.

The impact of that was we saw other operators basically also take measures to improve their situation. But in the case of MTN what they did was they pushed the price up on the starter pack but they flooded the market with starter packs, so a little bit of a technical game that they played. But that will come through in churn in the short term. Effectively the most important thing to look at in prepaid is actually your revenue growth on the one side, but also to look at your active customer growth as opposed to your total customer growth.

David Lerche
Excellent. Thank you very much.

Operator
Thank you David. Our next question comes from Jonathan Kennedy-Good from SBG Securities. Please go ahead.

Jonathan Kennedy-Good
Afternoon. I just wanted to touch again on the South African mobile voice. Down 12% seems to be quite a heavy adjustment downwards relative to expectations. Your data growth seems to be tracking in line with your guidance, but I just wonder are you seeing improvement post the quarter end in the SA voice scenario? Typically this quarter has reset the base on prior years and given us a view on outlook for the year ahead. So I just struggle to understand how we expect a material bounce going into next year and to meet your guidance if voice is materially worse. I mean you mentioned that you are doing promos to counter MTN, has that reversed some of the customer loss you saw in the last quarter for example?

Shameel Joosub
Basically the customer thing was self-inflicted, so we basically decreased the customer base on purpose to improve the arbitrage. We saw the improvement in contribution margin coming through. Those cuts happened at the end of September. So you saw the impact through the quarter, and we managed to recover and that is why we've ended the quarter probably 200,000 or 300,000 less on the active customer base, so really no impact in terms of customers. The voice revenue, as you say, we had a bigger decline. It is important to remember that the underlying prepaid trend is -2% and not -7.6% as reported. The reason for that is there has been a lot of movement between prepaid and post-paid in the quarter which is a weakening from 0.9% that we saw before. That weakness is coming through in voice. You will still see a decrease in voice into the new year. I think we can expect a weakness in voice as we transform more of the base. Although contract will be more or less complete by March and hybrid by November and the contract segment should return back into growth as we go forward, you will still find some weakness on prepaid. What we should be able to do is improve the -2% back into flat and then back into positive as we go forward.

Jonathan Kennedy-Good
Essentially the -12% is not the run rate that you should be seeing for voice going forward?

Shameel Joosub
We estimate that prepaid voice specifically will decrease by 6-7% next year, offset by a very strong growth in data.

Jonathan Kennedy-Good
That's helpful. Thank you.

Operator
Thank you. Our next question comes from Alex Balakhnin from Goldman Sachs. Please go ahead.

Alex Balakhnin
Good afternoon. I have a question on the profitability as you feel some pressure on the top line in South Africa. You mentioned that you had to introduce some initiatives. Is there risk that your profitability will come under pressure out of those steps, or the cost savings you have initiated and mentioned will largely offset the greater leverage and higher expenses? So some prospects around that would be very helpful. Thank you.

Shameel Joosub
Effectively what we see happening is the weakness in the revenue line does not necessarily reflect the EBITDA line. So we see some leverage coming through the measures that we've taken specifically to compensate for voice. However, we need to accept that it will be soft you can't compensate for the full MTR decline, but we will see a more positive result than what we are seeing in the service revenue line.

Ivan Dittrich
I think you should really look at this financial year which ends in March as a reset year. This year has been hugely impacted by the MTRs. But going forward if you take a 12 to 24 month view the cost savings initiatives that we've got going will continue and we see costs growing at less than revenue. So going forward your EBITDA growth should be higher than your service revenue growth.

Alex Balakhnin
Thanks so much.

Operator
Thank you. Our next question comes from Richard Barker from Credit Suisse. Please go ahead.

Richard Barker
Thanks very much. Three quick ones if you wouldn't mind. Just following on from what you just said there about costs and margin outlook, given what has happened on the revenue line do you think that we will see EBITDA margins for the full year likely to be up year on year, given the pressures you're seeing? That is the first question.

The second question is a bit more detailed, and it comes back to this issue of reclassifying revenues between segments. I think I missed what you said in your introductory remarks about exactly what had happened there. I wondered if you could just run over that again and just explain why that was necessary, and just comment on the underlying trend. I think you said -2% in prepaid. Does it also mean we need to adjust the underlying growth in post-paid down as well to reflect the reclassification? I was just a bit confused about what was going on and what is like for like there.

And then the third question is quickly on SMS and messaging which seems to have shown a remarkable degree of stabilisation given the trend that we've seen in the last several quarters. Can you just talk about what is driving that and whether that is sustainable? Thanks very much.

Ivan Dittrich
Just talking about your questions in reverse order, what we have seen in terms of the messaging trend is messaging was relatively stable compared to last year. That was mainly from a contract perspective because our bulk messaging has grown by 50% due to Cell C redirecting some bulk messages via re-routing via WASP. In terms of prepaid messaging the decline has been similar to what we've seen in previous quarters. With regards to your question on EBITDA margin, if you look at the first half due largely to the impact of MTRs the margins in H1 was lower than the margin that we has experienced in H1 last year. And then historically seasonally our H2 is a slightly more profitable half than the first half. So you would expect to see a slightly better EBITDA margin perhaps in H2 compared to H1. But obviously MTR is going to have material impact on the numbers.

Richard Barker
Thank Ivan.

Shameel Joosub
Maybe just to explain what happened. Firstly let me touch on the full service revenue growth quarter on quarter on quarter so that we basically understand where we are. In Q1 we had about R11.9 billion of service revenue, which is your underlying revenue excluding MTRs. And basically in Q2 we had R12.5 billion. That R12.5 billion had a once-off of R325 million. So R12.2 billion is the real

number. So effectively quarter on quarter in the first quarter you saw a 0.6% decline over Q4 last year. In Q2 you saw a 2.4% underlying improvement over Q1. In Q3 your absolute number is R12.4 billion in terms of service revenue. So you saw a 1.4% improvement over Q2. So the trend is improving, not getting weaker. I think that is the first thing that obviously is encouraging from our perspective.

If we break it down into the two segments, what happened between the two segments previously if we look at your hybrid plans what we were accounting for is effectively the contract part of hybrid in contract and the prepaid part of hybrid in prepaid. And essentially we have basically defined that as being wrong, and that we should change it because a contract is a contract irrespective. The hybrid is a committed revenue portion because you've got a 24 month cycle. What we have done is reclassified the revenue that was previously being recorded into prepaid back into contract. So your underlying trends for contract customer revenue is -2.3% year to date, -2.7% in Q1, -1.4% in Q2 and -2.9% in Q3 as you start to get to the lower end of the contract base and effectively start to complete the transformation. You are finding a little bit more weakness. And in Q4 by and large the contract part is finished but the hybrid part will improve. The weakness is more coming from pure contract than from the hybrids, which seem to have a more stable trend quarter on quarter.

In prepaid the underlying trends are 0.8% up year to date. The year on year trend was 5.9% up. -0.9% in Q2 year on year. In Q3 -2.2%. So you can see the weakening coming through there. Where is it coming from? If you look at our one month active customer base growth as opposed to the 90 days that we are reporting, in Q1 you had an 8.3% growth year on year in customers which came though from the strong growth from the previous year in customers. In Q2 you had a 0.8% increase in customer base. And in Q3 you had a 1% increase in customer base. That is what I am really referring to. The customer base has not decreased. So overall year to date you've had a 1% increase in your customer base and a 0.8% increase in prepaid customer revenue. So there has been a weakening on the prepaid trend, but that has come from the increased competition, the base transformation and effectively the weaker consumer. And I think it is fair to say that last year you were running a little bit unabated without having strong competition from MTN specifically. You had Cell C, but a strong MTN is very different to dealing with a strong Cell C.

Richard Barker
Thank you, Shameel. That is very clear.

Operator
Thank you. A final reminder at this stage that if you would like to ask a question please dial star one on your phone now. Our next question is from Madi Singh from Morgan Stanley. Please go ahead.

Maddy Singh
Hi. Thanks for the call. My question firstly is on the capex. I just wanted to understand how far you are in your project spend, and how much more investment is planned under that, and how is that split? And secondly just also following up on your previous question on prepaid and post-paid exchanges, should we continue to assume that the increase in the post-paid revenue base will follow through in the rest of the year and the year ahead? So basically we keep the base as the third quarter base rather than the last year's base. Thank you.

Ivan Dittrich
In terms of project spend we are now basically nine months into the project, which is a three-year investment project. Our guidance that we've given for this investment is increased capital intensity at 14% to 17% over the three-year period. You will see just for the quarter we've achieved a 15% capital intensity which was a bit lower than our run rate for the rest of the year. But we've got a

strong capex spend in our fourth quarter. So after this year there will still be two years where after our capital intensity will return to the more normalised levels of 11% to 13% for the group.

Shameel Joosub

The trend in terms of prepaid and post-paid; from a reported perspective obviously it stabilises and goes back into growth. From an underlying perspective if you're looking at the -2.9% and the -2% for prepaid then you still have a little bit of a weakness in the fourth quarter before you start to go back into growth next year. So both reported and underlying will be back into growth next year in contract. But the difference between reported and underlying in the fourth quarter will be positive versus negative.

Maddy Singh

Sure. I just want to link the capex spend and also the revenue trends you're seeing. Given that it is only nine months you are doing higher spend are you seeing positive impact on the revenues yet? Or do you think it will still be some time before that starts to show? And if so, how much longer do we need to wait for that?

Shameel Joosub

I think we are already seeing the positives coming through. We are seeing the positives coming through in terms of being better able to manage our base transformation versus our main competitor, MTN. And I think you could see that in their half-yearly results with the massive declines, the double-digit declines that they were having versus us. Secondly, I think we see it coming through in things like data traffic. Remember in the half their traffic grew 55% and their revenue grew 15% on data. Ours grew 21% and our traffic grew at 75%. So you are definitely seeing off a much larger base. So effectively you are seeing those benefits coming through in that. And I think the other encouraging factor for me is when you look at post-paid churn, down to an all-time low of 7.6% always good in terms of hygienic measure. If your churn is going up customers are less happy with you. But if your churn is dropping effectively you are being able to maintain your base at a much better rate. And obviously as the contract market starts to saturate a little bit more and your growth has tapered down it is important that you hold on to the customers that you have.

Maddy Singh

Okay. Thank you very much.

Operator

Thank you. Our next question is from Craig Hackney from NOAH Capital Markets.

Craig Hackney

Hi. Thanks. Just coming back again to South African subscriber revenue. This is the first time that I can remember where your December quarter revenue hasn't shown a sequential increase on the third quarter. You've spoken at length about the competitive impact. I guess there is a macro-economic overlay as well. Is it possible to isolate the impact of over-the-top services in terms of cannibalisation of voice and SMS? Do you have any way of seeing how that is impacting on these weak revenue numbers, or is it just too complicated with it all now in the bundle?

Ivan Dittrich

Craig, you broke up there. You said what is the impact of over-the-top?

Craig Hackney
Is it possible to isolate the impact of over-the-top services cannibalising the voice and SMS in terms of the weakness that we see now, or is it too difficult to that with the bundling strategy?

Shameel Joosub
I think the bundling strategy protects against that. You've got to remember that the over-the-top is a double edged sword. The over-the-top plays a big role in increasing your data traffic. So you see the positive coming through very much in your big data traffic growth and the fact that 27% of your revenues in the group are already coming from data. And obviously within the next three years I would say 40% of our revenues start to come from data. Now, where you see the impact is on messaging. The weakness in messaging is essentially coming through from the over-the-top play. We've seen a bigger adoption of smartphones. So as you push more smartphones out into the marketplace you do have the negative impact on SMS revenue.

Craig Hackney
I suppose then if you can sustain the stable data pricing as you've seen Q2 to Q3 then that over-the-top trend could actually play to your advantage.

Shameel Joosub
Correct.

Craig Hackney
All right. Thanks.

Operator
Thank you. Ahmed Mutara from Renaissance Capital has our next question.

Ahmed Mutara
Afternoon guys. Thanks for doing this call. Just a couple of questions. Shameel, you talk a lot of smartphone penetration and adoption but not much on the content side. It does seem like a 358 MB average use of a smartphone seems to be slowing to some extent. Is there anything you guys are doing in terms of the content side to drive that growth? Just in terms of rationality, we didn't see much rationality from MTN last year on the pricing of voice. Would we not be seeing them potentially being a bit irrational this year in terms of data pricing given your advantage on data networks? Or do you think that they've accepted the fact that they have to be rational going forward?

And one more question in terms of ARPUs. It seems like the lower ARPUs are the ones you've disposed of to MTN through your strategy for integration and hybrid packaging. And the last question is just in terms of on-net and off-net traffic. Looking at the minutes of use on your network you get the sense that increasingly traffic is on-net on the voice side. Those are the questions. Could you just address that please? Thank you.

Shameel Joosub
Let me start with the on-net question. Firstly, on the on-net, yes, it is a clear strategy that we have moved more traffic on-net specifically through the on-net bundles that we have pushed out. I would say Power Hour obviously plays an instrumental role there. So that has been a deliberate strategy. On your question, are we giving away lower-end customers to MTN, I think the answer is no. effectively we are not giving away any customers to MTN. I think in reality if you look at the market the subscriber numbers – and that is why it is important to track active customer growth. You do have a percentage of your customers that are rotational. That is the wholesalers playing games and

so on – your real customers in the market there are no more people left in the country in terms of penetrating. So your growth is probably really 1% or 2% in real terms that the base is actually growing by in terms of this entire market. The rest is moving between the operators and so on.

I think a bigger play comes from converting those customers to using data. Effectively what you want to do is to get more customers using data. While your average in data will be going down, in fact the average will be going down in terms of smartphone usage because you are adopting new customers all the time. As you bring on new customers the existing customers continue to spend more and you're seeing strong growth coming through there. I think the important thing to look at is the 62% growth in data traffic. So you are saying your traffic growth is extremely strong. Your revenue growth is sitting just on 20%. The question you've got to ask yourself is why is traffic growing at 62% and revenue only growing at 20%? Surely pricing plays an impact. Yes, it does. Firstly, with the stabilisation of pricing that helps to improve data growth. Secondly, you should start to see the traffic starting to taper off a little bit because your base is getting bigger and bigger. So I think you start to see a little bit of that starting to merge more.

The other part of why you see the data traffic growth not being able to monetise the full part is because people are still growing into the bigger bundles that you gave them. So it is important to track how those data bundles are evolving. The reason why smartphones are important is effectively your data usage on a smartphone device is almost tenfold the usage on a feature phone device. Obviously you don't see that the day you convert the customer. You see that progressively over time. And I mean just the difference between an Apple and an android. An Apple is almost double that of an android. The more Apple phones you put into the market the more you are able to monetise that. And finally you are still running a big BlackBerry base. So if you decrease the BlackBerry base you are able to monetise the data better in terms of revenue because of the fixed revenue model that you have on BlackBerry. So you are able to monetise all of that a lot quicker and a lot faster.

On the content side I think the content side is really coming through. So we are working on more. I think there is always more to be done on the contract strategy. The over-the-top and social media and so on is playing a big part. So the third-party content is really driving data usage up a lot, specifically your adoption of Facebook, Twitter and so on. Secondly, your usage of the internet over the mobile is also going up quite nicely. And lastly the area where we are probably under-investing is video on demand. I think video on demand is purely a growth area and we are working on and will be launching soon a video on demand platform where effectively we can monetise more data, more revenue through the usage of video over the mobile.

Ahmed Mutara
Thank you guys. That is very clear.

Operator
Thanks so much. Franca di Silvestro from HSBC has the next question.

Franca di Silvestro
Good afternoon. Just two very quick ones. What trends are you seeing on your network at the moment in South Africa with the volume of traffic you are carrying? Do you have any concerns that maybe you are not putting in enough at the moment. Secondly, perhaps just on Eskom. If you look at the quarter ahead and what it is meant to be, do you have any concerns that progressive stage 3 or stage 4 load shedding might actually impact your margins more negatively than you are anticipating?

Shameel Joosub
Thanks Franca. I think from a network perspective and a capacity perspective we manage it all the time. Effectively the way we do it is we closely monitor capacity at site level, at switch level and so on to make sure that we always have sufficient capacity. I call it leaving money on the table. We can't leave any money on the table. So we divert capex to the areas where we need to deal with potentially blocking faster. So there are a number of warning signs in place of where these can potentially happen from. And into next year what we have done is prioritise capex as we are preparing the budgets specifically for capacity first. So we normally work on capacity first and then coverage second. And also we put a bigger priority on what I call revenue-generating capex and opex-saving capex than anything else and cut out all the nice-to-haves. So there is a very tight process in terms of how we allocate capital.

Secondly, from an Eskom perspective, yes, there is an impact. What we've had to do is divert capex to make sure that we have upgraded the batteries even more. And secondly, we've had to divert capex to make sure that we have more generators available to recharge the batteries quicker. The impact of it is, and people don't necessarily relate the availability of networks to the availability of power, but it is a reality. We should get some benefit coming through from the fuel cost saving, and that will probably help to compensate a little bit for some of the costs we are experiencing. So there is a little bit of weakening that comes through from availability, but our availability has not declined a lot because of Eskom as yet. So it is still a 0.1% impact because we are managing it through the batteries and so on. But it does have an impact.

Franca di Silvestro
Thanks very much.

Operator
Mr Joosub that concludes the questions. Do you perhaps have any closing comments?

Shameel Joosub
No, I think just in closing it has been a tough quarter, both in international and in South Africa. But I think it was always going to be a tough year when we had the mobile termination rate declines. But the good news is as we finish the year I think we see a much more positive situation as we go forward. And I think the international markets I would really look at it as a blip in terms of you do have these things happening from time to time. The underlying growth factors are still intact, and there is still a lot of growth left in those markets and we will see the return on our investment.

Operator
Ladies and gentlemen, on behalf of Vodacom Group that concludes today's conference. Thank you for joining us. You may now disconnect your lines.

END OF TRANSCRIPT