

Conference call transcript

24 May 2021

ANNUAL RESULTS

Operator

Good day ladies and gentlemen and welcome to the Telkom SA Ltd annual results analyst conference. All participants are currently in listen only mode and there will be an opportunity to ask questions later during the conference. If you should need assistance during the call, please signal an operator by pressing * and then 0. Also note that this event is being recorded. I would now like to turn the conference over to Mr Siphon Maseko. Please go ahead, sir.

Siphon Maseko

Thank you very much, Chris, and welcome to everybody. Good afternoon. And to those that are in the US, good morning. With me here I have our Group CFO, Dirk Reyneke, and the Investor Relations team. I would then want to start by unpacking our annual results performance in the following manner. I will start by unpacking the operating landscape, the key strategic themes underlying the performance, and the impact on our business. Dirk will then unpack the financial year-end performance and how we are building financial resilience in this environment. I will then come back and provide feedback on the three value unlock initiatives and then also conclude by discussing the outlook.

I'm very pleased that we have completed the year with improved profitability, robust earnings, very strong liquidity and a strengthened balance sheet in a very challenging operating landscape. As you may well have known, the weak economy was complicated by the COVID-19 pandemic which then impacted spending. The individuals' disposable income was under pressure and corporates responded by also delaying and deferring their project spend, which impacted on some areas of our business. On the competitive environment side the landscape in competition was intensified as promotions and pricing became a tool for some of our competitors to attract and retain customers. And also during the national state of disaster the importance of being equipped to work and learn from home was elevated, leading to sector innovation.

Then on the regulatory side the delay in the spectrum auctioning process due to the non-availability for use of especially the low band frequencies and the process in totality to date has been very disappointing. We believe that the allocation needs to promote competition and not to entrench the current duopolistic structure and be informed by prevailing market conditions. And then on the business continuity side we saw that our purpose as a company, seamlessly connecting South Africans to a better life, came alive as telecoms was declared an essential service, enabling us to continue servicing our customers. Despite the fact that the physical world was shut down for most of the period in the last financial year, we could keep the digital world open and enable that existence to continue and support our wide stakeholder base.

Looking at the strategic themes that underlie the performance this year, when I joined Telkom back in 2013 we set out to transform the business from being a legacy fixed voice business to a data-led, fibre-enabled provider of converged services. And the performance of this year under review demonstrates the success of our evolution from a business that was legacy voice dominated that is now reflected in the operating metrics and the financial results that we shared this morning. Our

key objective was to de-risk our fixed voice business, scale our mobile business and remunerate our asset base by maximising returns on our capital investments. The successful execution of this strategic intent is visible now as more than 65% of group revenues today represent revenues from next generation products and services. Our mobile business continues to go from strength to strength with another stellar performance in this year. The mobile subscribers now exceed 15 million and we are now firmly the third largest operator in the country.

We are also pleased with our progress of monetising and remunerating our asset base as we set out to convert the last mile connectivity underpinned by world-class fibre transport and access networks. Our homes passed has a pleasing connectivity rate now of 51%. When it comes to our backbone fibre network and mobile infrastructure these provide a solid and scalable base to provide a converged fixed and mobile service offering as we build and further enhance our broadband leadership. We are the only ones who have an all IP network on the fixed side and an all IP network on the mobile side. We witnessed also at the same time very good revenue growth in our mast and towers portfolio.

Our successful transformation of the business with capex spend in the right areas has seen us deliver a solid financial performance in a very challenging environment. I will share some highlights and Dirk will unpack these later on. Our top line growth was very resilient in the face of the pandemic. Improved profitability was underpinned by our growth in mobile business and our sustainable cost management efforts. Robust earnings growth, double digit growth in EPS and HEPS. Strong cash generation. Our cash preservation efforts continue to deliver great benefits with free cash low significantly improving from prior year, and we have de-risked our balance sheet. Our underlying net debt to EBITDA has improved from prior year.

Telkom Business continued with its growth trajectory and the pandemic was also very positive for our consumer business. The mobile business benefitted by an ever-increasing demand for connectivity by consumers working and learning from home. We saw massive mobile data usage and a strong overall demand for mobile connectivity due to innovative high-speed broadband products at attractive price points underpinned by the expansion of our 4G and 4.5G network. We saw 27.8% growth in the subscriber base to 15.3 million subscribers and with the blended ARPU increasing by 15% to R104. Our pre-paid base is now in excess of 12 million, growing by 35% for the year with pre-paid ARPU increases of around 17.5%.

The mobile business delivered year to date service revenue growth of 34.5%, an increase of over R4.3 billion year on year. Year to date mobile EBITDA almost doubled, growing by more than R2.7 billion to R5.6 billion, and our EBITDA margin expanded by almost 10 basis points to 27.9%. Data continues to deliver aggressive growth. We saw a 25.6% increase in the broadband base to 10.3 million subscribers, of which about 8.7 million are smartphone users. This growth emanates from an ever-increasing demand for broadband by consumers working and learning from home, which actually got us to see about 53% growth in mobile broadband traffic. So, huge revenue growth, and our revenue grew 41% to over R12 billion.

BCX was negatively impacted by COVID-19 as the lockdown took hold and the work from home response impacted fixed voice revenues from enterprise customers. IT revenue also came under pressure as corporates deferred capital expenditure and delayed projects given the increasing levels of uncertainty. The slight economic recovery seen in the latter part of the year resulted in some latent growth coming through. The BCX response to a very challenging environment was cost containment and cash preservation. You can't control if customers come through the door. However, what you have absolute control over are your costs and how you manage your cash. Despite the decline in revenue, EBITDA is up 6.6% largely driven by cost efficiencies. EBITDA margins are up from 13.2% to 15.7%. And direct costs and opex declined by 12.1% and 12.7% respectively. BCX also concluded the Section 189 process in March 2021 resulting in their staff complement declining by about 6%.

Openserve, our investment in the network enabled us to carry a 28% increase in the fixed broadband traffic to about 1,428 petabytes. This was achieved even with an overall broadband access connection reduction of 15.3% as average monthly data usage per subscriber increased with 67% compared with the same period for the previous year. While overall we have seen a decline on the copper based broadband ecosystem, data-led products such as Pure Connect or Naked DSL have shown the need for affordable data using all technologies is still very relevant.

We continue to focus on connecting customers to our FTTH network and increased the number of homes connected with a connectivity rate of 51%. We have been working hard with our partners and have reduced our overall cost to connect FTTH by approximately 50%. Our drive to connect business customers to our Ethernet based network saw 15% increase in connections. We also increased fibre to the base station by about 10%, which is a significant enabler for 5G and for fixed broadband traffic. However, whilst we saw an increased need for data in the period, fixed voice usage continued to decline, and thus Openserve performance remains under pressure. The pressure on the Openserve performance trends witnessed in the first half of the year continued in the second half with year to date revenue down 10.9% to about R13.4 billion.

As for Gyro, the Gyro operations adapted to and navigated the uncertainties and the realities of operating in the COVID-19 environment. They optimised the M&T portfolio, commercialised the property portfolio and also drove the process of enhancing our buildings' operating efficiencies. Masts and towers continue to grow by commercialising existing towers and executing on new build pipeline. The revenue increased by about 6.6% to R1.2 billion supported by an 8% growth in the number of new leases. The environment has presented us with an opportunity to further rationalise on property operating costs and consolidate office space as employees are working from home. I will now hand over to Dirk who will further unpack our numbers.

Dirk Reyneke

Thank you, Siphon, and good afternoon everybody. Before I unpack the salient features of our financial results, it should be noted that the published prior period results were restated with the cost of third party services in BCX of R68 million. The current results are therefore measured against the restated prior period numbers. Siphon has referred to the group financial highlights. Just a little bit more detail in terms of resilient group revenues underpinned by strong mobile revenue growth, with a growth of 0.4%, EBITDA growth of 11.7%, and EBITDA margin expansion of 2.8%, mostly supported by our ongoing focus on cost reduction, the surge in headline earnings per share of 53.4%, strong cash generation, a positive reported free cash flow of R2.1 billion – which is 15.8% year on year improvement – and then we've de-risked the balance sheet and strengthened the balance sheet. The reported net debt to EBITDA ratio post IFRS is at 0.9x versus 1.3x in the previous financial year.

If we unpack these highlights further, in terms of group revenue supported by the growth in mobile the overall top line demonstrated resilience in the face of the pandemic, as I said up 4% to R43.2 billion. Our revenue streams were impacted in different ways by COVID-19 during the year, whereas mobile service revenue grew 34.5% underpinned by a surge in data traffic growth of 53.2% with subscriptions growing to over 15 million in the mobile space. This was largely due to an increase in people working from home, online schooling and ongoing investment in our mobile network.

Similar to what we indicated in H1, most enterprises remained under severe financial pressure as a result of the national lockdown. We saw enterprise customers reducing or deferring their spend on IT resulting in a 12.7% drop in IT revenue. Migration to work from home impacted the enterprise fixed business as fixed usage diverted to mobile connectivity, leading to a significant drop in fixed voice revenue. You will note that our fixed voice revenue declined by 25% compared to 22% in the previous financial year, but it's important to note that legacy fixed voice revenue now only constitutes 15% of our total revenue base. Legacy fixed data continued to decline as we migrate customers to the next generation network. As a result we saw an increase of 30.8% in new fixed data revenue.

On the real estate side we continued to commercialise our current mast and tower portfolio in Gyro, and the Gyro revenue increased by 5.7% to R688 million despite the slowdown in permitting and construction process due to the national lockdown. We refer to the solid EBITDA growth underpinned by sustainable cost management, EBITDA growth of 11.7% year on year to almost R12 billion with an EBITDA margin expansion of 2.8% to 27.7%. The cost management programme served as a catalyst for the falling annual direct cost to revenue ratio from 48.2% in the prior year to 39.1% in the current year.

During the earlier part of the year whilst in the grip of the national lockdown our mobile cost of handsets and equipment slowed down. The purposeful relook at our distribution channels and partnerships further contributed to the direct cost optimisation. Overall the total cost to revenue ratio was optimised from 76.8% in the prior year to 73.8% mainly due to benefits realised from our restructuring programme, sustainable cost management and a significant improvement in mobile profitability contributing positively to the overall group.

Earnings per share and headline earnings per share were driven by operational growth. Headline earnings per share increased 53.4% to 561.5 cents per share, while basic earnings per share increased 89.6% to 529.1 cents per share. The higher profit is mostly attributable to the 11.7% increase in EBITDA driven by growth in our mobile business and relentless focus on our sustainable cost management programme. We refer to the sustained free cash flow generation despite the acceleration of capex for growth. Free cash flow improved by 15.7% to just over R2 billion from the prior year R1.7 billion. This improvement was driven by the 20.9% growth in cash generated from operations excluding the payment of the VSP costs. This was mostly driven by the mobile business and cash release initiatives of approximately R1.2 billion.

We have de-risked the balance sheet. A conservative funding approach enabled us to report a healthy cash balance in excess of R5 billion as at the end of March. We de-risked the balance sheet by repaying net loans of R1.1 billion. This resulted in our reported net debt to EBITDA ratio improving to 0.9x from 1.3x in the prior year.

That concludes the current year results. If we then look at what to expect in the mid-term, we're giving a three year guidance. Given the uncertain economic environment which we expect to continue in the next few years, we have a renewed focus on our sustainable financial framework. The sustainable framework focusses on growing revenues, specifically growing our new revenue streams e.g. mobile and data broadband, improved profitability underpinned by our sustainable cost management programme to contain opex below inflation and optimise our direct cost, and free cash flow generation. We are intent on improving our free cash flow. Cash preservation will continue to be key as we navigate the unprecedented challenging environment. Thus we will continue to drive working capital optimisation and handset receivables financing. With regards to disciplined capex allocation we will continue to drive maximum operational and capital productivity and ensure capex investments give us maximum returns.

Underpinned by our sustainable financial framework our new medium-term guidance seeks to ensure we grow our new revenue streams, improve profitability and maximise our capex returns. We strongly believe that we are well positioned to deliver a solid performance over the next three years and therefore in terms of quantitative numbers the guidance in terms of revenue is mid to high single-digit growth. EBITDA we expect mid to high single-digit growth. Capex we think will stabilise and remain at similar levels of currently the R8 billion to R8.5 billion, and all that while we maintain the net debt to EBITDA ratio at below 1x.

In conclusion I think it's important following the suspension of the dividend policy for three years last year that management reviewed its capital allocation framework which seeks to maximise returns on capital investment, maintain a healthy balance sheet and generate strong free cash flow. After two years of strong free cash flow generation we believe that Telkom is generating sustainable free cash flow. We have sufficiently de-risked the balance sheet and we have adequate capacity to fund the strategic capital investment programme. Therefore notwithstanding the uncertainty regarding spectrum and COVID management believes that Telkom is in the position to reconsider the suspension of the dividend policy ahead of the time that was previously communicated. The dividend policy is in the process of being reviewed and a new dividend policy will be communicated on the release of the FY2022 interim results in November 2021. I will now hand back to Siphon to take you through the value unlock strategy and conclude with an update on our outlook. Thanks Siphon.

Siphon Maseko

Thank you very much, Dirk. Just moving on to the value unlock strategy, we remain very committed in this strategy of unlocking value from our portfolio of businesses. It is a very key component of our capital allocation framework and will afford management flexibility to rebase the balance sheet amongst other things. The masts and towers in Gyro we

successfully completed the market sounding exercise. The take-away from the sounding exercise provided valuable insights which are all currently being considered. The outcome will be in alignment with our group's strategic intention with structure and size important considerations, including, amongst other things, whether it's public capital or private capital.

Openserve separation, we've made also further progress there in the separation of Openserve as a standalone business. As a strong, scalable and future enabled unit we believe its true value lies in the unlocking of its potential and trading multiples. And then on the data centre optimisation we have repositioned and consolidated our current data centres and real estate infrastructure, and this presents us with an operational and financial unlock option as we take advantage of the ever-increasing data consumption driven by technology evolution and customer trends. We are in the early stages in this regard to data centres and will revert with progress at the interim results.

So looking forward we really have created a solid business, a scalable asset base on which we intend capitalising our fixed, mobile and mast and tower businesses. Our significant fibre footprint provides us with a distinct advantage in a world of rapid technology evolution and soaring data demand. We've also built a strong platform around our IT business. We've seen in the latter half of the year some of the growth that is starting to come through at BCX. Looking at their customer pipeline it looks very strong, both committed and those that are about to commit. We've seen satisfactory returns on capital investments in these areas, and as such we will continue to create value with focussed investment and resource allocation within the disciplined financial framework.

This together with the initiatives to significantly unlock value from our business units and a strong balance sheet presents the flexibility for us to seize the various opportunities to grow our business into the future, especially as we're entering this new decade of 2020. I will now hand back to Chris, who is the operator, so that he can take questions and Dirk and I will do a double act there. Thank you very much.

Operator

Thank you very much, sir. Ladies and gentlemen, at this time if you wish to ask a question please press * and then 1 on your touchtone phone or on the keypad on your screen. You will hear a confirmation tone that you have joined the queue. If you wish to withdraw your question please press * and then 2. Our first question is from Vikhyat Sharma of RMB Morgan Stanley. Please go ahead.

Vikhyat Sharma

You've been very clear on next generation products contributing 65% to your top line. I'm more interested in finding out the inflection point which, Siphon, you have mentioned before that eventually Telkom will reach where your operating profit growth will start actually exceeding the decline in fixed. How far are we from there? Is it the next two years or three years? And I think a second question if I may. Mobile growth is slowing down. The capex is still remaining the same. One of the concerns would be everyone else is now becoming a little bit more competitive. Yes, there is a bit of a normalisation that will happen, but are you still confident that you will keep this mobile growth trajectory and stronger than the market?

Dirk Reyneke

Vikhyat, let me take the first one. I think in terms of revenue mix we believe we have reached the inflection point with the fixed legacy voice only being 15% of the revenue pool currently. If you look at the revenue growth certainly the growth in mobile and next generation products has now exceeded the churn/loss in legacy voice and legacy data. So we believe we have reached that inflection point where the operational revenue will start growing faster than the loss as a result of churn in the legacy business.

In terms of capex expenditure versus mobile, yes, we will continue to invest in that space. The current ratio of 53% spend on mobile and 29% on broadband or fibre will probably normalise slightly and the two will move closer to each other, but we see ourselves continuing to invest on similar levels in absolute terms with mobile probably still being more than 50% of the total investment if you combine the two.

I think your third question related to revenue growth in mobile. Yes, it's a question of mix. Where most of our competitors in the country have still got 60% or 70% of their mobile revenue on fixed voice we've got 65% of our mobile revenue on data. We do think that the data market will still grow. We also think that our network is enabled to accommodate the growth. And certainly if or when the spectrum auction happens that will give us even more capacity to grow on the 4G and 5G space. So we think still a strong growth trajectory on the mobile space on the back of data compared to the competitors' mix of mostly mobile voice. I hope that answers the questions, Vikhyat.

Vikhyat Sharma

Sure. Thank you. Just one small follow-up. The revenue inflection point is very clear. When you do think the operating profit inflection point will be reached, as in when the decline in fixed will actually be ahead of the growth in next generation services. Is there a timeframe that you can give? Two years, three years?

Dirk Reyneke

I think in terms of operating profit that will probably depend on the contribution margin from the next generation products. And there we do see further efficiencies specifically on the mobile direct cost as well as the IT direct cost. In terms of the wholesale business we don't see significant further efficiencies at that level. But we do think with the correct capex investment we can certainly get further synergies and efficiencies on the mobile direct cost specifically relating to roaming where that is still a significant part. And similarly there are still pockets of direct cost in the BCX space relating to IT services where we think we can claw back on some costs. So I must say I'll have to look at the timeline against that, Vikhyat. I haven't necessarily projected that. But we think it will depend on how soon we get the contribution margin up on both the mobile and the BCX space.

Vikhyat Sharma

Thank you.

Operator

Thank you. Ladies and gentlemen, a reminder that if you wish to ask a question please press * and then 1. The next question is from Preshendran Odayar of Nedbank. Please go ahead.

Preshendran Odayar

Firstly, congratulations on the results. I've got three sets of questions if I can. Can you tell us what your network headroom or capacity is that you have particularly on your mobile network? And what impact would ICASA pulling the temporary access to spectrum at the end of this month have on your guys' operations and ability to carry traffic?

The second question is I looked at your upgrades to your revenue guidance and it looks good at mid to high single digits. But seeing that your FY21 revenue growth was flat yet underpinned by what I could call lockdown induced increases in data demand, I just want to know how you are going to achieve your mid to high single-digit revenue growth targets for the group as you lap the COVID related demand spikes that we had over the last year.

And then the last question is just more of a clarification on what would be your normalised sustainable free cash flow. And just correct me if I'm wrong here, but your R2 billion free cash flow that you reported for the full year is after your VSP cost. So if I adjust that out your free cash flow generation in the second half was about R2 billion. I'm doing a matchbox calculation of about R4 billion of free cash flow per annum. Is that a fair assumption? That's it. Thanks.

Sipho Maseko

Sure. Thanks very much, Presh. I will deal with some of these questions and Dirk will build. So where is the growth coming from, which was your second question? We are starting to see growth coming from Openserve which has been very impressive especially in the second half of the year, and we see that growth holding on. So the traction in terms of all of the capex we've been putting with regards to fiberizing as much of the market as possible is beginning to come through and we

saw green shoots of that in the second half. And we're also seeing it in the fibre to the home side as well. That is beginning to really generate very decent revenues.

The IT side as well, as I've indicated the demand for IT solutions, we've started to see that coming across as well as companies having been traumatised by what COVID demonstrated as lacking are looking to build cloud services, really looking to strengthen their IT platforms. And then on the mobile side we continue to see data driving the growth. And that point is a very key point for us because in absolute terms the growth that we are attracting on the mobile side is testament to the investment strategy and to the infrastructure that we have deployed. And we are also driving the reduction of our direct costs where we are spending the capex, and especially where we see good traffic growth so that we can reduce our roaming costs. So we see that as continuing.

Insofar as the capacity that is there, remember we built what you would call an optical network. It's an all IP network. So for us to get more capacity it's investment in software capability. So through a software upgrade – which costs far less than what it would cost you to actually lay fibre anew – the cost of growth comes in at a far lower price point once you've built the optical transport network. So we are able to expand that capacity. It is almost like a concertina, Presh. So when there is a lot more traffic you can expand the capacity, and when that traffic reduces, you can reduce the capacity. So that is how we see it.

What is the risk of ICASA withdrawing the spectrum? It would be probably the final nail in the coffin in terms of recklessness by ICASA. Why? Because this spectrum is not just there for us to use commercially. Actually the spectrum is there for us to support government's efforts. We've connected schools. We've connected universities. We've got about 1,000 IP addresses just of different government departments. In fact, actually if they leave the network that will give us sufficient capacity to be able to carry what we would call commercial traffic if they withdraw that. So it would be the penultimate recklessness and erratic-ness by the regulator. And then your last question was free cash flow.

Dirk Reyneke

Presh, I think in terms of free cash flow you are correct to say the R2 billion free cash flow is after the VSP cash of R1.3 billion or R1.4 billion. I think many people will just add the two together and say a sustainable free cash flow is just over R3.5 billion, around about R3.5 billion. But included in the current year I think which counters that are also the cash release initiatives of which we had R1.2 billion. That's the tail end of the vendor financing initiative where we moved vendors from a 30 day payment term to a 90 day payment term. And further we also had just over R400 million cash in from the device financing initiative that we've previously communicated.

I think on the back of a cigarette box calculation if you then look at the guidance if you take the EBITDA, the 6% growth, the capex of R8 billion to R8.5 billion, if you deduct finance charges and tax, you will probably get back to R2 billion to R2.6 billion. You can then take the IFRS adjustment offset by other non-cash-flow items in the movement of working capital. So we believe a sustainable free cash flow is closer to R2 billion to R2.5 billion, Presh.

Preshendran Odayar

Thanks very much, Dirk. And thanks as well, Siphon, for the answers. Very clear.

Operator

Thank you very much. Ladies and gentlemen, a final reminder, if you wish to ask a question please press * and then 1. Sir, we have no further questions in the queue. Do you have any closing comments?

Siphon Maseko

Thank you very much. My reflection here is that we now have really built a solid foundation. We have a very robust and strong financial framework. We've got a very strong balance sheet. We are generating jolly good cash. We have very clear strategic goals that each of the businesses are focussed on. Our value unlock path is very clear and we are committed to it.

The regulatory environment we think will settle down and everybody will get rational. We did not start by just rushing to court. In fact, we ended there.

We've always wanted to find a way in which all matters related to spectrum and other regulatory issues are addressed in a way that is fair, that is transparent and that enables competition. We have got this far on our own steam and we truly believe that no one's shareholders have a better right than another's shareholders. So it would not have made sense for us to go to an auction, buy spectrum that we can't commercially use when others would get spectrum that they can commercially use and thus strengthen the duopoly. We can never rely on government meeting their deadline on the digital migration. Previously they have missed all of the digital migration deadlines that they have set for themselves. And we actually now think everybody is becoming rational. It is only last week that the Free State was switched off and the digital migration has happened.

Insofar as the actual outlook for the business is concerned, I could not have been more confident. I think the big challenges around cost the worst is behind us. We now have odds and ends that we need to tie up especially on the people side. We continue to focus on those costs that hide in cost of sales, open up that line, look at what is inside there so that we can be as efficient as possible. There is a lot of discipline in how we allocate resources, whether it's capex or opex. And I think the organisational muscle is getting better and better in that regard. We have been able to reach very interesting levels of capital productivity. We've reduced our cost to connect a home by at least 50%. That actually gives us tremendous flexibility in terms of the scale and the speed of the rollout. We are seeing a very elevated connection rate on the fibre side. And we think that our small and medium business will start to come through as well as we're looking for a different way in which we service that part of the market.

The leadership team, as you may well know, is very stable. Dirk came into the role and has helped me close out the year in the fourth quarter, and that went very well, but more importantly as well, set up the right plans for the next three to five years with very clear implementation plans, and we have focussed the team on how we execute. So with all of that I would really want to thank you. We will be seeing quite a lot of shareholders and analysts in the next couple of days. If you have any further questions, please just send an email to the investor relations team. Many thanks and have a good day.

Operator

Thank you very much, sir. Ladies and gentlemen, that concludes this event and you may now disconnect.

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