Conference Call Transcript

23 July 2015

ANALYST PRESENTATION

Operator

Good day, ladies and gentlemen and welcome to the Vodacom Group Ltd quarterly results conference call for the period ended 30th June 2015. Vodacom Group CEO, Shameel Joosub, will host the conference call. I will read the forward-looking disclaimer before handing over to Shameel Joosub.

This conference call which sets out the quarterly results for Vodacom Group Ltd for the period ended 30th June 2015 contains forward-looking statements which have not been 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 it is available on the investor relations website www.vodacom.com. Thank you. Shameel Joosub, over to you.

Shameel Joosub

Thank you. Good afternoon and good morning to those in the US. Thank you for joining us to discuss our quarterly results. I'm here with our CFO, Ivan Dittrich, the Financial Director of Vodacom South Africa, Till Streichert, and Financial Director of our International Operations, Sitho Mdlalose, who has joined us for the first time. I also have with me our group Executive of Investor Relations, Monique Nienaber.

I am pleased with our performance in the quarter. The marked improvement we saw in the fourth quarter last year particularly in South Africa continued into the first quarter of our new financial year. In the international operations the pricing environment in Tanzania has stabilised, supporting improved performance. We achieved solid performance in the DRC due to the adherence by all operators to the minimum price floor, and Mozambique and Lesotho continued to deliver strong growth.

We have also made substantial progress with our group strategy. We invested R2.4 billion in capital expenditure during the quarter as part of our accelerated capex programme. As a result we have delivered wider coverage and faster connection speed in all our markets.

We attracted 1.9 million new customers in the quarter across our operations to increase our group active customers to 63.5 million customers. The number of group data customers grew 10.8% year on year to 28 million, representing 44% of our group active customers. Machine to machine customers increased 16.9% year on year to 1.9 million SIMs now in machines.

In South Africa contract pricing transformation is nearing completion. We have migrated 81% of our contract customers to integrated bundles and 71% of our contract revenue is now in bundle. Our international operations delivered strong underlying performance through solid commercial execution. They now contribute 25% to group service revenue from 23% a year ago. We have maintained our number one market share position based on customers and revenue in all our markets.

If we now take a look at our financial performance, we achieved strong growth in the quarter with limited impact from mobile termination rate cuts in South Africa. Our group revenue increased 7% to R19.6 billion and service revenue grew 5.1% to R15.7 billion. In constant currency group revenue expanded 6.5% and service revenue increased 4.7%.

We again achieved strong growth in group data revenue of 35.2% to R4.8 billion. This was driven by a 65.7% growth in data traffic across our market. Data revenue now constitutes 30.9% of our group service revenue.

Let’s now unpack our two reporting segments in a little bit more detail. I will start with South Africa. Our strategy in South Africa has not changed and we are consistently delivering on it. To reiterate, our strategy is to increase investment by adding capacity in voice and data which helps us to create clear network and customer experience differentiation whilst at the same time investing in new areas of growth. Secondly, it is to bring down prices by creating products that maximise elasticity, and then to offset the inevitable price decline in voice with a massive increase in data.

Revenue grew 5.5% in South Africa boosted by strong growth in data and increased equipment sales. Our equipment revenue grew 13.8% representing 23.1% of revenue compared to 21.4% a year ago as a result of an increase in smart device sales – smartphones, tablets and modems. Our smart devices account for 58% of our equipment sales. This is in line with our strategy of putting smart data-capable devices into the hands of more customers.

Our service revenue returned to growth, increasing 2.8% following four consecutive quarters of negative year on year growth that has been heavily impacted by mobile termination rate cuts in the prior year.

Our price transformation strategy which is aimed at offering the best value to customers was executed through a clear, segmented approach offering bundles at affordable and competitive prices together with delivering worry-free integrated plans to customers. This led to a 14.7% reduction in the blended average effective price per minute and a 9.1% reduction in the average effective price per MB. This was offset by growth in outgoing voice traffic of 4.9% and in data traffic of 45.7%.

We have seen benefits of our contract price transformation which is nearing completion in the form of reducing contract churn by over 3% to 7.2%, our lowest ever, and a 3.8% increase in ARPU to R386 as we continue to see early benefits to ARPU of 4G migration and increased data usage. 63% of our hybrid customers switch to UChoose packages which give customers access to integrated plans with an option to access prepaid promotions on an ad hoc basis. Overall contract customers excluding machine to machine grew 3.1% to 4.9 million, supported by higher gross connections and greater customer loyalty.

Our prepaid price transformation also continued with prepaid active customers increasing 2.3% to 28.4 million. Our customer value management initiatives through which customer needs are analysed and product offerings tailored for each individual play an important role in driving increased customer activity and value generated. Voice bundles supported by continuous adoption of our More Power promotions are proving increasingly popular with the average number of voice bundles sold increasing 29.3% to 54.5 million bundles a month now. This helps drive our continued price transformation, reducing the average effective price per minute by 13%.

Improved data monetisation and efficiency continued in the quarter with the gap between data revenue and data traffic growth narrowing, which you will remember from previous quarters was one of the important initiatives for us. We continue to see data as a key pillar of our growth strategy. In unlocking the data opportunities we are focussed on the following four key strategies. Firstly, improving data utilisation within our customer base through access to better smart devices. Secondly, increasing network coverage and speed to improve the customer experience. Thirdly, stimulating data bundle adoption. We now sell 23.5 million data bundles per month. And then lastly, driving increased usage through content initiatives such as Deezer.

Execution of these four strategies has resulted in data revenue growth of 34.8% to R4 billion with data traffic of 45.7% more than offsetting the 9.1% decline in average price per MB. Data pricing remained stable during the quarter but the decline in pricing really came from migration to bundles. Data now contributes 33.8% of service revenue in South Africa compared to 25.8% a year ago. So to put it into perspective, 34.8% of our revenue is now growing at more than 30%.

We increased data utilisation in our customer base to 17.7 million data customers, representing about 53% of our customers who are using data services. However, we are still seeing a big data opportunity in the remaining 47% of our customers who don't use data. We see a further opportunity in converting the 5.7 million customers that are not on smartphones that are using data to proper smartphones. Machine to machine customers grew 16.9% to 1.8 million and our 4G customers increased by 117% to 1.8 million 4G customers.

In line with our strategy in driving access to better smart devices the number of active smart devices on the network increased 32% to 11.9 million, boosted by sales of low-cost smart devices such as Vodacom Kicka and Vodacom Smart Tab. The average amount of data used per month increased almost 35% to 408 MB per smartphone, with tablets using an average of 774 MB. While I am encouraged by this increase it still leaves room for further growth is only 36% of our customers are using active smart devices.

As we improve the penetration of smart devices in our customer base we see a positive impact on ARPU with about a 13% uplift as we move customers from a 2G to a 3G device, and about a 15% ARPU uplift as we move customers from a 3G to 4G device. These uplifts are in total ARPU, not just for data, signalling further room for data growth. The average amount of data bundles sold per month more than doubled year on year to over 23 million. I'm excited by the usage patterns we see in data with ARPU migration to larger data bundles within our customer base, as reflected in the increase in average monthly consumption of data per smartphone.

We invested R1.7 billion to increase data speed, capacity and coverage in order to provide customers with the best network experience. During the quarter we added 229 3G sites to total 9,031 3G sites covering 96.4% of the population with 3G. We also added 572 4G sites to total 3,172 sites covering 41% of the population with 4G.

If we now move on to our international operations, we delivered service revenue growth of 12.9% in our international operations, 11.3% at constant currency. The improved performance was underpinned by a solid execution of our commercial strategy together with strong growth in data and customers across the group.

Active customers grew 11.5% to 30.2 million as we continued to invest in our network to increase our coverage and differentiation. Mobile data in our international segment increased by 36.9% with data traffic growing 140.4%. Data revenue contributes just over 22% of service revenue. I think the next big focus area for us in international is to try and narrow the gap between the revenue increase and the traffic increase similar to the exercise that we embarked on in South Africa.

Our active data customers are up 23.8% to 10.3 million, representing 34% of our active customers. We continue to focus on our commercial and network offering to drive data growth, ensuring our customers have access to better low-cost smart devices such as Vodacom Kicka and Smart Tab, extending our 3G network coverage and driving the adoption of data bundles.

The demand for mobile financial services remains strong in all our international markets. Active M-Pesa customers increased 18.1% to 7.8 million. Following the launch of M-Pawa in Tanzania last year 9.8% of M-Pesa customers are actively using the trading and loans product.

We continue to invest in our network to differentiate our offering in terms of network coverage and performance. Our capital investment in the quarter represented 16.5% of revenue in the international segment and is targeted to accelerate during the remainder of the financial year. To support wider coverage and significant data growth we expanded our 2G sites by 31.9% year on year and 3G sites were increased by 50% year on year.

In conclusion let me just give you some market updates. On Neotel the regulator ICASA has approved the transaction subject to conditions that it has submitted out for comment. The Competition Commission has made a recommendation to the Competition Tribunal that they approve the acquisition of Neotel subject to certain conditions. The matter will now be heard at the Competition Tribunal with hearings set to take place on 23rd November to 11th December 2015. We are hoping for a ruling soon thereafter. There is a proper work plan that has been agreed with the authorities and with all interested parties. The transaction will ultimately result in increased communication infrastructure and the accelerated rollout of broadband connectivity in South Africa.

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

Operator

Thank you. Ladies and gentlemen, at this time if you would like to join the question queue please dial star and then one on your phone, or if you decide to withdraw your question please dial star and then two to remove yourself from the question list. Our first question comes from Merrill Lynch's Cesar Tiron. Please go ahead.

Cesar Tiron

Hi everyone. Just two questions from my side. The first one, I would like to understand why the divergence between the revenue trajectory on the prepaid and the post-paid this quarter. Is it mainly because most of your initiatives to monetise data are focussed on post-paid? And finally a question on margins. Is it fair to assume that the acceleration of rollout did not have any negative impact on the margins, because it is mainly driven by service revenue and not handset sales?

Till Streichert
It is Till speaking. On your first question in terms of the difference between the segments in terms of revenue, we put a lot of focus on the contract revenue side. We've got good customer growth in terms of net base growth. We've got record low churn, which obviously helps maintaining the strong customer base on contract. And we equally have got two months of price-ups that we have put through on the contract side. So that is in essence the source of the comparably strong growth on the contract side. On the prepaid side if you look at the trends in essence we have equally seen a good trend recovery in terms of the growth. Actually this growth is equally sourced by customer base and ARPU stabilisation.

Shameel Joosub
I think maybe just to add, there is more pricing transformation happening in the prepaid side than on the contract side where you are nearing the end of the pricing transformation.

Ivan Dittrich
Sorry, what was the second question again?

Cesar Tiron
The second question was to understand if this re-acceleration of revenue growth has any impact on the margins.

Till Streichert
Is your question whether they have an adverse effect in terms of margins? Just give me more clarity on the question.

Cesar Tiron
The question is to understand if the fact that the service revenue growth has accelerated we should expect margin enhancement.

Ivan Dittrich
I think in terms of guidance that we've given on margins previously is that we look at the 2015 financial year as a re-set year. In 2014 our margins were impacted by a number of one-off events like the MTR matter that we had as well as certain foreign exchange losses etc. We have also guided that we expect our cost base to grow at a lower rate than our revenue, so you would expect to see some operating leverage, and as a result you would expect over the medium term to see some degree of margin expansion.

Cesar Tiron
Sorry, when you made that statement did you expect such strong revenues this quarter?

Shameel Joosub
I think the answer is that the guidance still stands. So we still see the positive uplift.

Ivan Dittrich
And I think when you model for the next few quarters you must just remember that our Q2 last year was impacted by a once-off R325 million relating to revenue that was recognised on deferrals in prepaid. So you would need to take that into account in your model.

Cesar Tiron
Thank you.

Operator
Thank you. Just a quick reminder before we go to our next question, if you would like to join the question queue please dial star and then one. SBG Securities' Jonathan Kennedy-Good has the next question. Please go ahead, Jonathan.

Jonathan Kennedy-Good
Good afternoon. Just a follow-up on your comment around the R325 million. Was that all recorded in voice revenue in Q2 last year? And then secondly, given we've had the start of your prepaid voice pricing transformation can we expect in the second half of the year the decay in voice revenue to slow somewhat from levels at around 10% down at the moment? And then finally just a question on Neotel. Given the substantial delays on the completion of the approval does Neotel have any recourse to renegotiate the purchase price of that deal?

Till Streichert
Let me take the first two questions. To answer your question on the R325 million prepaid voucher balance sheet relief that we disclosed at half one and respectively at the full year, yes that was voice. And you need to factor that in when you interpret the reported results for Q2. And if you simply look at last year's reported results and you exclude the R325 million from that you would effectively see an uplift of around 2.8% to service revenue. So that's on the first question. On the second question in terms of voice erosion, in essence if you look at the year over year trend by quarter you do see already that Q1 represents basically a stabilisation in that. Q4 was -10.7% year over year, and Q1 was -10.6%. So as we progress with the pricing transformation we would effectively expect that there is some more stabilisation happening on voice.

Shameel Joosub
I think on Neotel the answer is no. there isn't any clause that allows them to renegotiate the agreement.

Jonathan Kennedy-Good
Thank you. All right. Thanks.

Operator
Our next question comes from Craig Hackney at NOAH Capital Markets. Please to ahead, Craig.

Craig Hackney
Thank you. Just on your capital expenditure in the first quarter. As a percentage of revenue it seems to be on the light side compared to your guidance. Are you expecting quite an acceleration for the remainder of the year, or have you hit any potential snags that have made that capex lower than you would otherwise expect? Thanks.

Shameel Joosub
I think the capex will basically accelerate during the year. Generally we do have a little bit of a slow start going into April, and then it kind of ramps up during the year. We are already accelerating a number of projects where we expect a significant catch-up in the second quarter already. So I think the capex part will be within guidance for the year.

Craig Hackney
Okay. Thanks very much.

Operator
Thanks. Our next question comes from Citibank's Radebe Sipamla. Please go ahead, Radebe.

Radebe Sipamla
Afternoon guys. I just wanted to understand how much of the good performance from the SA business can be attributed to the industrial action that disrupted MTN's operations in the quarter. And just in terms of the performance in the quarter how much of it was down to a stronger operating performance? And the last question, do you see the strong performance in your SA operations continuing to Q2?

Shameel Joosub
I think maybe just to start with the MTN issue firstly I don't think that the results that we are seeing have basically come from a weakening or the industrial action at MTN. I think yes, we probably would have gained a little bit of customers and so on from that, but I don't think it had a significant impact. I think the good performance is really a continuation of what happened in the fourth quarter, and I would say a continuation of the delivery of strategy. I think it is very important that you pick a strategy and that you basically keep focussing and delivering on the strategy. And so I would write the performance down to the capital investment and the clear strategy of being able to monetise data a lot faster. So the accelerated capital investment I would say is bearing fruit, and we are seeing that result come through in the increased data revenue, which if you think about it was exactly what we tried to achieve when we set our accelerating our capital investment. So that is very encouraging.

Secondly on the international side I think the performance that you're seeing in international is basically coming through from a recovery in terms of price stabilisation, which happened during the year last year, especially towards the end of the year. And those measures that were put in are now starting to bear fruit, if you like. And I would say also borne out by a lot more market rationality across the board. I think that comes through quite clearly.

Ivan Dittrich
On the Q2 question I think the answer there is we are continuing to focus on our delivery and to execute on our strategy to make sure that we continue with good momentum. As I said earlier, when modelling Q2 just remember the R325 million that boosted revenues in Q2 last year.

Radebe Sipamla
Okay. Thanks guys.

Operator
Thank you. Our next question comes from Deutsche Bank's Mike Gresty. Please go ahead.

Mike Gresty
Good afternoon guys. I just wanted to chat a little bit further about the price transformation on the prepaid side. If I understand the numbers correctly you've still got 46% of subscribers that are on the legacy plans. And my understanding also is that you proactively are migrating those guys over time to your new plans. With the positive surprises come through in data revenue to what degree is that enabling you to accelerate the migration? And what sort of timeline do you now think we are on to complete that transformation? I just wanted to get a sense if you accelerate that transformation you still think that voice decline is going to slow. Would it not maybe accelerate a little bit if you're pushing your transformation?

Shameel Joosub
I think what we're saying is that obviously we put a plan in place of how we are doing it. Yes, the data revenue does give us a little more room to move, if you like. That is what we are saying. We are saying a stabilisation of trend in terms of voice decline. We are not seeing acceleration of that.

We need to obviously balance that versus strong data growth against the pricing. So yes, we do take the opportunity as we see it. But no, we won't accelerate it further than the current trend. We still think it will take about 18 months. I think it is also important for us to deliver a revenue within the guidance. Yes, it is possible to accelerate, but we have to balance all factors.

Mike Gresty
Great. Thank you guys.

Operator
Thank you. Ladies and gentlemen, one final reminder, if you would like to join the question queue please dial star and then one now. We have a follow-up question from Craig Hackney. Please go ahead, Craig.

Craig Hackney
Thank you. Just looking at over the top voice, do you have any indication within your smartphone customer base what sort of percentage or how much over the top voice is taking place? Secondly, have there been any discussions with the regulator around regulation of over the top voice at this stage? Thanks.

Shameel Joosub
Okay. So let me start with the regulation part. Effectively there hasn't really been much movement yet. We have made applications to the regulator and so on. We think that is a topic that needs to be discussed. I think it is a topic that will have to be discussed worldwide. I was saying earlier today that I think the OTT play, although very small today, will start to accelerate and I think you will start to see a little bit more of that. I think what will happen is that either it gets regulated in the proper fashion or otherwise the decline that will come from OTT in voice will have to be offset by price stabilisation in data. So you won't see price decreases in data if OTT becomes a bigger part of it. So those declines that you might have seen in data pricing will be offset. I think currently the OTT is less than 1% of our traffic. So it is still very small, but I think something that one has to keep a watchful eye on. I think in the end if OTT becomes bigger it will become a factor. one would have to ensure that data pricing is appropriate to be able to accommodate for that.

Craig Hackney
Okay. Thanks very much.

Shameel Joosub
We also get the uplift in data traffic.

Craig Hackney
Yes, sure. Thanks, Shameel.

Operator
Thank you. Our next question comes from David Lerche at Avior Research. Please go ahead.

David Lerche
Hi. Good afternoon everyone. Just a very simple one. Messaging in both South Africa and the international business, that revenue has looked a lot better than the trend over the last little while. Can you maybe give us an indication of whether you expect that to stabilise at the current levels or whether you expect that to resume its decline?

Till Streichert

From a South African point of view we have had relatively strong messaging revenue related to wholesale bulk messaging. That is quite positive. On a separate note, in terms of the trend line you do see substitution from effectively over the top messaging services in general. But in bulk SMS type communication it is still very much SMS-based.

Shameel Joosub

And maybe just to explain what has happened in the mobile messaging part in South Africa. Your decline, as Till said, in terms of substitution, that is still happening. But what we have been able to do is put proper interconnect agreements in place for messaging where there was a lot of arbitrage happening. So we saw a massive decline due to arbitrage and we have managed to pull that back by putting proper interconnect agreements with all the different parties in place.

David Lerche

Excellent. Thank you.

Operator

Thank you. Shameel, it appears there are no further questions in the queue. Do you perhaps have any closing comments on the analyst side?

Shameel Joosub

No, I think we have covered everything.

Operator

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

END OF TRANSCRIPT