Conference Call Transcript

13 November 2017

H1 2017 RESULTS ANALYST

Operator
Good day ladies and gentlemen and welcome to the Vodacom Group Ltd interim results conference call for the six months ended 30 September 2017. Vodacom Group CEO, Shameel Joosub, will host the conference call. I will read the forward-looking disclaimer before handing over to Shameel.

This announcement which sets out the results for Vodacom Group Ltd for the six months ended 30 September 2017 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, 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 at 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 should need assistance during the call please signal an operator by pressing star and then zero. Please also note that this call is being recorded. I would now like to hand the conference over to the Vodacom group CEO, Mr Shameel Joosub. Please go ahead, sir.

Shameel Joosub
Thank you Chris. Good afternoon everyone and good morning to those joining the call in the US. I'm joined by our CFO, Till Streichert, and Sean van Biljon, our Head of Investor Relations. You have already seen the numbers and we have taken you through most of it at the results presentation. For this call I will take you through a few of the highlights in the half and discuss a couple of more detailed trends that have emerged during the period. I'm pleased with the results achieved so far. It was an exciting first half after successfully acquiring a 34.94% strategic stake in Safaricom and completing a listing of a 25% stake in Vodacom Tanzania. We are very glad to have Safaricom on board and look forward to close cooperation with Bob and his team in the future.

From a group perspective we have seen strong customer growth of 11.8% and we now have more than 71 million customers or over 100 million if you include Safaricom. Of these 34.7 million are using data, or over 51 million with Safaricom. Group revenue was up 6.9% on a normalised basis taking currency fluctuation into account. EBIT was slightly down 0.2% or (1.4%) normalised. We are confident this will pick up again in the second half and we will continue into next year in order to achieve guidance. Net profit increased 7% to R6.7 billion which includes two months of profits from Safaricom. We have spent R5.4 billion on expanding and improving all our networks. Headline earnings were up 1.1% to 445 cents per share, impacted by additional shares issued for the Safaricom transaction. And finally the board declared a dividend of 390 cents per share in line with policy and translating into a yield of just over 5% on the current share price.

Our South African operations continued to deliver good results supported by strong customer additions and growth in data and enterprise services. Encouraging has been good growth in our customer numbers, adding 2.9 million in the first half of the year. Our international operations continued to gain momentum. Tanzania has performed very well on delivering on its turnaround strategy while Mozambique and Lesotho delivered strong results. Currency issues and a tough economic environment in the DRC impacted their performance this half.

On Safaricom, Safaricom performed very well delivering 12% service revenue growth supported by strong data and M-PESA revenue growth during the six month period. We have included two months of profit during this first half as the deal was concluded in the beginning of August.

Our results show that we continue to make good progress against the strategic priority of network differentiation, offering customers more value through segmented and personalised offers through Just 4 You while reducing effective pricing. Our bundle strategy and personalised offers are delivering good results, and this half we saw 1.1 billion bundles in South Africa with big data being an enabler for revenue growth and efficiencies for the future.

Looking at some of the trends in a bit more detail, in South Africa you would have noticed a slowdown in service revenue growth in the second quarter. Growth was impacted by the following. The first is on data. We had a softer quarter following the investment we put into driving data uptake through promotions like Meg Your Day during which we gave customers free access to recreational platforms to encourage data usage. We believe this will stimulate data usage in the future by creating increasing recurring usage as more customers are engaged on these platforms. The result was a 51.4% growth in data traffic. The initial results from the Meg Your Day promotion have certainly yielded results and we continue to see good growth supporting underlying demand. We are convinced that we have changed behaviour. Other data metrics remain strong with more smartphones on the network, more data users, up 9.6%, and a higher usage per customer.

Service revenue was also impacted firstly by more customers engaging on our more data packages which have more included value. I explained this in our first quarter. When upgrading customers we are now migrating them to more inclusive bundles for more spend. This creates some short-term effects where customers first need to grow into these bundles with the result that we have to defer revenue for up to a month as customers use the bundles. Migration to these packages now stands at 25%. Secondly, we have made changes to our deal structures to drive device affordability. This was somewhat at the expense of service revenue growth but achieved our objective of putting a better device in customers' hands thereby improving long-term usage trends.

On EBITDA in South Africa firstly I'm happy with the growth that we have seen in EBITDA of 2.7%. We did bring forward some publicity spend in this period which will normalise again in the second half. We are also accounting for the Rain roaming agreement now in direct expenses. And finally, as we bridge to EBITDA we wrote back some depreciation in the prior year on assets that were still in use but fully depreciated. That actually reduced the cost in the prior year, hence the higher growth in this year. And finally on margins, as low-margin business such as handset grows in contribution this affects margin with some dilution.

In our international operations we continue to see good results. However we had some pressure in the DRC this half. We have spoken before about the decoupling of the Congolese Franc to the US Dollar. The effect is that this translates to increased cost to consumers which has made the economic challenges in the country much worse. Due to the forex effect that this creates we have had to make an accounting adjustment in the second half of $15.8 million. Of that $11.4 million related to the first quarter. Offsetting that was a tax refund we received on ICA taxes recorded in revenue of $9.9 million. If you therefore normalise for DRC growth in Q1 and Q2 it would have been 5% and 5.6% respectively. It would have been down 5% and 5.6% respectively. Tanzania continues to improve every quarter with good results reported on Friday. And then Mozambique is growing strongly with further encouraging trends in macro and currency environment. Lesotho also continues to grow strongly.

I would also like to give a little bit of colour on the dividend. I think Till explained it well in the presentation. Due to the timing of the receipt of the dividend from Safaricom the board has taken the decision to include in the interim dividend 50% of the dividend received from Safaricom. The board intends to pay the remainder of the Safaricom dividend at the end of the financial year as part of the final dividend, adjusting for any currency fluctuation on actual receipt of the dividend from Safaricom. This creates a more even dividend profile between the two halves.

On the regulatory front on out of bundle we remain focussed on data pricing in South Africa and have demonstrated this in the reduction of our out of bundle rates. We will continue to address data pricing by reducing these rates in the medium term in a controlled way to manage the impact on growth and profitability. It is a bit of a balancing act to be able to continually invest capital in extending the network and increasing the coverage while we continue with our stated intention of reducing the cost of data.

On spectrum access to high demand spectrum in all our markets remains a pressing and immediate problem. We continue to make new plans and find innovative ways to extend quality and coverage to all citizens. However the allocation of high demand spectrum is crucial to drive down the underlying cost to carry a MB of data, and will result in more efficient capex spend, which in the absence of spectrum has to go into building new sites to keep up with demand. On the Competition Commission investigation in the beginning of October the Competition Commission launched an investigation into the national treasury government contract. We are confident that we have followed due process and we are fully committed to fully cooperate with the Competition Commission in resolving this investigation with them.

Finally let me move to our medium term targets and provide an update on priorities. 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. Data revenue continues to grow fuelled by strong demand for data services. M-PESA is a key area of growth in our international markets. South Africa has performed well but we have noted a slightly softer second quarter. The reduction in out of bundle rates and the promotional activities created some short-term pressure on data revenue growth. The effects of this will be managed through driving higher uptake and elasticity to compensate for the price transformation. We will also be relooking at the yield of our pricing and our Just 4 You promotions to ensure better yield so that we can monetise data better. The international markets except for the DRC are back on a healthy growth trend. The underlying drivers of growth remain strong. This concludes my comments and Till and I are now ready for any questions.

Operator

Thank you very much. Ladies and gentlemen, at this time if you do 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 now. Our first question is from Chris Grundberg of UBS. Please go ahead.

Chris Grundberg
Hi guys. Thanks. I just wondered if you could give firstly an update on your fibre plans. You have historically talked about a co-build strategy. I wondered if you still have that under discussion with any other parties and maybe where you'd got to on it. And then maybe an update on what your uptake looks like on the existing rollout that you have pinned down. And then as a second question just back on the mobile market, I wondered if you could give an update on your views on the general landscape at present, if you're seeing any kind of increased pricing pressure at the moment or if it's relatively stable at this time. I remember your last comment at the last quarterly call. Just where you think it is at the moment and anything interesting you're seeing out there. Thanks.

Shameel Joosub
Okay. Let me start with the competitive pricing. I think from a competitive pricing perspective nothing too aggressive. I think some moves on big data bundles specifically with Rain, but it's a small part of the market and obviously we have the ability to match it because we obviously match the footprint to have competitive offers out there. So we're not too worried about that. I think Telkom has done okay in the bigger LTE replacement part. So some good progress there from Telkom. MTN and Cell C, no great shakes I think. I think Cell C is very much under pressure from a capex perspective and from what we can see very little investment going into their network. MTN from a competitive perspective a lot of investment in closing the gap to us in terms of coverage and so on, especially in the big cities. But we're making sure that we continually stay ahead and that we can always ensure that we have the best network in every town and city that we operate in.

On fibre we have passed 39,000 homes and there has been a 6,000 uptake currently of signed contracts. We have also built a sales organisation to resell other people's fibre of the 175,000 so that we're scaling up. On the co-build front let's just say that discussions are progressing well with a potential partner and we will announce something in due course.

Chris Grundberg
Thanks. And you haven't got any further with the quantum of funds for that co-build strategy?

Shameel Joosub
No, because a lot of the ongoing funding will be raised within the co-build. So we will use debt funding as well.

Chris Grundberg
Got it. Thank you.

Operator
Thank you very much. Our next question is from Madi Singh of Morgan Stanley. Please go ahead.

Madi Singh
Yes. Hi. Thanks for the conference call. In South Africa the data revenue trends, can you please shed some more light around the trends in the fourth quarter and especially the out of bundle rate cut. How are customers responding to that? What kind of elasticity are you seeing specifically on that? And by when do you expect out of bundle to become a very negligible part of the overall revenue that it stops becoming an issue? And then secondly on international markets any specific competitive or regulatory issues that any of the markets are facing? Thank you.

Shameel Joosub

Okay. So let me start off with the underlying data trends. I think obviously still a lot of potential in the South African market. 40 million customers, only 19.9 million using data. So a clear opportunity to still grow that. Up strongly 9.6% growth for the half. 17.3 million customers using smart devices. 14.8% growth there. But there is an opportunity of 2.6 million people who are using data on the wrong device. And then as far as 4G devices go 62% increase in the number of 4G devices to 6 million. But as you can see of the 17.3 million smart devices only 6 million are 4G. So a big opportunity there as well. Actual usage per smart device is up 19.5% to 776 MB. And almost 12 million customers now purchasing data bundles. So a 55% increase in the number of data bundles sold.

In terms of out of bundle rates at the half basically 15% of our revenues now come from out of bundle in South Africa. And effectively with the recent drop that will decrease it. I think when you look at elasticity on the out of bundle rates it really comes down to the time period. So you start to see 0.4 or 0.5 immediately but then you see a recovery over the next weeks and months in terms of it. So it's a temporary weakness because customers do end up every month utilising more data. So that elasticity depending on the period that you're looking at should decrease quite considerably. But obviously still early days in that respect.

From a regulatory perspective across the countries I would say the biggest issue at the moment is spectrum, the spectrum auctions in Mozambique, Tanzania and the DRC there isn't any timeline against that, and that is obviously holding up progress on 4G. So that I would say is probably the biggest thing. A lot of the customer registration issues and so on are behind us. And then you do have the odd thing from time to time, but nothing too serious.

Till Streichert
I think the mobile termination rates and all of that are now the norm, you know.

Madi Singh
Just following up on the data in South Africa. So you said out of bundle is only about 15% of your total data revenue. By when do you expect that to become negligible to the overall situation? And what kind of revenue growth are you seeing in the fourth quarter compared to third quarter? When I say third quarter I mean calendar year, not the financial year.

Shameel Joosub
Okay. So it's very difficult to answer the one about when does the out of bundle become miniscule, because to be frank it really depends how quickly we drop the out of bundle rates. And I think what we're seeing is a phased approach. So we dropped now. We will drop maybe in October next year again. We've got to balance it. It has got to be balanced on elasticity, balanced on traffic, balanced on growth. So we plan in every budget cycle to do what we call price transformation or hygiene and we plan that every year. We have just done one now which will filter into next year. So I think it really depends on the different measures of traffic growth, of revenue growth and so on, and what we can afford to be honest at a particular point in time.

Madi Singh
And in terms of the revenue trends in the December quarter? Is there any change already compared to second quarter of your financial year?

Shameel Joosub
Look, I think you can assume that data growth will be in the teens. Shall we say that? In the mid-teens.

Madi Singh

Okay. All right. Thank you.

Operator
Thank you very much. The next question is from Myuran Rajaratnam of MIBFA. Please go ahead.

Myuran Rajaratnam
Hi guys. Thanks for taking my call. A question on what Till said during the presentation. You said that you limited voice revenue declines to less than 5%. Now, maybe I've got my calculations wrong, but in the first quarter if I remember correctly the voice revenue decline was 4.2% and for the half it was 4.8% negative.so that means in Q2 you effectively went above 5%. And the trend looks negative. So I just want your comments on that. And also specifically is this partially because you sold more data and people are using more things like WhatsApp calling and so on? I've got another question.

Till Streichert
Okay. Look, that's correct. In essence if you look at the two quarters the second quarter was basically slightly softer. In South Africa it was minus 5.5%. When we called out awhile back that we want to contain or limit the voice decline to below 5% that is more a broader target. So the second quarter I would rather attribute to basically a bit of softness which Shameel has described. And I think going forward we should be seeing in essence voice revenue at a relatively stable rate of decline and as I said below our internal target on below -5%.

Myuran Rajaratnam
And the reason? Is it just general macro softness or do you think it's actually the selling or more data? People are sticking to VoIP and WhatsApp calling and that kind of thing which are quite easy to use on your handset.

Till Streichert
No, minutes of use are kind of steady. It is a little bit a function of with the new tariff structure or tariff family that we've launched we equally had a little bit of an increase on some of the minute packages which in essence is in fact basically the voice revenue. but I would look at relative stability vis-à-vis the target range that we've called out and would not read too much into the -5.5% that we had in the second quarter.

Shameel Joosub
A little bit of pressure also from the contract using of financing which we have now stopped.

Myuran Rajaratnam
Right. The second question is looking at studies done by some of these comparison websites and also some of these analysts who cover your company it looks like Telkom's data rate on the mobile side there's a significant gap between them and the other three. They are lower by a significant margin across all the bundles, just generally looking. I mean one or two they might be different, but it looks like there is a gap. And the data strategy seems to be working there. So is that something the other three vendors ignore, or do you at some point in the future actually have to cut prices?

Shameel Joosub
I think when you look at our data prices also look at our effective rates because we are very focussed on bundle and bundle engagement. Remember we sell 1.1 billion bundles in the half, so 2.2 billion bundles minimum for the full year. So effective rates are important. And if you compare effective rates you will see our effective rate compared to Telkom is quite comparable. So that's the one part. Secondly I think where Telkom has been playing is in the fixed wireless replacement in

terms of not having to replace the copper lines and so on. Now, what we are doing is we are offering new packages in the bigger data bundle space. To put it into perspective, because we were reviewing it the other day, that full market is about 10,000 connections a month. Now, we will ensure that we're competitive in that space. But it would be more targeted where we have the capacity or where we know that we will have the ability to replace it with fibre going forward.

Myuran Rajaratnam
Right. And if I may just one last question. I was on the presentation, but on the webcast, and it was quite a bad line and I couldn't hear what the question on the BEE was. Now, the BEE according to my calculations it sounds like given that you have to actually accrete value to the BEE shareholders this time around a little bit more regularly, on an annual basis, it might seem a little bit more dilutive than the previous one. I just want to get a sense of that because it's an overhang on the current business if you like.

Shameel Joosub
Look, I think let's just be clear what our intention is, what we intend doing with BEE. So remember the last deal was done in 2007/2008 so effectively ten years hence we're now going to do another BEE deal. What we want to do is there's a lot of value that will be created in the current deal. And what we want to do is to make sure that we can get shareholders to reinvest that money into a new BEE deal so that we can get the equity contribution that comes from them into the new deal, and therefore minimise some of the costs associated with the BEE deal. But really the size of the deal and everything will be orchestrated around unlocking the value from the current deal and replacing that to ensure that we don't lose BEE points as such.

Myuran Rajaratnam
Okay. When we see it we will understand it a bit better. Thanks for taking my call.

Operator
Thank you very much. Ladies and gentlemen, a reminder, if you wish to ask a question please press star and then one. Our next question is from Mike Gresty of Citi. Please go ahead.

Mike Gresty
Good afternoon guys. Just a couple from my side. First of all the deal with Rain. You obviously made a few comment in the presentation this morning about that, one of which alluded to the possibility that the revenue side of this deal is not as apparent yet. And it really relates to the build out of towers. I think you mentioned something like a plan over the next couple of years to build something like 4,000 towers in this venture. Can you explain how the margin dynamics work there? Should we see on a car guard basis margin improving as you generate more rental revenue versus roaming costs? That's not very clear to me. And then the second question just relates to the post-paid side in South Africa where we saw quite a pleasing uptick in the number of subscribers added in the last quarter. And I was wondering if that was the government contract that Competition Commission are busy looking into. Is that the effect of that starting to come through? Because to date it has been actually quite slow as I understand it. So if you could just chat to that that would be helpful.

Till Streichert
Okay Mike. Let me start with the Rain question. Just again the structure of the deal is basically a site rollout commitment over a few years. We have got an income from a facility leasing agreement with Rain and from a service agreement. And in essence we pay for roaming capacity to them. Now, our income is obviously driven by the number of sites that get rolled out, and we are growing into that as we roll out those sites. On the roaming cost side we in essence pay for capacity on a kind of pay as you go basis. So that is basically on a sliding scale. And also as you can imagine with more

volume the efficiencies build into that agreement. But of course since we are buying something if you take the revenue line and the cost line on our side of course you are going to see a net outflow because we are buying capacity. That's pretty simple and straightforward. What is in essence difference is we will take that net outflow above the line since there is no depreciation and amortisation involved in it vis-à-vis a traditional or classic upfront investment with cash out and then amortisation charge. Now, the benefit that is obviously coming through is that it eases the spectrum pressure for us and gives us from capacity point of view a lot of road for the next couple of years. And obviously on the back of that you see our service revenue growth supported, effectively being able to be driven on that side. So it has got the financial mechanics of the deal as such and obviously as it gives us access to capacity on a pay as you go basis you're going to see service revenues reported by utilising the roaming capacities that we've got access to.

Mike Gresty
And just on the post-paid side in SA?

Shameel Joosub
Can you repeat your question?

Mike Gresty
I was just saying the last quarter we saw quite a nice uptick in net adds on the post-paid side and I was wondering whether that was chiefly the government contract starting to kick in. because it seems to have bene pretty slow to have had any meaningful impact on your subscriber momentum in previous quarters. So I was just wondering what lay behind the improved post-paid net adds.

Shameel Joosub
Your net increase is partly coming in from the public sector, but also I would say a recovery back to stronger growth. Because remember in the first quarter we had the issue of the lag over of the postponement of the churn programme that we brought in where we were delaying some of the churn to give people a chance to recover. That affected the first quarter numbers. And then basically in the second quarter you recover back to normalised growth trends, where we are still doing very well in terms of acquisitions. Also remember this is what is impacting some of your numbers in the half because we did invest a little bit more in A&R in the first half on purpose to try and get more customers on board quicker. And that did affect obviously your EBIT or EBITDA growth in the first half as well. And that we balance out during the full year.

Mike Gresty
Got it. Thank you very much.

Operator
Thank you very much. Our net question is from Richard Majoor of Macquarie. Please go ahead.

Richard Majoor
Good afternoon gentlemen. Two questions please. The first one I see now that you've stripped out your fixed line from your other service revenue it's evident you're getting healthy year on year nearly 20% growth in other service revenue. Do you think that is going to continue? Is that driven by the Cell C roaming on Vodacom's network or are there other factors driving that? The second question, is there any progress or update on Vodacom's on demand content video strategy? Thank you.

Till Streichert
Okay. Let me deal with the other service revenue question first. Look, we've seen pleasing developments on the growth rate. Within there you've got the classic bulk sale of messaging. We've

got our machine to machine IOT business in there which is growing at 22%. We've got advertising revenue in there which is growing nicely. And we've got as well mobile voice sale revenue in. Those lines we've seen over the past few quarters quite healthy and positive development. So I would imagine that we see basically that growth somewhat being continued.

Shameel Joosub
I think on the TV platform and so on, the content part and the partnerships are going quite strongly with Facebook and Google and so on. So we've got very strong partnerships. You will see the free data for Facebook being one of them. So I think that's part of it. But also our video platform is doing nicely. The music services and so on are also doing well. The full video platform will be launched towards the end of the financial year.

Richard Majoor
Thanks very much, Shameel.

Shameel Joosub
And cloud and hosting continues to grow strongly as well. And I think we see a lot of success in the cloud and hosting space.

Richard Majoor
Great.

Operator
Thank you very much. Are those all your questions, Richard?

Richard Majoor
Yes thank you.

Operator
Thank you very much. Ladies and gentlemen, a final reminder, if you wish to ask a question please press star and then one now. Sir, we have no further questions in the queue. Do you have any closing comments?

Shameel Joosub
No I think that's it. I think we're looking forward to a stronger second half, but we're pleased with the results thus far.

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

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