Conference call transcript

23 November 2022

INTERIM RESULTS INTERNATIONAL ANALYST CALL

Operator
Good day ladies and gentlemen, and welcome to the Telkom interim results international analyst call. All participants will be in listen only mode. There will be an opportunity to ask questions later during the conference. If you should need assistance during the call, please signal for an operator by pressing * and then 0. Please note that this call is being recorded. I'd now like to turn the conference over to Mr. Serame Taukobong. Please go ahead, sir.

Serame Taukobong
Thank you kindly, madam. Good afternoon, everyone. Good morning to those in the US. With me I have our group CFO, Dirk Reyneke, and our new Head of Investor Relations team, Nondyebo Mqulwana, and Kamohelo Selepe from the investor relations team. I would like to unpack our interim results performance as follows. Firstly, I will start by unpacking the drivers behind the business performance that we witnessed in the first six months. Dirk will then unpack the financial performance. I will come back to conclude with our strategy and operational outlook.

This period was characterised by strained economic conditions placing consumer under pressure and an intensely competitive landscape. Group performance suffered under a sluggish economy, the increasing electricity and fuel prices, rising interest rate cycle and high unemployment which constrained and impacted levels of consumer spending. Accelerated load shedding in this period also impacted our performance and our costs. As competition intensified in the mobile sector, we continued to innovate to protect Telkom's value proposition in the market. We saw good growth in our mobile subscriber base, sustained the growth trajectory in the fibre market as corporates reviewed spending on their IT information infrastructure. We continued to pursue our migration strategy and continue to manage the transition from old to new technologies. However, this migration impacted on our revenue growth and overall profitability.

Just looking at some group salient features at a high level. Group revenue was stable at R21.2 billion. We have seen good revenue growth from newer technologies, and today the majority of our revenue comes from our NGN next generation networks. NGN revenues, however, are at lower margins and have impacted overall profitability. Our EBITDA reduced by 17.3% to R4.9 billion. Load shedding put further pressure on margins as our diesel costs alone increased by 154% over the period. This has impacted our cost base over the period. Dirk will provide more details on our thinking around the management of these costs.

Turning our attention to the business performance, I will now unpack how new technologies are driving growth. In Telkom Consumer, we've seen very good growth in broadband at both wholesale and retail level. Our data led strategy is delivering in the mobile business. The mobile customer base grew by 10.9% to over 18 million subscribers with a blended ARPU of R88 supported by growth of both post-paid and prepaid subscribers. Mobile broadband subscribers now represents 61.2% of our total base. This growth has also been supported by high data growth traffic of 14.1% to 550 petabytes. A bit later, Dirk will talk about how we are working to change the mix between prepaid and post-paid subscribers to drive higher levels of annuity revenue from mobile broadband subscribers.

At Openserve we see the same trends proceeding. We're expanding our fibre to the home footprint while focusing on connecting premises simultaneously. Homes passed have increased by 35.8% to 961,000, while homes connected have increased by 33.7%. This has ensured that we lead with the highest connectivity rate in the country at 46.2% versus the national average ranging between 33% and 36%. Today 73% of our fixed line broadband customers are on next generation technologies, being fibre access. Our hosting and provisioning of landing facilities and the ownership of a fibre pair in the Google Equinor cable system supports our ambition by increasing our capacity by more than 10 times.

From an IT perspective we're encouraged under BCX by the improvement in the IT market. Progress on strategic programmes has resulted in healthy groups in our total IT business. Our agreement with Alibaba Cloud signed over the past couple of months is part of our plan to boost our IT business. In our masts and towers business for Swiftnet, we have increased our productive capital to 3,945 towers with 26 new towers and five in-build solutions over the period. We have a healthy pipeline of permitting over 2,000 sites. I will now hand over to Dirk to take you through the group numbers in more detail.

Dirk Reyneke

Thank you, Serame, and hello everybody. If you look at the group salient numbers, group service revenue under pressure with group revenue declining marginally by 0.7%. EBITDA was impacted by higher handset costs and operating expenses. EBITDA was lower at R4.9 billion with EBITDA margin contracting by 4.7% to 23.4%. That all culminates in earnings declining significantly, headline endings as well as basic earnings per share down 51.9% and 52.5% respectively. We continue to invest in capex. Capex allocation is still in the favour of growth areas with capex increasing 2.2%. All the above had an effect of increasing at net debt to EBITDA level as we had to fund strategic capital requirements with free cash flow under pressure and negative free cash flow R1.9 billion, due mainly to the impact of prepaid post-paid mix and operating free cash flow.

If I go into all of these independently, the group service revenue declined. I have referred to the 0.7% driven by a decrease in legacy fixed voice and data as customers migrate to new technologies such as fibre and LTE. The mobile growth was a supported by an increase in NGN offerings in mobile and our IT business which recorded growth of 2.3% and 16.5% respectively. Important to note that these NGN sales are lower margins. And therefore, to replace the business lost as a result of our legacy exit remains a challenge. Our strategy of repositioning the prepaid post-paid mix in the mobile business impacted revenue and free cash flow negatively. But this was intentional. This was offset by reduced acquisition costs and higher lifetime value of customers. I think in short people are aware of the IFRS 15 impact there. You sell contract debtors, and you have to defer the revenue over the periods of the contract while you recognise the costs upfront.

EBITDA was impacted by higher handset costs. Group EBITDA margin contracted by 4.7%. And that's attributable to a 31.4% increase in cost of handsets, equipment, software and directories following the strategy to move from prepaid to post-paid. Opex increased by 5% year on year, despite an average groupwide salary increase of 6%. And therefore, we believe that the 5% well below inflation or CPI of 7.8% is actually a good story. Included in this opex there are specific out of our control expenses such as diesel as a result of the current electricity shutdowns. The diesel costs for H1 was 50% more than our diesel cost for H1 in the previous year. We've optimised our roaming costs further. It contributed to an improved cost to serve in the mobile space as we maintain stringent roaming traffic thresholds and migrate traffic to our network where possible.

I think important to say what are the cost initiatives that we are currently driving. We will certainly further reduce costs in the direct cost space. And there we think of the roaming cost, a further full year benefit of the second roaming agreement with MTN for the first time. Further in the direct cost we looked at channel optimisation. We need to move our bricks and mortar channel ownership model to a more franchise model and a more automated virtual channel model. And then we will address the legacy cost base on all lines. So, as we move from legacy technology to next generation technology, clearly should have an impact on all lines including staff, maintenance, etc. So, I think cost remains a topic very high on our agenda. And we will certainly prioritise that to get our cost to revenue ratio back to the acceptable levels of 74% to 75% rather than the 78.7% where we ended this half.

If you look at capital allocation, as I said, in favour of growth areas. We continue to invest in the growth areas, mainly fibre and mobile. The capital investments for the period increased by 2.2%. And we are projecting a capex to revenue ratio of 74%. You will know the swing in capex between fibre and mobile. By and large that was caused by the spectrum cost where we bought spectrum in March and that was only capitalised in the first quarter of the current year. Secondly, it's driven by the fibre to the home rollout where we have increased fibre to the home, at reporting date just below a million homes passed. As we speak, we’re probably have over a million. It increased by 35%. We've increased our homes connected ratio by 34%. And we maintained an active fibre connectivity ratio of 46.2%, which in any benchmark, I think is a really good number.

If we then move across to the balance sheet, we saw the net debt to EBITDA moving up to 1.7x from the 1.2x. I think in recent history, that's probably the highest it's been for a while. We still believe that that's within acceptable limits. It is by and large to fund the R1 billion operating profit shortfall, as well as the R700 million to R800 million investment in working capital. We believe that will improve by year end. We will probably not get back to the 1.2x, but we are certainly of the opinion that 1.7x should improve before year end. And then lastly, in terms of the cash flow, we generated negative free cash flow of R1.9 billion, way below the comparative period. Cash generated from operations decreased by R1.7 billion primarily due to the R1 billion decline in profit and the R816 million deterioration in cash calculations. And the cash collections refer to the to the investment in working capital that I've just mentioned. That relates to the deferment of revenue on both handsets and debtors of 24 to 36 months as a result of IFRS 15.

The free cash flow was partly offset by an increase in handset sales, where we have taken R730 million of handset sales off balance sheet. We expect to invest in our business with capex to revenue ratio of between 16% to 18% for the year. Returning to shareholders remains a key element of our capital allocation framework. And as you know, we have suspended dividend policy three years ago. We will reintroduce a dividend policy when we announce our results at year end, March 2023. We aim to continue to create value and generate positive free cash flow to reward the shareholders in the medium term once our working capital cycle stabilises in line with the new demand patterns and evolving customer requirements. I thank you and hand back to Serame to give an update on our strategy and a bit of outlook forward. Thank you, Serame.

Serame Taukobong

Thank you, Dirk. Looking forward, our key theme is to accelerate NGN growth and manage costs. We do expect similar macro-economic and market conditions in the second half of the financial year. We will drive growth in our fundamentals. All business units are focused on driving revenue growth, cost reduction, and also managing our cost base. On the consumer side, it's about driving the continued mobile broadband growth, optimising the prepaid post-paid mix, cost saving initiatives to manage our cost base. As the rollout of fibre in Openserve continues, we expect to see continued growth in broadband, stronger demand for backhaul especially in the carrier and enterprise segments. Equally driving cost-based management and cost savings initiatives, including the decommissioning of legacy assets, rollouts of alternative power sources to mitigate the impact of a load shedding on our sites. We are also looking to optimise reducing the reliance on diesel and enable smart building capabilities at our properties to reduce cost of utilities.

BCX is expected to see sustained growth in the IT business. Product sales will be a key driver with the focus on improving mix to drive both revenue and margin growth, and equally a continued focus on cost management in BCX. In Swiftnet, we'll see performance of H2 similar to H1. The decommissioning of sites and terminations by customers, particularly one MNO, will result in growth decline from these customers. However, we are continuing with our new towers and in-building solutions in order to have a competitive pipeline ahead of H2. As operators modify their network and network equipment, lease renewals and increased tenancies will drive revenue. Gross margins remain steady for this business.

At group level, we are fortifying our organisational structure to drive focus on execution and the delivery of our strategy. In addition, we have geared ourselves up for 5G. We really believe that we are ready for 5G, and each business unit will be focusing on their 5G initiatives. On the 27th of October 2022, Telkom Mobile switched on its 5G network with 136 active 5G sites across four provinces. We are now over 160 of these active sites. Our 5G rollout is based on locations with high data demands, as well as other criteria such as affordability, using our current LTE ecosystem as an indicator. Telkom Mobile's immediate focus is on providing fixed wireless access solutions.

Openserve is best placed to support 5G network rollouts by all MNOs and other customers. While other means are available to facilitate 5G connectivity, in order to fully enjoy the full experience 5G promises, fibre backhaul is the backbone that connects 5G sites and thereby deliver high speed connectivity with a low latency. We feel that Openserve is strongly geared for this. BCX is co-investing with mobile in rolling out 5G sites to deliver its converged communications and IT businesses in the future. BCX will be focused on developing smart solutions for enterprise customers, including sector focused solutions for localised private use. BCX will also invest in R&D to bring its own IP and skill sets into the market, as well as also introducing its own 5G products. In pursuit of the group's 5G strategy, Swiftnet successfully launched its first 5G outdoor distribution antenna system in small sites. These sites form the basis for future site development in support of MNOs’ 5G rollout plans.

To close, our strategic priorities. We remain focused on driving costs on our core business and capitalising our strengths. We remain steady and are making good progress in our broadband leadership ambitions. Our revenue is still challenged as we manage the migration from legacy to next generation technologies. In order to deliver a sustainable future growth, we will use adjacencies to support growth. I will now share a bit more colour in terms of these strategic initiatives in the pursuit of unlocking our value unlock strategy. We do believe that the share price does not reflect the intrinsic value. However, we are starting this journey in ensuring that we execute the realisation of this value.

In Openserve on the 1st of September, we completed the structural separation of Openserve. As of our broadband strategy, Openserve is using its capacity and scale to drive growth by expanding on existing opportunities, such as commercialisation and monetisation of dark fibre, and also taking opportunities in emerging niche markets, such as supplying backhaul to smaller fibre providers. In Consumer, we believe that investment in IT will support the legacy migration process, helping us to reduce the costs associated with the management of the legacy business. In BCX, we are continuing opportunities in IT high growth areas, such as cyber security advisory services. In Swiftnet, we are continuing to review ideal partnership options for this business that will enable us to realise value. Lastly, Gyro is important to drive efficiencies for the group. And here we are looking at property development partners to help us realise value in legacy assets.

In summary, therefore, as we conclude, we are confident that our strategy and we will continue to invest in future data led technologies. We will continue to look at offsetting the negative impacts of legacy revenues by replacing them with NGN. We are keeping a very close eye on our cost base and have plans in place to draw back some margin. We are utilising our network ecosystem to build the capabilities. We are pushing and driving value unlock to gain momentum. We are looking at ways to affirm and realise value in the masts and towers business. The separation of Openserve serves to open up opportunities to affirm the value of Telkom. We continue to support and accelerate core businesses with partnerships. Furthermore, we are fortifying our organisational structure to drive focus on execution and the delivery of our strategy by reorganising ourselves with our products, services and a passion for execution. I will now hand over to the operator for any questions. Thank you.

Operator

Thank you very much. Ladies and gentlemen, if you would like to ask a question, please press * and then 1 on your touchtone phone or on the keypad on your screen. If you decide to withdraw the question, please press * and then 2 to remove yourself from the list. Again, if you would like to ask a question, please press * and then 1. We will pause to see if we have questions. The first question comes from Vik Sharma from RMB Morgan Stanley. Please proceed with your question, Vik.

Vikhyat Sharma

Hi, guys. Thanks for the opportunity to ask questions. I think my question relates to you obviously talk about building a data enabled network, and yet the mobile data obviously didn't do as well. There was a bit of a decline there. Just to figure out the reason. Was it the competitors who declined the price, so the price premium was out of whack? Where is that price discount relative to the competitors right now? And going forward, do you think your pricing rationalisation is enough? Because I saw the growth in the mobile broadband side was positive, and yet the revenue declined. So, going forward, is there further rationalisation that needs to happen on that pricing of data, or do you feel comfortable in terms of a level has been reached that possibly from here you won't be declining or competing with the other competitors going forward?

Dirk Reyneke

I think, let me try that, and then Serame can help me. I think if you're referring to the revenue, I think two things. First of all, when you look at overall revenue, and we look at data combined, you will note that the legacy, the traditional fixed data volumes has gone down by 11%. But your new fixed data products have gone up by 5%. If you then say, where's the legacy that's gone down? It's mostly on the managed data network services. And that's in the SMB space as well as the BCX space. But we think in terms of the NGN, in other words, your data connectivity, that will continue to grow. So, we are comfortable that as long as we monetise our fibre roll out, in other words, keep to the 46% to 50% penetration of inventory that we have built, the data growth should continue.

Serame Taukobong

I think just to add further, if we look at the mobile revenue, it was a tale of two quarters. We've managed to claw back in Q2 from a negative 3.6 to remaining flat for the entire H1. So, I think the trajectory is on right way. With pricing I think we've seen now where the other operators have landed on their pricing. We still believe that we have enough headroom to ensure that we remain competitive. We've seen this and how it responded with our post-paid tariff plans, having seen what the market activity was doing. And it has reflected in the growth of our post-paid base. So, we do feel that from a pricing perspective, mobile can still remain competitive in the market. I hope that covers you there.

Vikhyat Sharma

Thank you.

Operator

Vik, do you have any further questions?

Vikhyat Sharma

No. Thank you.

Operator

Thank you so much. The next question comes from Wessel Joubert from Oystercatcher Investment. Please proceed with your question, Wessel.

Wessel Joubert

Thank you for the opportunity. I've got two questions or three questions actually. Just on the collection on the handsets, do you guys expect to see any deterioration on handsets, or how well do you expect that collection to go? That's the first question. The second one is, you guys are talking about getting back to the dividend policy. Looking at free cash flow and your expectations of it, how do you line those two up or what would you expect to put forward to not be overly generous with the dividends? And then, if possible, what percentage of the costs relate to the legacy businesses that you guys are now closing down? Thank you.

Dirk Reyneke

Wessel, let me try that. So, first of all, in terms of collections of the handsets, we've done a detailed exercise. So, I justify that on three bases. So, first of all, we are selling off the mature handset contract debtors book. So, once it's over six months in terms of tenure, we try and sell it off to the banks. We've done tranches last year, and we've done R600 million to R700 million this year. And the banks are comfortable that the credit experience that they're getting from that end of the book is outperforming their expectation. And that's why there's appetite to buy further. And as the books mature, we will probably do another tranche of R500 million to R600 million before year end. That’s the one thing.

The second thing, if you look at our days outstanding, if I look at zero to 90 days, and even up to 120 days, it ran at 64% to 65% if I looked at the last four halves. So, we don't see a significant deterioration in terms of days outstanding at the top end. And the third, and I think this is important, the scientific forward looking IFRS 9 modelling that's done. We do our modelling and then our external auditors do their own modelling. They don’t audit my model. They take our data and they put it in their models. They calculate a number in the forward looking expected loss. And suffice to say that the variance between mine and their model are very close. Well within the materiality levels. So, I think from a debtors quality perspective, there is no reason to be concerned.

If I understand your second question right, it is to say free cash flow versus dividends. So, let's start with free cash flow. R1.9 billion negative free cash flow for the year. I think I said it this morning. We will certainly anticipate that that should improve. Will we get to positive free cash flow in the current year? Probably not. So, I cannot see while we are investing in fibre and while we are investing in working capital to fund the post-paid prepaid mix change, that we will get into positive free cash flow territory in the current year, although the half year number should improve. And that then links to dividend. We've been consistent in our message that we suspended our dividend policy three years ago. We will re-introduce the dividend policy when we announce our year end results, our March 2023 results. That dividend policy will probably be linked to cash flow. Given that you’re a negative cash flow forecast for the year, although you reinstitute a dividend policy, it doesn't automatically end into a dividend declaration.

The one the one outstanding or the one thing there that can change the game is any proceeds from a value unlock is currently excluded from my cash flow forecast that I'm giving you. I hasten to say that the value unlock proceeds will not trigger a special dividend. So, when we get that money in, the market mustn’t expect a special dividend. We will use that money to first of all change the gearing of the balance sheet. Secondly, continue to invest in capex in the strategic growth areas. And the residual will fall into the free cash flow bucket which will then be considered when you look at the dividend declaration.

I think the last point is the percentage of costs relating to revenue. It’s probably the most difficult of all the answers. On the revenue side, it's very clear that between fixed voice and line rental and traditional fixed data products, roughly R4 billion of revenue. If you said to me, what is the cost directly related to that, I'm guessing a number. But it's below R1 billion. And why do I say that? Those are high margin products. The infrastructure that drives that cost is repurposed. So, if you take the ducting as an example, we now are running fibre through the copper ducting. When we stop copper, the ducting will not be trenched out of the ground and that cost will not go away. We've got a man in the van servicing copper customers. He's currently also servicing fibre customers. So, we are retraining, reskilling and repurposing a lot of the legacy costs.

So, one mustn’t think it's a one on one level. I think bear with us. We have said by year end we will let you have ROIC pro formas based on technology. That will show you clearly what the average income versus average asset investment is for the different technologies, being NGN, mobile, IT and legacy. I’ve seen those numbers for half year. We will present them at year end. And then it will become clearer. But to split the costs directly attributable to legacy is probably the single most complicated exercise on our income statement. I hope that helps.

Wessel Joubert

It helps a lot. Thank you very much.

Operator

Thank you. Ladies and gentlemen, just another reminder, if you'd like to ask a question, please press * then 1. The next question comes from Madhvendra Singh from HSBC. Please proceed with your question, Madhvendra.

Madhvendra Singh

Yes, hi. Thanks for taking my question. Just one question actually on your mobile network. If you could share what percentage of traffic is currently on roaming on the other mobile operators and what percentage is carried on your own network? Thank you.

Serame Taukobong

Okay, I think given the nature of those contracts, we generally don't disclose those numbers.

Madhvendra Singh

Thank you. Yeah, okay. I was just wondering how much of the traffic actually is carried on your own network in a sense that if you are growing your revenues, and if more traffic is carried on your own network, then there will be a link to margin improvement or scope to improve margin that way.

Serame Taukobong

Yes, let me try and answer that differently without going into contractual breaches. If you look at when we did the first roaming agreement, I think it was in 2018 when I joined, roaming cost as a percentage of revenue was sitting at 19%. If we look at where we are right now, that cost is down to less than 10%. I think about 9.1%. So, that gives you a flavour that more and more of our traffic we are keeping on our network. Thus, as highlighted, that continuous investment in mobile to mitigate the increasing cost of roaming both from load shedding, as well as ensuring that we drive more efficiencies. So, roaming is one of our big cost initiatives. I hope that answers you better, Madhvendra.

Madhvendra Singh

That does help. So, actually, that does take me to the second question. In terms of regulatory framework, you are probably one of the big wholesale backhaul data capacity providers to the entire telecom sector in South Africa probably. So, in terms of regulatory framework, is it possible for you to increase pricing on those in a significant way given high inflation rate and so on? Is that a possibility for you? And would you be looking to do something on that side?

Serame Taukobong

So, I think if you look at that, Openserve is an open access network provider. We do provide backhaul. Actually, the biggest customers for Openserve is Vodacom, MTN, then Telkom Mobile. So, the key thing there is making sure that [break in audio] of that market, and not necessarily drive costs up. Did my answer come through?

Dirk Reyneke

No, Serame. We lost you. Can you just repeat it?

Serame Taukobong

Sorry. So, what I was saying to you is if you look at Openserve, the biggest driver of Openserve traffic is actually the traffic that they provide for backhaul for the MNOs, their customers being Vodacom, MTN and Telkom Mobile. The key thing for us is making sure that our share of this market increases to provide longer tenure higher value propositions.

Madhvendra Singh

Okay. All right. Thank you.

Operator

Thank you. Mr Taukobong, at this time, we have no further questions in the queue. If I may hand over to you for closing remarks.

Serame Taukobong

Thank you very much, Claudia. And thank you very much, everybody, for listening. I think in essence, we are confident that our strategy of investing in future data-led technologies will bear fruit. We are continuously managing the impact of the decline in legacy revenue by offsetting this with NGN. As I said, we are also speeding up our value unlock propositions to make sure that you can execute these, and we'll make an announcement certainly by the year end of certain high roads that we have made in this regard. Furthermore, as I said, we are fortifying our organisational structure to drive focus on execution and delivery of our strategy by reorganising ourselves with our products and services, and a strong passion and focus on execution. I thank you kindly.

Operator

Thank you very much, sir. Ladies and gentlemen, that does conclude today's teleconference. Thank you for joining us and you may now disconnect your lines.

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