Conference Call Transcript

12 November 2018

INTERIM RESULTS ANALYST CALL

Operator

Good day ladies and gentlemen and welcome to the Vodacom Group Ltd conference call for the six months ended 30 September 2018. Vodacom Group CEO, Shameel Joosub, will host the conference call. I will read the forward-looking disclaimer before handing over to Mr Joosub.

This announcement which sets out the results for Vodacom Group Ltd for the quarter ended 30 September 2018 contains forward looking statements. These statements have not been reviewed or reported on by the group's auditors with respect to the group's financial condition, 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, revenues, expenses, 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 it is available on the investor relations website on www.vodacom.com. Please note that 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 an operator by pressing star and then zero. Please also note that the conference is being recorded. I would now like to hand the conference over to Mr Shameel Joosub. Please go ahead, sir.

Shameel Joosub

Thanks Chris. Good afternoon everyone, and good morning to those joining the call in the US. I'm joined by Till Streichert, our CFO, and Sean van Biljon, our Head of Investor Relations. Before we look at the numbers let me give you the key take-outs from the last six months. We concluded our new R16.4 billion BEE transaction, the largest in the South African telecoms industry, securing our level 3B status and an effective 20% black ownership to make Vodacom the most empowered telco in South Africa. We launched 5G in Lesotho, another strategic milestone for the Vodacom Group, paving the way for our other operations to follow once we get spectrum allocated.

Following the acquisition of our strategic stake in Safaricom we have included a full six months of results in these numbers, contributing R1.4 billion in our pre-tax profits, and we will be receiving a dividend of approximately R2 billion by December. M-PESA and financial service business in South Africa are showing good growth and are becoming a more material part of our business. Between our international operations and Safaricom we have over 34 million customers using M-PESA and over R1.6 trillion transacted annually across the platform as we are Africa's biggest mobile money platform. We continue to add new services to the platform and expand customer payment options. In South Africa our financial service business is yielding excellent results and will be more than a R1 billion profit business this year. At the half year revenues from FinTech grew 55% to R709 million.

Our digital services business is making good progress in enabling new data platforms such as our recently launched video play platform. Our initial focus has been on ensuring rich customer experience. More than 600,000 customers are engaging and playing on the platform since launch two months ago, and it is growing quite nicely. We continue to build our digital telco capability by introducing new ways of using big data and machine learning. We now use this to drive intelligent decision-making including optimising capex, greater sophistication in financial services, and constantly improving our personalised product offers to customers. For example improved processes have resulted in a marked improvement in our call centres with a 20% reduction in call volumes.

From a group perspective we are seeing growth customer growth, adding almost 5 million customers. Safaricom added 373,000 customers. Together we now have over 109 million customers. A reminder that as we transition into the new IFRS 15 standards my commentary today is based on IAS 18. Till can give you some further explanation of this during the call. Group revenue was up 5.6% with consistent growth in South Africa and double digit growth in the international portfolio. EBITDA grew 4.7% with excellent improvement in our international operations where we have seen strong margin expansion. EBITDA has been impacted by the BEE transaction costs and our roaming agreement with Rain. Albeit that headline earnings per share were down 13.5%, if we adjust for our M&A activities, which include the BEE transaction and Safaricom from the prior year, we actually saw headline earnings per share growth of 6%, reflecting strong growth in the underlying business.

We have spent R5.3 billion on expanding and improving all our networks. We now have 4G live in all markets and 5G commercially launched in Lesotho. We now lead in the majority of all major network performance metrics across our footprint. And finally, the board declared a dividend of 395 cents per share in line with policy and translating into a yield of just over 6.1% on Friday's closing share price. This is a super outcome of delivering growth in the dividend on a per share basis of 1.3% despite the issuing of 114.5 million shares in relation to the BEE deal.

Let's look at the segments in more detail. In South Africa service revenue grew 4.6% supported by strong gains in customer additions in the period as customers continue to choose Vodacom for value and quality. You will have noted from our results that we have a R292 million deferred revenue release relating to our new more value plus plans. If we exclude this service revenue grew 3.5% which is very pleasing given the economic environment currently. In the contract space we gained 177,000 customers with both the enterprise and consumer segments delivering strong growth. Overall contract customers were up 5.7% from the prior year. In the prepaid segment we continue to perform well as customers find resonance with our bundle offers with varying validity periods and personalised offers through Just 4 You. In fact, over 80% of prepaid bundles bought had hourly, daily, weekly or fortnightly expiry periods. We added 2.3 million prepaid customers in the first six months. That is a 10.9% increase on the previous year.

Data revenue was up 7.5%. Usage for paid services was strong at 36%. However we did take some steps to reduce free usage on items such as Facebook and other free offers to focus on converting users more effectively. Other data metrics remain strong with 19.1 million smart devices on the network, of which 8.6 million are 4G customers. We currently have 20.5 million customers using data and a higher usage per smart device. To continue giving customers more reasons to consume we recently launched our video platform called Video Play, the next step to our platform strategy. Video Play is intended to co-exist with our subservices, but where we differentiate is how we price for these services. We are bringing our bite-sized bundle strategy to video where you can have daily subscriptions, weekend or weekly subscriptions, per episode downloads and more. You can also charge these to your bill or your airtime balances. Although still quite new we are seeing really good take-up on the service with more than 600,000 already engaging since launch.

The FinTech space in South Africa has been an amazing success. Customers have accessed R2.9 billion or a quarter of airtime sold through our airtime advance platform. It now boasts 8.4 million customers using this convenient service, which conveniently advances you airtime which is payable on your next recharge. We have also harnessed our big data capabilities in this space which is aiding in driving take-up of this service. On the payment side we have now also launched our own payment gateway with direct processing into the acquiring bank, which will aid in trading commissions paid and also give us more opportunities to offer other payment services.

EBITDA grew 2.8% with margins contracting due to the roaming agreement with Rain. Excluding this EBITDA margin expanded by 0.1%. I'm very pleased with the performance of our international operations. Improved trends were driven by strong growth in the DRC and Mozambique, consistent results in Tanzania despite the tough competitive environment, and continued growth in Lesotho. From a reported versus normalised growth perspective results are more closely aligned due to relative stability in currencies in this period. Service revenue increased 12.8% and EBITDA grew exceptionally well at 20.7% to almost R3 billion.

During this period our international operations' contribution to the EBITDA growth was ahead of South Africa, which bodes well from a diversification perspective. Data revenue was a stellar performance with growth of 26.6% and Just 4 You propositions have proven very successful in monetising the demand for data. We added 1.4 million customers in the six months to reach 18 million data customers. I'm pleased to say that all our markets now offer 4G services following the launch in Mozambique where we now have a unified service license. Demand for our mobile financial services through our M-PESA platform remains strong in all our international markets. Active M-PESA customers increased by 22.6% to 13 million across our international markets. M-PESA revenue grew 25.2% representing 15.1% of service revenue. We are seeing good progress across the portfolio on profitability with EBITDA margins expanding strongly by 2.1% to 30.1%. This was driven from scale benefits from strong top line growth but also our vigorous focus on cost containment across these operations.

Safaricom announced their results a week ago. Their performance is solid with service revenue increasing 7.7% and EBIT increasing 18.7%, supported by strong data and M-PESA revenue growth. We are very pleased with their performance which is tracking in line with our expectations. We have included profits of R1.4 billion after deducting amortisation of fair value assets and will receive a cash dividend of around R2 billion in December, 50% of which is included in the interim dividend and the remainder to be paid at the final dividend.

Let's move on to some more topical items to update you on. In South Africa our effort to reduce the cost of data is highly depending on reducing the cost of a MB of data. To achieve this we need access to the right spectrum. While we are encouraged by the significant progress recently regarding the licensing of 4G spectrum in South Africa, which by all indications will happen in March next year, there are still a number of areas of concern related to the inconsistencies in the proposed ECA Amendment Bill and the policy directions issued by the ministry to ICASA on the licensing of the 4G spectrum. Both of these processes are undergoing a consultation process and we have submitted our comments. The Minister and regulator have both indicated the intention that the spectrum auction will be done under the existing regulations. These processes pave the way to a successful hybrid model which will include both the creation of a wireless open access network and spectrum being auctioned to the industry. We remain committed to engaging with the relevant stakeholders to find a suitable outcome to move South Africa forward.

Finally, let's move over to our medium-term targets and provide an update on priorities. We are positioning ourselves as part of our vision 2020 to become a leading digital company. To this end we are changing the way in which we operate to be more agile and utilise big data and machine learning in a bigger way across the business. Data and M-PESA will continue to drive growth for our international operations. The key focus for me will be a closer cooperation with Safaricom and also fast-tracking access to spectrum across our markets. I'm pleased that Telkom has selected Vodacom as its new roaming partner and we look forward to delivering on this long-term mutually beneficial agreement. Apart from the commercial benefit this partnership will also result in cost savings for Vodacom. Our group medium-term targets remain the same. Mid-single digit growth for group service revenue, mid to high single-digit growth for group EBIT, and capex of 12% to 14% of group revenue. This concludes my comments, and Till and I are now ready for any questions.

Operator
Thank you very much sir. Ladies and gentlemen, at this time if you wish to ask 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 is from Evgeny Annenkov of Bank of America Merrill Lynch. Please go ahead.

Cesar Tiron
Yes, hi. Sorry, it's Cesar from Bank of America. I have three questions if that's okay. The first one is on the service revenue growth in South Africa. Do you expect to see deterioration in the next quarters? The second question is on the Telkom roaming agreement. Do you believe this is of a significant nature to replace the revenues you will lose from Cell C? And then the third question would be on spectrum. When do you think the regulator would proceed with the spectrum awards in 2019? Thank you so much.

Shameel Joosub
All right. Thank you Cesar. So firstly on the service revenue growth I think the big part is that we do see an acceleration of data revenue growth for the remainder of the year. So that will translate into a better service revenue performance. So that's the first thing. The second one, Telkom roaming. Yes, it does replace the Cell C roaming part. It replaces it completely, so there won't be any gap. Now, how that works is that basically the Cell C one will step down to the floors over the next couple of months. So they will phase out their part. But remember they have a floor until November 2020. Telkom will phase in from December until June, and we will have their full traffic after June. From a spectrum perspective by all indications the auction will happen in March. That is for 4G spectrum, and in 2020 for 5G spectrum.

Cesar Tiron
If I can just follow up, do you have any indication as to the reserve price for spectrum, or not yet?

Shameel Joosub
No we don't. I think we are working internally off the last ITA which is about R3 billion a block. We don't see it being higher than that, because remember there were a lot of complaints around the R3 billion where the smaller operators were saying that it's a set-up for Vodacom and MTN. So if anything it goes lower.

Cesar Tiron
Thank you so much, Shameel.

Operator

Thank you. The next question is from JP Davids from JP Morgan. Please go ahead.

JP Davids
Good afternoon. A couple from my side. Firstly on the voice performance in South Africa. That looks like a very resilient performance through the first half of the year and the second quarter in particular. You have talked a lot about reasons to consume on data. Is there anything new you are doing on voice to support those trends, or where are you seeing that resilience come from? And then switching gear to capex into the network, it looks like you've made some ongoing speed gains on your 4G network in South Africa. Can you talk to us a little bit about that? What is driving that? Is that more densification of the network? Are you doing anything new with regard to [unclear]? Any sort of colour there would be helpful. Thank you.

Till Streichert
JP, on the voice question in fact there is just one element to remember. Out of the R292 million deferral release about half of that went also into voice in the second quarter. So that is technically just a little bit of a boost. But beyond that I think we are reaching the point where actually the voice decline is really stabilising and therefore going forward we are seeing relative stability, just marginal decline in the voice revenue.

Shameel Joosub
Just to add, we also continue to push bundles on voice, your Just 4 You bundles and personalisation as well. On the second one, the capex and the speed gains, what we have been doing is focussing a lot in terms of making sure that we get the results so that we could maintain the best network claims. So I would say it's a combination of factors. It is using things like carry aggregation. It is making sure that we optimise all the different network elements. And also to be frank it also required a bit of investment. So that has ensured that we are still the best network in South Africa and that we have got a gap between us and competition. And I think that bodes well for the future, especially since we've seen the competitors not being able to monetise it and now announcing that there will be a step down in capex going forward.

JP Davids
And just following up on that, Shameel, if I may. Has the Rain agreement made any meaningful impact to your network quality? Clearly you've got access to some more spectrum. I don't know if you've been able to quantify the positive impact that has on the network performance.

Shameel Joosub
Look, it helps with offloading specifically because of the amount of traffic that we're carrying. So it does help with the offloading, but obviously we prefer to use our own network wherever possible.

JP Davids
Okay. Thank you.

Operator
Thank you very much. The next question is from Jonathan Kennedy-Good of SBG Securities. Please go ahead.

Jonathan Kennedy-Good
Afternoon. Just a follow-up from this morning on your working capital absorption. I think you mentioned that there was some capital equipment you imported there. I'm just wondering how much of that we should see reverse in the second half, because I think it's quite a meaningful number in terms of your free cash flow number.

Till Streichert
So, look, we've stocked up a little bit on the device side ahead of the festive season. We had some favourable deal prices which we utilised, and equally some of the new device launches around the Apple iPhone. So it is actually very similar to what you have seen in the previous years where our H1 carries a little more of working capital investment and then in the second half that reverses out. And I am foreseeing the same to happen also this fiscal year, again taking us to a fairly decent cash conversion, which was last year above 63%. And I think we are going to achieve a similar figure.

Jonathan Kennedy-Good
Thank you.

Shameel Joosub
I think it's important to note that the iPhone launch was earlier this year and therefore impacted the half. We normally fall into what we call wave three, but we have been upgraded in importance to wave two as a country. So that is why it has actually come in earlier.

Jonathan Kennedy-Good
Thanks.

Operator
Thank you. The next question is from Ziyad Joosub of HSBC. Please go ahead.

Ziyad Joosub
Hi everyone. Thanks for the questions. Just two questions please. The first one on other operating expenses. It grew 10.2% year on year. Was a lot of that through higher bad debt? If you could just give a bit more colour on why it grew so fast and how we should model for this going forward. And then the second question is you mentioned that half of the deferral went into voice. Did the other half go into data? Thank you.

Till Streichert
Okay. So let's start with the second one. 50% went into voice. 35% went into data and 15% into SMS. That is the split. On your first question, other operating expenditure, it is actually really related to our network growth. We have added over the last 12 months more than 1,000 sites. Each site comes with lease costs, energy costs and maintenance costs. And as we expanded our coverage and densified our network those are costs that have come through there. It is really that, but that sits on another line.

Ziyad Joosub
Thank you. Thanks very much.

Operator
Thank you. The next question is from Madhvendra Singh of Morgan Stanley. Please go ahead.

Madhvendra Singh
Yes, hi. Just following up on the question on Rain roaming, given that we have the spectrum auctions very likely in the first quarter of next calendar year would you review your roaming deal with Rain? And is there any chance it could actually be terminated given that it is a drag on the margins? Secondly, has there been any margin hit coming from the handsets given that the Rand was quite weak during the period? Thank you.

Shameel Joosub

Okay. On the roaming agreement with Rain we have certain commitments that we have made to Rain that are long-term commitments. We will not be looking to cancel the Rain agreement. In fact we will utilise it as much as we can. That said obviously there is a floor in the agreement of how much we spend with them. So everything above the floor or the minimum commitment that we've made we can then move onto our own network. So that's the one. In terms of handset pricing, yes, your weaker exchange rate has impacted the in a number of ways. Firstly, you had more expensive devices which means that your elasticity of demand you would have sold more smart devices during the period. That does get impacted, so you sell a lower level of volumes. And secondly, we have seen a slight downgrade of where people have gone for the device and changed some of the underlying packages, so taken a lower package. We are trying to manage that with longer contracts and so on, and have put measures in to ensure that we offset that.

Till Streichert

And just to add to that, remember the actual terminals business we always manage towards a target margin of 4% to 6%. And we have pretty much achieved it again in this half. It is really what Shameel has highlighted. But from an actual equipment margin point of view same as before.

Madhvendra Singh

Okay. Thank you.

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 Alistair Jones of New Street Research. Please go ahead.

Alistair Jones

Hi. Thanks for the question. I'm just trying to drill into the recovery in data revenues that you are expecting for the next couple of quarters. I just want to try and understand where that was going to come from. If I break down the pricing and the traffic trends traffic has definitely taken a dip. I think it is growing at around 25% or so. And then pricing has actually eased year on year. I think Q1 was down 17% and Q2 was down 15%. Is pricing going to get better as in the declines are going to be less than the 15%, or are you expecting traffic to accelerate on the back of maybe slightly better consumer spend trends? I would just be interested to hear how that revenue improvement is coming through. And then secondly it would be useful to get an update on how you see the competition in the market, if any of the other operators are making any particular moves that you need to keep an eye on, or if anything is changing out there, that would be great. Thanks.

Shameel Joosub

Okay. So let me start off with competition. So no big changes in terms of competition. I would say very much the same, Telkom being a slight aggressor, Rain having actually pulled back on their offers having realised they can't cope with the level of traffic and so on. So you are seeing a bit of reasonability I would say in the market. I think with the consumer being under pressure not too much big discounting and so on, except for the normal promotional activities going into summer and so on. So that's the one side.

In terms of recovery of data I think it's important just to understand that one of the big things that we did in the first half is that we re-priced the big data bundles. And the big data bundles are your 5GB, 10GB and 50GB and so on where Telkom was almost running away with it and the market was slow to respond to it. Over a two or three year period they were starting to build up momentum. What we did was we changed our price points to ensure that we get the growth and take our fair share of the market in the bigger data bundle space. So that has recovered quite well. It was a massive decrease in pricing, probably about a 40% discount. But we did see a 40% requisite increase in traffic on those. So the good news is that we are offsetting it, and so we are seeing the results coming through. And we have seen an uptick in the number of connections. That has borne out into the growth of 5.7% in the contract base. So that's the one side.

The second part is on traffic. It is also important to note that when you are doing the year on year comparison on traffic you must remember the big Meg Your Day promotion that we ran last year where we gave away a lot of free traffic and it actually was a bit dilutionary. It was too successful as we called it at that point in time. So if we're looking at paid traffic, paid traffic is up 37% so still very healthy in terms of your paid traffic growth. And we have been managing down free traffic over time. In terms of pricing overall 16% decline for the first half in terms of pricing. I think the pricing pressure will still be there, but I think it gets offset by more elasticity with data. So we will see the elasticity coming through in the data space.

There is still one overhang which by all accounts will maybe even happen next year now with the ongoing fight between Cell C, MTN and the regulator on the out of bundle rates. MTN have a clause that from six months after the court hearing is when the implementation is. So it could be that this part of the year we don't see the implementation of the regulations. That said we are ready to implement. There are certain clarification points that we are still looking for from the regulator. They have been delaying because of the court case, and once the court case is finalised we are seeking those clarification points. Thank you for joining us.

Operator
Thank you very much, sir. Ladies and gentlemen, that then concludes this conference call and you may now disconnect your lines.

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