Conference Call Transcript

19 May 2014

ANNUAL RESULTS

Operator

Ladies and gentlemen, welcome to the Vodacom Group Ltd annual results conference call for the year ended 31 March 2014. Vodacom Group CEO, Shameel Joosub, will host the conference call. I will read the forward-looking disclaimer before handing over to Shameel Joosub.

This announcement which sets out the annual results for Vodacom Group Ltd for the year ended 31 March 2014 contains forward-looking statements which have not been reviewed or reported on by the group's auditors 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 conditions, 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 or 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 which is www.vodacom.com. There will be an opportunity for you to ask questions today. Please note that this conference is being recorded. At this time I would like to hand the conference over to Vodacom Group CEO, Shameel Joosub. Please go ahead, sir.

Shameel Joosub

Thank you. Good afternoon and good morning to those in the US. Thank you for joining us to discuss our annual results. Our CFO, Ivan Dittrich, is here with me, as well as our group executive of investor relations, TC Ralebitso. Richard Boorman from media relations is also here with me.

Before we go into the detail let me say that I'm very pleased with our results. The stand-out features for me from the group perspective were we invested R11 billion, which is 14% of revenue, to expand coverage, capacity and quality across all our markets. This has been key to our strong performance. We also added more than 7 million customers to reach 57.5 million customers across the group.

In South Africa service revenue returned to growth following a decline in the prior year as we continued with our pricing transformation. Remember this is a deliberate strategy. Across our growth pillars we have seen good results. Demand for data services remains strong. We have increased the number of group customers using data by 21% to 23.8 million, which represents 41% of our active customer base.

The international segment delivered solid performance again. We achieved a 55% EBITDA growth and the contribution to group EBITDA increased to 15.6%. From an enterprise perspective our enterprise business grew 21.7% to R10.2 billion to contribute 17% of group service revenue, up from 14% a year ago.

If we look at the group financial highlights we delivered good growth across all our key financial measures. Group revenue is up 8.3% or 7.3% normalised. And service revenue is up 4.7% or 3.7% normalised, in line with our guidance of low single-digit growth.

Data revenue grew by 32.7%, driven by a 94% growth in data traffic. Data now contributes 21.4% to group service revenue. Our EBITDA grew by 8.2% and our EBITDA margin stayed steady at 36.1%.

Headline earnings per share adjusted for R310 million non-cash fee charge grew by 5.2% to 917 cents. Free cash flow grew 8.6% despite significant network expansion. Lastly, the board has approved a final dividend of 430 cents, which takes our total dividend per share for the year to 825 cents, up 5% from a year ago.

If we look at our two reporting segments separately, I will now start with South Africa. We reversed the decline in service revenue in the prior year. We delivered growth of 0.3% as we continued with our deliberate pricing transformation. Excluding the impact of MTR service revenues grew 3% year on year. Overall revenue grew 5.5% on the back of an increase in device sales of 28.6%.

Data growth is a result of our strategy to invest heavily in our network. The investment has given us the ability to offer bigger bundles to our customers at lower prices. For the prepaid segment we reduced our effective price per minute by nearly 24% to 55 cents per minute through our bundles and time-based promotions. This led to a 21% increase in MOU and most notably we effected 2.3 million new customers in a highly competitive environment.

We proactively migrated 56.3% of our contract customers from voice packages to integrated plans, which combines generous allocations of voice, SMS and data at legacy pricing [?]. Currently 65% of our contract revenue is now in bundle, driving down the cost to our customers. By including more value in our plans we have been able to retain our customers and to secure the average monthly spend. Contract ARPU declined slightly by 3.5% to R389 per month.

We launched the uChoose plan for our top-up customers in November 2013. The uChoose plan gives customers access to integrated plans and an option to access prepaid promotions like Power Hour on an ad hoc basis. 59% of new top-up connections were uChoose packages, a very strong take-up.

Data was the key driver of our service revenue growth this year. Data revenue grew 23.6% year on year, contributing 22.7% of South African service revenue from 18.4% a year ago to offset declines in voice revenues. The data revenue growth was supported by an 80% increase in data traffic as we reduced data prices by 25% through our integrated bundles and promotions. We also increased data customers by 11.9% to 16 million. 51% of our customers now use data services, which still shows a big opportunity with 49% to go.

The growth in data was also supported by our very successful handset financing programme through which we increased the number of smartphones and tablets 23.5% to 7.8 million devices. The main benefit of these devices on our network is that they consume high volumes of data. The average usage per smartphone grew by 82% to 253 MB for the year. In the quarter to March smartphone usage was sitting at 307 MB. Tablet usage for the year was up 25% to 743 MB. Our handset financing programme has also been central to revenue growth, with a 5.5% increase in revenue boosted by a 28.6% increase in equipment revenue, which represents 20.3% of revenue.

We continued to invest in our network to increase our differentiation. We invested nearly R7 billion to increase our coverage and capacity and improve quality for voice and data network. We increased our 3G coverage to 92% of the population in South Africa and increased our LTE coverage by just short of 1,000 sites in South Africa. As we see strong growth in data traffic we also invested heavily in our transmission.

We now have 74% of our sites in South Africa connected to our own high speed transmission. Independent tests rate our network to be the best. Our data customers experienced the fastest download speeds, quality and coverage.

Our discipline on cost containment has also been very positive. We continued to make progress with our cost containment initiatives, delivering a third successive year of flat cost growth despite the 6% inflationary environment and a weaker Rand.

We reduced the number of leased sites to about 10% as we increased the number of sites on our high-speed transmission and also achieved savings in customer care costs. This resulted in EBITDA growing by 3%. However, EBITDA margin contracted by 0.8% in South Africa to 37.9% primarily as a result of the high contribution to revenue of the lower-margin equipment revenue.

We now move on the international operations. We continue to achieve solid financial performance as we cross important operational milestones. The performance of the international segment for reporting purposes was boosted by the devaluation of the Rand compared to the functional currencies of the underlying operations. The portfolio again served as a good Rand hedge.

Service revenue for the international portfolio grew 23.4% to increase the international operations' contribution to group service revenue from 19% to 24.4%. The growth in service revenue was supported by a doubling of our data revenue as we grew active data customers by 86.4% to 7.7 million customers, which represents 30% of our active customer base.

Additionally, through our bundle strategy we reduced the effective price per minute in each market, stimulating a 39.2% rise in outgoing traffic for the portfolio. This resulted in a 21.8% increase in active customers to 26 million customers.

We are now proud that we surpassed the 10 million customer mark in the DRC and today 45% of group active customers are from the international operations.

EBITDA grew by an impressive 55.4% to add 15.6% of group EBITDA, up from 10.8% a year ago. The overall EBITDA margin improved 6% to 29.6% as we continued to benefit from greater scale and efficiencies. The mobile network operations achieved an improved EBITDA margin of 31.5%.

Like in South Africa we maintained a constantly high level of investment in the network to increase coverage, capacity and quality to underpin our growth strategy. This year we invested nearly R4 billion, which is 27% of service revenue.

Moving on, mobile financial services is another key pillar of our growth strategy in the international portfolio. We are pleased with the continued success of M-Pesa in Tanzania and the good performance we have had across all our other markets where we recently launched M-Pesa. M-Pesa customers increased 21.6% to 6 million customers across all our markets. In Tanzania M-Pesa contributed 18.8% of service revenue, up from 14% a year ago, and over $1 billion in transactions are processed per month in Tanzania. An additional benefit is nearly 25% of all airtime is now purchased via M-Pesa which carries consequent cost savings and also increases the reach of our distribution network.

We are expanding on the successful model we have developed in Tanzania in building the ecosystem that allows for close integration with banks, utilities, retailers and employers to drive acceptance by our customers and transaction volumes. We are excited by the prospects for growth in other financial services that we can offer after we have achieved wide adoption for M-Pesa in our markets.

In summary, we are pleased with the progress made in capturing the opportunities in our international markets. With less than 60% voice and less than 30% data penetration our international markets are an attractive opportunity for growth. In this regard we increased our shareholding in Vodacom Tanzania from 65% to 82.2% in April 2014. We continue to position ourselves in the bigger markets in anticipation of opportunities that may arise.

This concludes the performance of the group for financial year 2014. I will now take you through our medium-term plans. Our growth strategies are underpinned by continued investment to expand our network coverage, capacity and quality. To this end the board has approved a massive capex programme which will be implemented over a three year period commencing F2015, this year.

We plan to spend R30 billion during F2015, an approximately 20% increase in capex compared to the 2014 capex period. The capex acceleration plan will be informed by the outcome of the MTR review process in South Africa. Based on our current plans we intend to spend R17 billion in South Africa and the rest in our international operations.

We will focus on expanding our data coverage to all areas where we have voice, increasing our 3G population coverage from 90% to closer to 100%, accelerating the rollout of LTE sites and on building our fibre to businesses at a larger scale.

In our international operations we will focus on building our ultra low-cost sites in rural areas, particularly in DRC, and accelerating 2G and 3G sites in other markets to close the network leadership gap where required.

We intend to fund some of our massive capital investment through our debt facilities as we have enough capacity with net debt ratio of just 0.3 times EBITDA.

Our medium-term guidance given the uncertainty with regards to MTR in South Africa we maintain our group medium-term guidance at low single-digit growth service revenue and mid- to high single digit EBITDA growth. Our capital intensity will be between 14% and 17%.

Our dividend policy has not changed. The board maintained its dividend policy of at least 90%.

Now some specific comments on the Neotel acquisition. You will hopefully all have seen the press release that we put out this morning announcing that we have reached an agreement to purchase Neotel. The enterprise value is R7 billion. This is good news in competition in both consumer and enterprise sectors. On the consumer side the combined entity will be a strong fixed player who will be able to offer a wide range of services. It will also help us to accelerate the provision of services like fibre to the home.

On the enterprise side it creates a business with more than R5 billion of revenues that combines our distribution and marketing strengths with Neotel's fixed network and product capabilities. The end result will be a business that can supply a wider range of converged services. Neotel's [unclear] skills are a key part of the value in this transaction and we are looking forward to having them on board.

One would caution we still need to obtain regulatory approvals for this transaction. We don't have a specific timeframe on this, although we estimate it will be completed within the financial year ending March 2015. We are hopeful of a six to nine month period, but we will only know once we really start the process. Until this has been completed there will be no change and no integration activity. It will continue to be business as usual for both companies. Having said that, this is still a big step to have completed and I'm really looking forward to the final completion.

Thank you. That concludes my comments. We are ready to take any questions.

Operator
Thank you, Mr Joosub. Ladies and gentlemen, at this time if you would like to ask a question please press star then one. If you decide to withdraw your question you can press star then two to remove yourself from the list. To ask a question please press star then one. Our first question is from JP Davids of Barclays. Please go ahead.

JP Davids
Hi. Good afternoon gents. The first question I have is on your enterprise business. In the presentation you highlighted the strong growth that business is showing. Can you talk a little bit about the free cash flow returns profile of that business and also what it would mean adding Neotel to the mix, i.e. presumably a big scale effect there?

A second question on handsets. You mentioned that you're rolling out a $45 handset in South Africa if I'm not mistaken. If you could just provide some colour on what your go to market strategy would be around that and if you would potentially subsidise the product. Thank you.

Ivan Dittrich
Okay. Just on the free cash flow question on the enterprise business, from an EBITDA margin perspective it is still lower than the voice business. Obviously there is going to be lower EBITDA to start with. And then we are investing more in that business, so a part of the capital acceleration programme is directed towards that business, which will also have an impact on the free cash flows thereof in the medium term.

Shameel Joosub
I think, JP, we are very much happy to keep investing the money into the business to grow it. So it is not highly cash generative at this stage, but it will be in time. The international ones are more cash generative than the South African ones at this stage because we are pumping a lot of money into the investment.

JP Davids
May I quickly...Sorry, I guess the follow-up on that one would just be what gives you confidence that this is a good free cash flow engine over the medium to longer term, the enterprise market? Clearly it is going to be a competitive space.

Shameel Joosub
I think once you've built up the infrastructure and you have a deeper level of infrastructure available then your ability to execute becomes a lot more effective. And also re-utilising the infrastructure. Remember our strategy was very much a build strategy. When we win a big account, say we win Imperial as an example, you've got to go physically build all the sites to connect all their different branches into a VPN [?]. But once the infrastructure is up you can re-utilise elements of this infrastructure for the next client and the next one, and so on. We are seeing that with DHL as well, just to give an example. So we have the DHL account for the whole of Africa. We have points of

presence in almost every country in Africa to provide DHL services. Now, on its own the deal was a loss-making deal. But now that we've had it, it helps us to bring on clients like Barclays Africa and so on that we are re-utilising the same infrastructure for. And I think that is why we're quite happy that we can see it. In South Africa we've been investing in creating new products and services and, to continue to grow that business. We also see a number of synergies obviously with Neotel and overlaying the two assets, which will immediately make it more profitable and allow us to on the one side rationalise some of the costs and on the other side find immediate revenue synergies.

On the $45 handset basically we have done that in cooperation with Vodafone and we will be launching it in July.

JP Davids
Thanks. And can you give any insight as to whether you will be subsidising that handset, any sort of colour around your go to market strategy?

Shameel Joosub
Obviously in prepaid it won't be highly subsidised. We will probably just sell it at the selling price. In contract there will always be subsidy. So you know.

JP Davids
More around the prepaid side, i.e. are you going to try use this handset to proliferate smartphones in that segment?

Shameel Joosub
Correct. Very much so. But we don't put in a lot of subsidy in prepaid specifically because of the non-permanence of the offer.

JP Davids
Thank you.

Shameel Joosub
We try not to subsidise handsets. Here and there a little bit, a couple of Rand here and there, but that's about it.

JP Davids
Thank you.

Operator
Thank you. Our next question is from Paul Marsh of Berenberg. Please go ahead.

Paul Marsh
Thank you. I have three questions if I could. Just on the MTR situation, maybe you could just clarify what happens from 1st April. I believe you have to go and actually make the cuts that were originally proposed and then the regulator has six months to review the situation. What does that mean in terms of how you're going to book the revenue impact of that? You would presumably book the revenues with the MTR impact, but then if there is an easing of those proposals will they be retrospective? Do you know that yet? And then do you write back that revenue in a restatement? I guess I just want to understand how that might affect the service revenue trend outlook over the next six to 12 months.

The second question is just on the restatement of international revenues. I think you took a R300 million revision. Was that for the whole of last year or is that specifically taken in Q4? And then with respect to the international organic service revenue trend, which I think was 24.9% growth excluding currency effects, to what degree was that impacted by that restatement? Maybe could you give a number without the impact of that restatement so that we can compare that with the Q3 15.1% trend? Thank you.

Ivan Dittrich
Okay. It's Ivan speaking. From the MTR perspective we are booking the revised MTR rate with effect from 1st April. It is very unlikely that any changes that are made six months from now would be retrospective. So we don't expect that at all. With regards to your question on the revenue adjustments in international, the bulk of the R300 million was taken in Q4 last year and some of it was taken in Q2. But the majority in Q4. If you look at the international service revenue in Rand terms, so in Rand reporting, it was just over 23%. If you normalise it for constant currency then it would have been 18.4%. And then if you normalise for constant currency plus the deferred revenue impact it would have been 15%.

Paul Marsh
Did that improve, accelerate compared to Q3 on a like for like basis, or did it slightly slow down a bit, or was it about the same?

Ivan Dittrich
It is about similar, about the same.

Paul Marsh
Okay. Sorry, I didn't give my third question. It was about M-Pesa in Tanzania. You gave a percentage of revenue for the year for M-Pesa. I think it was 18.8%. Are you able to give us a Q4 number?

Ivan Dittrich
We don't have that immediately to hand, but we will answer that in the next five to ten minutes.

Paul Marsh
Okay. Thank you.

Operator
Mr Marsh, any further questions, sir?

Paul Marsh
No, that's it. Thank you very much.

Operator
Thank you. Ladies and gentlemen, a reminder, if you would like to ask a question please press star then one. Our next question is from Craig Hackney of Noah Capital Markets. Please go ahead.

Craig Hackney
Thank you. Good afternoon. I have three questions please. If we assume that you are successful in acquiring Neotel, could you just talk a little bit about what impact if any you think potential local loop unbundling would have on your business plans for Neotel or the combined business going forward? Secondly, in your presentation this morning you had a slide on Neotel that gave a couple of interesting points around integration costs. But that slide didn't seem to appear in the presentation

that's on your website. If you could just give us those key data points that were on that slide, that would be appreciated. And then lastly, if it would be possible to get the net interconnect number in Rand for both South Africa and international. Thank you.

Ivan Dittrich
Shameel, do you want to talk about the local loop unbundling? I will do the other two.

Shameel Joosub
Local loop unbundling will not affect Neotel negatively in that they don't have that much to unbundle, specifically in terms of copper. Having said that, the local loop unbundling will be highly beneficial to Neotel as the SNO. I will also add that none of this has been built in to the business plan.

Craig Hackney
Right. Do you see the fact that ICASA has dismissed this fixed access line deficit argument as being quite a significant step forward in terms of getting some LLU regulations underway?

Shameel Joosub
I think so. I think the big issue is that Telkom successfully dodged this one for many years. All other markets around the world have opened up on this issue, or most markets. So I think we are in a situation where I think the regulator has just got to basically push forward on the local loop unbundling. And obviously we will start pushing for that as soon as we have a vested interest.

Craig Hackney
Yes.

Shameel Joosub
Up to now we have not pushed too hard.

Ivan Dittrich
Okay. Just before I answer your other two questions, just to confirm that M-Pesa as a percentage of service revenue in Q4 was 18.8%. That is just to Paul's previous question that we haven't answered yet.

Then in terms of net interconnect, net interconnect in South Africa is just over R1 billion. And international is just over R300 million. I would say with regard to your question on Neotel and some of the key themes that were discussed on that slide – and by the way the presentation should be updated on the website now – is that there are cost and capex synergies that have been estimated at an annual run rate of approximately R300 million before integration costs in the fifth full year post completion. And the total cost of the synergies expected on a net present value basis after integration costs is about R1.5 billion for cost and capex synergies and just under R1 billion, about R900 million for revenue synergies.

Craig Hackney
Okay, great. Thanks very much.

Operator
Ladies and gentlemen, a reminder if you would like to ask a question please press star then one. Our next question is from Mike Preston of Deutsche Securities. Please go ahead.

Mike Preston
Hi there guys. Just two from my side please. Just looking a the quarterly run rate, first of all in South Africa one thing that stood out for me was some softness in your prepaid ARPU over and above what I expected in terms of the normal seasonality there. Obviously we haven't seen any of the interconnect impact yet or the latest pricing, so I was just wondering if you had any comments as to what you're seeing in the market, your strategy that might be behind that.

And then just on the international side, if you look at the service revenue country by country, certainly against my numbers it looked a little weak, but the overall result was quite strong, implying there is something else in there, possibly the enterprise business that has come through particularly strongly. I wondered if you could shed some light on those two things please.

Ivan Dittrich
Okay. So firstly if you look at the prepaid ARPUs which were slightly softer in Q4 compared to Q3 that was mainly due to our data revenues in Q4 being slightly lower than what we had in Q3. You will remember that in Q3 data revenue in South Africa had grown by over 30% in the quarter, which was substantially higher than what the normal run rate would be and certainly what we had guided in the past. That then normalised in Q4 again. That is probably the biggest single contributor.

Mike Preston
I was going to say it wasn't anything to do with any particular weakness on the subscriber side or anything to do with your promotions which might have cannibalised the top end or anything like that?

Shameel Joosub
No, not at all. We did take Power Hour above the line, so there was some dilution coming through in there. I would say the market was also very competitive in that period, so important for us to do it. The other thing is that obviously there was some working day impact in the quarter as well. Shorter February and then obviously your December numbers boosted by seasonality.

Mike Preston
Great. Thanks.

Ivan Dittrich
Sorry, we didn't fully get your second question. It was about country by country...

Mike Preston
Against my numbers – I guess it is all relative – there seemed to be something particularly strong outside of simply looking at what service revenue suggested the run rate was versus the overall numbers for the international division. And it is usually as a result of things like your enterprise business that doesn't sit in your APRU numbers that generates that. It looks like that was particularly strong in the fourth quarter. I don't know if that...I can go back and check it, but that's what I had.

Ivan Dittrich
Business managed services revenue grew pretty strong across the portfolio. So that could have been contributing towards it. I think that is probably the major contributor.

Mike Preston
All right. Thanks very much.

Ivan Dittrich
And then obviously foreign exchange in terms of translating the international performance into Rands. That had quite a meaningful impact and the international portfolio acted quite nicely as a Rand hedge this year. And then I don't know what your assumption has been in terms of the revenue adjustments that were made in the previous year, but that obviously had an impact on the reported growth numbers as well.

Mike Preston
All good. Thank you very much guys.

Operator
Our next question is from Steven Pettifer of Bank of America Merrill Lynch. Please go ahead.

Steven Pettifer
Thanks very much. I have three questions please. First on your guidance, I just wondered if you could give any more colour around that implied margin expansion. Should we look towards your international assets to provide a lot of that given what is happening in South Africa now, or is it a watch this space issue? Secondly, I just wondered if you were able to give any colour on elasticity given what is happening in South Africa right now with pricing. And thirdly and finally, on your Neotel revenue synergy NPV of R900 million, I just wondered if you can give any colour on how much you think of that comes from spectrum-related opportunity. Thanks.

Ivan Dittrich
Okay. So in terms of the guidance we do expect some EBITDA margin expansion to come from South Africa, but then also some good expansion from the international portfolio.

Shameel Joosub
I think as we get into scale in international we are definitely seeing EBITDA margin improvement coming through. In South Africa if we can just get modest expansion we are happy with that. Then obviously it is more important that we grow the revenue line with new services than really worry too much. We've already got a healthy EBITDA margin in South Africa.

Ivan Dittrich
In South Africa I would say it is more about absolute EBITDA expansion and in South Africa there is still margin expansion that could be had.

Shameel Joosub
Your second question is about elasticity. Just to give you some colour the elasticity, effectively what we've seen in South Africa is a 21% overall decline in the overall price per minute down to 79 cents. And just to give you a little bit of colour around the elasticity, prepaid was down 23.6% to 55 cents. Your minutes of use was up 21% to 109 minutes per customer. So if we look at it overall, overall the price per minute is down 21% and overall traffic is up 28%. So effectively we are managing to get the elasticity that we require. It is resulting in a slight decline still in overall active ARPU both in contract and in prepaid, more significantly in contract which was down 3.5% on active APPU versus prepaid which was only down 1.3%. We are offsetting that obviously. That includes data, so that would be everything. And obviously embedded in there is really the MTR impact. If you ask me from an elasticity perspective we are managing to match the price per minute. We are almost getting a one to one elasticity, so that is going really well. What we have to take a knock on is the MTR impact.

Ivan Dittrich
And just on your question on Neotel revenue synergies and how much of that is spectrum related, we can't really comment on that at this stage.

Steven Pettifer
Okay, thanks. Just one follow-up please. On that margin question, is there is more to come on the back of your tower deal or should we look to other markets as they get bigger? Thanks.

Ivan Dittrich
Sorry, you broke up there. Could you just repeat the question?

Steven Pettifer
On that margin question again, should we look for the tower deal as it fits in to the margin benefits there as well?

Shameel Joosub
I think so. I think we will see slight improvements in margin in Tanzania over a period of time as we get more synergies from the Helios tower deal.

Steven Pettifer
Okay. Thank you.

Operator
Mr Joosub, there are no further questions at this stage. Would you like to make some closing comments?

Shameel Joosub
No, I think we're fine. I think we've covered everything. If there is nothing else I would just like to say thank you to everyone for joining us.

Operator
Thank you. On behalf of Vodacom Group Ltd that concludes today's call. Thank you for joining us. You may now disconnect your lines.

END OF TRANSCRIPT