

Conference Call Transcript

09 November 2015

ANALYST PRESENTATION

Operator

Good day, ladies and gentlemen and welcome to the Vodacom Group Ltd interim results conference call for the six months ended 30th September 2015. Vodacom Group CEO, Shameel Joosub, will be hosting this conference call. I will now read the forward-looking disclaimer before handing over to Mr Joosub.

This conference call which sets out the quarterly results for Vodacom Group Ltd for the period ended 30th September 2015 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 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 website www.vodacom.com. All participants are currently in listen-only mode and there will be an opportunity for you to ask questions later during the conference. If you need assistance during the call please signal and operator by pressing star and then zero. Please note this call is being recorded. I would now like to turn the conference over to Mr Shameel Joosub. Please go ahead, sir.

Shameel Joosub

Thank you. Good afternoon everyone and good morning to those in the US. I'm joined by our new CFO, Till Streichert, who was previously my Finance Director in South Africa. I am also joined by Belinda, who is now our CFO in the South African business. Before we look at the numbers let me tell you what stands out for me in this set of results. Firstly we really stepped up our level of investment to make the internet experience much better for all our customers across our markets. And the good news is that it is translating into accelerated data revenue growth far better than what we expected. I don't remember a time when we actually showed ARPU growth, so it is good to see the improved trend in South Africa with ARPU growing in the second quarter. Thirdly, we are making our offers more affordable to our customers, particularly bundle offers, and it is clear that this is how customers want to consume our product with over 500 million bundle sales in the first half. And lastly the international operations delivered 10% service revenue growth in constant currency, a step up from last year, 12.6% reported.

For those of you who have access to our presentation you will see the performance of our key numbers on slide four. Group revenue was up 6.4% to just short of R40 billion and service revenue grew 4.9% to R32.2 billion. If we adjust for FX and the prior year adjustment the numbers are 6.8% and 5.6% respectively. It is good to see that we are still adding customers to our network with group active customers up 6.8% to 65 million. We invested R6.2 billion in capex, which is over 16% of revenue. This has resulted in both 4G and 3G coverage extending and our network speeds getting even faster.

The more customers, more coverage and faster speeds has boosted group revenue growth by 34% to R10 billion from data. We tightened up things a lot to make sure that we maximise our return on channels and subsidy investment and Till has done a fantastic job of managing our cost programme. These two things have helped lift group EBITDA by 13% and delivered a 2.1% margin expansion to 36.7%. Our operating free cash flow was pleasing, up 31% to R5.8 billion. Headline earnings per share were up 6% from 415 cents to 440 cents. And the board has approved a final dividend of 395 cents in line with our dividend policy of at least 90% of headline earnings per share.

Let me now move into more specific highlights in South Africa. Data revenue was super strong, up 33%, supported by a 31% increase in smart devices on our network. This shows that the data demand is out there. Importantly we made significant progress in our price transformation with the contract segment nearing completion and prepaid voice bundle adoption increasing. We sold 500 million bundles in the first half of the year, 350 million in voice alone. We added 1.6 million customers in the first half, increasing our active customer base by 3.5% year on year to just less than 34 million customers.

On the reported tariff line service revenue improved 2.9% but if we exclude the prior year R325 million accounting estimate change service revenue grew by 4.3%. Revenue grew 5.1% or 6.2% if we adjust for the R325 million boosted by strong data growth and a 12% growth in equipment revenue from higher device sales. EBITDA grew 13.1% due to many commercial actions that we took in the second half last year as well as our strong focus on cost efficiency.

I want to spend more time focusing on detail and how well we executed on our data strategy in South Africa. I think we have made excellent progress on all four pillars. We had sustained data revenue growth of about 30% for three consecutive quarters, we see high demand for data usage and we have improved our data monetisation as well. We drive our strategy of growing data by firstly increasing 3G and 4G coverage, thereby increasing our addressable market. Access to more affordable devices is also improving data uptake. The launch of affordable daily and hourly bite-sized data bundles, for example R3 for 50MB and R10 for 100MB, led to data bundle sales doubling from last year. We sold more than 150 million bundles in the first half. By the way, those of you who have access to the presentation can see the strategy spelt out on slide nine.

The number of active smart devices on the network increased by 31% to 12.6 million supported by offering handset financing and more affordable devices. We sold 1.3 million Vodacom branded devices in the first half. The average amount of data used by customers on their smartphones kept increasing in the period and is now up to 425MB per customer. That is an increase of 27%. In South Africa we launched a cheap R999 3G tablet which has created a new market segment and has resulted in tablets increasing 126% to 1.4 million tablets. The story I have been telling you for several quarters about how customers' ARPU gets lifted by 16% to 17% is quite nicely laid out on slide 31 of our deck. So that is a 16% to 17% ARPU uplift when a customer converts from 2G to 3G or from 3G to 4G.

That is the South African highlights. Let's move on to our international segment. The international operations delivered a solid performance with double digit service revenue growth. Service revenue

increased 12.4% and accounts for 26% of group service revenue. And our EBITDA was up 10% and now actually contributes 16% of group EBITDA. Given the low penetration in these markets we still see good growth up 11% to over 31 million customers. As only about 42% of these customers are using data there is still lots of potential left for data growth. Data users were up 14% and data traffic increased 108%.

M-Pesa is progressing well with a 30% increase in active customers to 9.2 million customers, fuelled by expansion in the distribution channel and a growing ecosystem. In Tanzania M-Powa, our savings and loans product, is gaining traction with 1.3 million customers actively now using the service. We have also recently launched international money transfer and have seen good uptake on this service. On the network side of things we have also ramped up our capex in the international markets spending 26% of revenue. That has given us 47% more 3G sites and 24% more 2G sites and is underpinning the 108% growth that we are seeing in data. That is traffic-wise. That concludes our highlights on the key segments.

Let me just give you some updates on our medium-term targets and our priorities. We are confirming our medium-term targets which are low single-digit service revenue growth, mid-single-digit EBITDA growth and capex between 14% and 17% of revenue. Although our performance in the first half is tracking ahead of target for service revenue and EBITDA I would like to remind you the targets we are setting at a compound annual rate over a period from March 2014 to March 2017 and within our first year we delivered below target mainly due to the mobile termination rate cut. This means in year two and year three we are expected to be higher to compensate for the weaker year one. So basically the results that you are seeing in the six months are part of that outperformance.

Whilst service revenue and particularly EBITDA growth for the first half are very favourable compared to the targets we do not expect EBITDA growth to be sustained at such a high rate of 13% into the second half. Half two will carry higher costs for publicity, network and capacity building in fibre and in content. Year over year growth will be impacted by the tougher competitors in half two last year where profitability stepped up as a result of our efficiency initiative.

Just to share some of my priorities for the rest of the year, firstly I would like to conclude Neotel sometime soon. The spectrum remains critical in all our markets so working with the government to ensure we have spectrum to deliver 4G to customers is super important for us. Also I would like to accelerate our fibre deployment as we think this is a real opportunity for us. Neotel will give us the ability to clearly accelerate our assets here. We hope to sustain decent service revenue growth into the rest of the year with our 3G and 4G investments translating into higher data usage.

We see an accelerating demand for enterprise services and we will continue to leverage our strong mobile brand and Vodacom global footprint. We will also continue to focus on key acceleration units, particularly financial and content services. Commercially our focus will remain on data monetisation as well as price transformation while keeping focus on our costs. I also want to focus even more on the customer experience into the balance of the year. I think our markets will remain competitive and of course regulatory and macroeconomic risks are always there. Please don't forget that in South Africa we just took another cut in mobile termination rates, but it is not such a big thing like it was last year because the big impact was taken in the prior year.

Despite the pressures we are confident that our substantial investment in both network and customer experience will differentiate us and is expected to translate into customer growth as well as increased usage. That concludes my comments. Till and I are ready to take any questions that you may have.

Operator

Thank you very much, sir. Ladies and gentlemen, at this time if you do have a question please press star and then one on your touchtone phone. If you decide to withdraw your question please press star and then two to remove yourself from the queue. Again, if you wish to ask a question please press star and then one. Our first question comes from JP Davids from Barclays. Please go ahead.

JP Davids

Good afternoon. Just a couple of questions around cash flow please. In the first half of the year you obviously had a big working capital and other outflow. Can you unpack that number a little bit? Then slightly more broadly, do you expect your free cash flow and net income will converge if we look at the full year FY16 number and full year FY17 numbers. Will there be big differences in the cash flow statement? Thank you.

Till Streichert

Let me start off with the first one and then I will try to answer the second question. But I couldn't hear it in full, so perhaps you just need to raise your question again. In terms of unpacking the cash flow in essence we have stated an operating free cash flow increase of 13.2% on the back of a 13% EBITDA growth. And in essence the working capital absorption also. So we had a similar working capital investment as we had last year. And it is pretty much due to the handset financing that we are putting into the market. The only real difference between last year's working capital investment and this year was I think you are familiar with the fact that we are selling our handset finance receivables, those cash flows to third-party banks. And those tranches in essence we aggregate the cash flow and then once we've got enough we effectively offer them to the third-party banks. And that obviously happens at certain points in time. And one of those transactions was just concluded outside of the reporting period of the first half. And that is probably what you are looking at comparing last year to this fiscal year. But bottom line it is our good trading performance and EBITDA that flows into cash.

JP Davids

Okay, thanks. Would you like me to clarify the second part of the question or are you okay to give it a shot?

Till Streichert

No please just clarify again.

JP Davids

The question broadly is will working capital outflow reverse partly into the second half of the year? And along with that will there be more of a convergence or an alignment between net income and free cash flow for the full year 2016?

Till Streichert

Okay. In essence you've got to keep in mind for H2 that we are obviously continuing to invest on the capex side. So you would have effectively some cash out on that side. So I would be a bit careful of that basically coming back into cash.

JP Davids

Okay. Thank you.

Operator

Thank you. Our next question is from Cesar Tiron from Bank of America Merrill Lynch. Please go ahead.

Cesar Tiron

Hi. Thank you. Two questions please. My first question is whether you see any sign [break in audio] 2013. Your largest competitor is catching up with you in terms of network quality, and whether as a result there is a risk for you to increase your capex in the next couple of years, especially if we are factoring in the weaker Rand. The second question would be on LTE auctions and whether you think we could be negatively surprised by the price whenever the licenses will be auctioned. Thank you.

Shameel Joosub

Okay, maybe to start what we have seen is... And that's competition, right. Because we have put a big capital investment in MTN has increased its level of investment. They try to close the gap, but obviously we are continuing to invest as well. I don't think it means a step-up in the level of capital investment. But more importantly I think as long as we are getting the returns on the investment that justifies that level of investment that we are putting in currently. So I think we are seeing the results coming through, so we are quite encouraged by that. What we have instead done is instead of increasing capex we have reprioritised capex during the year. We have said let's put building of shops on hold and let's put more money into the network because we are seeing it monetised faster. So we did reprioritise certain projects so that we could get some of the data uplift coming through.

On spectrum I think from a spectrum perspective I think the way ICASA has currently written the document it seems to be more favoured towards obligations as opposed to trying to maximise the price. We think with the level of obligations that they've included in the deal we think that the reserve price will be lower in terms of that. We can't say what the exact amount will be, but effectively we think it will be lower.

Cesar Tiron

And would that lead to higher capex?

Shameel Joosub

No, I don't think it leads to higher capex. We have already put a lot of the capital investment in. Let me give you an example. Once we have upgraded to 4G if we get access to spectrum what it will mean is that we have to put active antennas throughout the network, which isn't a massive cost. It just means we can utilise the technology a lot better than what we are doing today and we can penetrate buildings, in-building coverage a lot faster. And even the quality of voice will improve a lot because we don't have to refund [?] as much.

Cesar Tiron

Got it. Thank you so much.

Operator

Thank you very much. Ladies and gentlemen, a reminder, if you wish to ask a question please press star then one. Our next question is from David Lerche of Avior Capital Markets. Please go ahead.

David Lerche

Hi. Good afternoon gentlemen and Belinda of course. Two questions from me please. Firstly you mentioned you have squeezed a further percentage point out of the channel. I'm just wondering how much more you can squeeze given that you've also brought in Nashua and of course are going to shortly bring in Autopage. And secondly just detail around the average cost of debt. It was about 7.2% for the first half but this morning you did mention that the new debt is coming in at 8.5% or thereabouts. Could you maybe give a bit of guidance on where you expect the average cost of debt to be going forward? Thank you.

Shameel Joosub

Okay. Just to be clear, what we did last year is we brought up the voucher margin so this year we are getting the full impact of that voucher margin coming in. That was 1%. Also Nashua is in the numbers. We migrated it in November last year. So you've got the benefit of that in the first half coming through as well and the saving. The next one is obviously Autopage. There will be about a R300 million a year saving from Autopage, very similar to what we had with Nashua. So that will help to reduce the cost. Obviously it won't be in this financial year. It will be in the new financial year because we are waiting for the competition commission and tribunal approvals to come through. Obviously it is a less complicated deal. Nashua took about five months. So we should see approval before March I would say next year.

Till Streichert

Okay, let me take the second question on the cost of debt. It was effectively a 7.2% average cost of debt for H1, which is 0.1% up from last year. And this is really on the back of the JIBAR increase. And what I've explained earlier today in the results presentation what you see also in the note of our financial results, note eight, is simply a detail as we increased the share of fixed rate debt. And I quoted a R4 billion long-term loan which we have taken at a fixed rate of 8.64%. And effectively R1 billion we have drawn down in the reporting period. That is really to improve the mix between floating and fixed rate. Again our average cost of debt was just slightly up by 0.1% from one year to the other.

David Lerche

Excellent. Thank you.

Operator

Thank you very much. Our next question is from Chris Grundberg from UBS. Please go ahead.

Chris Grundberg

Hi guys. Thanks. A quick couple from me. I wondered if you could give an update at all on your self-provisioning targets in SA if they have changed at all. It is pleasing to see the uptick there in terms of self-provisioning, but what do you think that percentage can get to? And then if you can flesh out any specific savings related to that in the period that would also be interesting. And then further, I may have misheard but I thought you said this morning that there was some restructuring around the DRC in the period. I probably missed the detail there, but if you could maybe flesh that out a little and perhaps indicate whether or not there is any more to come. And then very lastly just on Tanzania, I just wondered if you could give a little more detail on your current view of the competitive landscape, what you're seeing, how you're responding and what you think the outlook is there for the next year or so. Thanks.

Till Streichert

Shall I take the DRC restructuring one and then we will work it one by one through? On the DRC side, yes indeed I mentioned earlier this morning we had a restructuring charge of around R80

million in the DRC. That would go effectively through the payroll cost line in your financials. That is basically the answer to the third question. Now in terms of the self-provisioning target, we are sitting right now on around 85% self-provisioning. And we are looking at further savings, but definitely not as much as we've seen basically over the past three years in terms of self-provisioning savings. I think that is probably what you are looking at there. On Tanzania, do you want to take that question?

Shameel Joosub

Yes, I think from the Tanzanian perspective where we stand is basically we've had some price competition there. We have seen three sequential price increases coming through. So there is a recovery coming through in the numbers. We have also had a change in management and so on. And we have put some good recovery plans in place, and I think we will see a better performance in the second half of the year or rather a step-up in performance. The pricing points are definitely getting much better.

Chris Grundberg

That's helpful. Thanks.

Shameel Joosub

Thank you very much. Our next question is from Craig Hackney from NOAH Capital Markets. Please go ahead.

Craig Hackney

Thanks. In South Africa your messaging revenue showed some growth for the first time in quite a long time. The volumes are still under pressure but the average rate per message has gone up quite significantly. Could you talk a little bit about that? And on South Africa and international if you could give the interconnect costs for your SA and international segments please.

Till Streichert

Let me take the first question and then we go to interconnect costs. On the messaging, yes, you are right. This was strong. In essence the normal messaging continued to decline as you would expect given all the over the top solutions that are out there. But we did have indeed quite pleasing wholesale messaging growth. That was quite strong, which effectively gives you the balance of it. And on interconnect cost in South Africa in the first half of this fiscal year it was close to R1 billion. R992 million was interconnect cost. And in the international it was R390 million.

Craig Hackney

R390 million.

Till Streichert

That is correct.

Craig Hackney

Thank you very much.

Operator

Thank you. Ladies and gentlemen, a reminder, if you wish to ask a question please press star and then one. Our next question is from Myuran Rajaratnam from MIBFA. Please go ahead.

Myuran Rajaratnam

Good afternoon guys. Thanks for taking my call. I've got a couple of questions. If I can just kick off with the first one, the capex that you are guiding at 14% to 17% for the three-year period, can you sort of unpack broadly just ballpark how much of that money is actually going into the radio network excluding transmission, so on the radio side of things?

Shameel Joosub

Okay. Next question while we're waiting for that one.

Myuran Rajaratnam

The next one is your Vodacom Business service revenue. I think that grew by 12.8%. How much did the fixed line business grow? Was it different? Was it more? Was it less? Do you have a sense of that?

Shameel Joosub

The fixed line business grew by 31% and is now about R1 billion in the first half that came from the fixed line.

Myuran Rajaratnam

Right. Just on that then, is it cloud and hosting? Are you seeing that you are winning business from the incumbent? Is it new business? Where is all this revenue coming from?

Shameel Joosub

Effectively it is coming from within business. I think two things are happening. One is I think the market is expanding. The growth in the market is expanding. So in terms of data growth and basically enterprises needing to consume more data if you like. And so that is why I think putting in proper fibre into the companies becomes a lot more important. Secondly, we are seeing good uptake on our Office 365 and so on, and people being able to access that from in the cloud. That is also proving to be quite successful as well. And then IPDCN where effectively we are connecting more and more businesses where they are creating their own private IPDCN networks I think is also driving up the growth in enterprise quite nicely, besides mobile where churn is very low and data growth is growing at over 50% and so on.

Till Streichert

Just on the capex question I don't have the number at my fingertips, but in essence the majority of the capex will go effectively to radio access network, as you can imagine. But over time as we move into fixed line we will direct more of our capex into the fixed line space.

Shameel Joosub

I think you can work at about two-thirds going into radio and then rest into IT and basically into fibre.

Myuran Rajaratnam

Great. And if I may just squeeze in one last one, the contract price adjustment you've said quite clearly was a once-off. Is that still the case or is there scope for more?

Shameel Joosub

Look, I don't think we want to put prices up. I think basically if there is some tactical move here or there where one or two planes are out we will look at that. But I don't think we are going to put an overall price increase through in South Africa. In the other markets we have just put another price increase through in October in Tanzania and one in Mozambique.

Myuran Rajaratnam

Thank you very much.

Operator

Thank you. Ladies and gentlemen, a final reminder, if you wish to ask a question please press star and then one. Our next question is from Mike Gresty from Deutsche Bank. Please go ahead.

Mike Gresty

Hello there, guys. Just a couple from my side. First of all, I just wanted to get a sense of how high you would be comfortable to let your net debt to EBITDA go. I mean if you think of where it is now, and then we've got Neotel coming, potentially spectrum auctions, potentially increased investment into Neotel given that it has been quite capex constrained, conceivably it could be quite high on you. So you've talked in the past about what your debt funders would tolerate, but I'm just interested in what you guys would be comfortable with. The second question is just concerning costs in the international division. You highlighted forex and accelerated infrastructure rollout as some of the reasons aggravating your costs. But you could arguably have made the same case for SA, yet your cost containment in SA has been really impressive. Maybe not so much in the international division. What are the differences there why you're able to do it better locally than offshore?

Till Streichert

Okay, let me start off with the first one. We are on 0.7 net debt to EBITDA and we are obviously comfortable with that. We have talked about when we acquire Neotel that we will most likely go to around 1. If you ask the question would we go higher – the key question is what you would invest in that gives you a superior return that justifies gearing up further – we would probably go to 1.5 up to 2 times if there is a convincing case that delivers us superior returns. But we will obviously always maintain investment grade. I hope that answers the first question. On the second question in terms of cost efficiency programme I'm talking about South Africa and the international. So in essence I think we simply have put a lot of focus on the South African operations where we put what we call our multi-year saving programme in place with a dedicated project office, with a lot of commitment from everyone around the company, with a lot of best practise leveraging, taking into account Vodafone. They have got a lot of good things that we effectively leveraged off. And we simply added this all up and effectively formed a programme and executed diligently and disciplined. The international operations do have an opportunity on the cost side to take multiple markets where it is appropriate, those examples and those best practise ideas to improve their cost efficiency programme.

Mike Gresty

Just to narrow it down, are there any major one-offs? I think you mentioned the DRC number. There are some forex losses in there. Or is it more a case of just letting them grow into their markets before you start to really ratchet down on costs as you appear to be doing in SA?

Till Streichert

I don't think that it is a question of phases that we are in, because remember South Africa is growing quite nicely in terms of top line. In combination with the operational leverage that we have put through we have ended up delivering 13% EBITDA growth, which obviously is quite pleasing. Now, obviously the international markets are – as you point out – in a slightly different space. But I think there is an opportunity on the structured savings programme to leverage these things going forward.

Mike Gresty

Thanks guys.

Operator

Thank you very much. We have a follow-up question from Craig Hackney.

Craig Hackney

Thanks. In the international segment your other service revenue is up 19.6% year on year. Can you just explain the strong growth there please?

Till Streichert

The international other segment, that will be our Vodacom Business Africa growth that is rolling up into that segment.

Craig Hackney

Do you price most of those contracts in US Dollars so you get a strong currency impact?

Till Streichert

That is correct.

Craig Hackney

Okay. Thank you.

Operator

Thank you. Ladies and gentlemen, a final reminder, if you wish to ask a question please press star and then one now. We will pause a moment to see if we have any further questions. Gentlemen, it would appear that we have no further questions from the conference call. Do you have any closing comments?

Shameel Joosub

Thank you for joining us.

Operator

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

END OF TRANSCRIPT