Taiwan Mobile

2Q18 Results Conference Call

July 26, 2018

James Jeng, President: Good afternoon. Welcome to Taiwan Mobile's 2nd quarter investor conference call. Before I start our presentation, I'd like to direct your attention to our disclaimer page, which states:

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For the business overview, I will start with the operating performance of our telecom business.

Telecom Business – Cash Flows Stand Out

Despite the adoption of IFRS15 starting this year, we provide investors with our trends in telecom service revenue and telecom EBITDA on both pre-IFRS and reported basis. We think the pre-IFRS numbers better reflect customers' contribution and our operating results in the telecom sector.

In 2Q, the big 3 operators all had a flash sale of the SIM-only NT$499 unlimited rate plan. The subscribers' switch to the NT$499 plan resulted in a higher penalty income in 2Q, allowing our telecom service revenue to see a milder YoY decline.

Thanks to our cost rationalizations and the one-time penalty income, our pre-IFRS telecom EBITDA surged 13% YoY, helping the company to sustain a healthy operating cash flow. This, coupled with capex decrease, increased our free cash flow by 7% in 1H.

Growth Catalysts

In 2Q, video streaming and fixed broadband continued to see good growth momentum. For the video streaming business, we have been expanding our target customers from mobile users to fixed broadband users through our partnership with leading cable MSOs.

Through the combination of SVOD, TVOD, and Freemium business models, we grew our video monthly active user number by an impressive 185% YoY in the quarter, paving the way for our new AVOD revenue model.

For the fixed broadband business, with competitive pricing and effective bundles, the fixed broadband subscriber number in 2Q maintained a healthy 6% growth. As of the end of 2Q, our fixed broadband penetration rate reached 39%.

The expanding fixed broadband subscriber base provides new potential subscribers to our video streaming service.

momo E-commerce – Crown Jewel

For momo, the company reported solid financial results in 2Q. momo recorded a 25% YoY increase in total revenue, driven by the strong growth in e-commerce. In particular, its revenue through mobile platform surged 57% YoY and accounted for 60% of e-commerce revenue.

Year to June, total revenue reached NT$19.8bn, an increase of 30% YoY. Accumulated EBITDA reached NT$869mn, growing 19% YoY, surpassing the company's forecast.

Let me turn the presentation over to Rosie for the financial overview section.

Rosie Yu, CFO & Spokesperson:

Performance by Business

In 2Q, our reported consolidated EBITDA grew 1% YoY, of which telecom EBITDA stayed resilient YoY while momo's EBITDA saw an increase of 3% YoY.

Under the basis of pre-IFRS 15, our telecom EBITDA surged 13% YoY, thanks to our cost rationalizations and the one-off penalty income related to the NT$499 plan.

Results Summary

In 2Q, total revenue fell short of expectation mainly due to weaker demand for high-end handset bundles.

Our costs & expenses decrease and EBITDA increase mainly reflected the one-time penalty income from customers who broke the contracts and big savings on handset subsidies from customers' demand shifting from handset bundles to SIM-only plans.

We beat our operating and net income guidance by 10% and 7%, respectively, on the back of the aforementioned.

Year to June, accumulated operating income and net income both reached 54% of our full-year target. Despite the 7% decline in net income, our operating cash flow and free cash flow all increased YoY in the first half of this year.

Balance Sheet Analysis

Now let's move on to balance sheet analysis.

On the asset front, the major YoY change seen in 2Q was: (1) the decrease in contract asset, attributable to the reversal of handset bundled sales following a rising demand in the SIM-only plan, and (2) the increase in concession, resulting from the spectrum acquisition of the 2.1GHz frequency band in 4Q17.

On the liability front, we issued unsecured corporate straight bonds of NT$15bn in April, allowing us to repay a total of NT$21.6bn for short-term and long-term debts in the quarter.
In addition, shareholders' equity went down sequentially following AGM's approval of dividends. After the earnings distribution, we still have NT$34bn of excess reserves available to top up dividends in the future.

On the financial ratios, net debt to EBITDA improved to 1.23x as our gross debt balance decreased from a quarter ago. Also, our ROE stood high at above 20%.

Cash Flow Analysis

2Q18 operating cash inflow fell YoY mainly because of a reduction in handset payable and a temporary payment related to pending future court rulings.

Investing cash outflow decreased YoY mainly due to a reduction in capex, NT$934mn in cash freed up as we took back more guarantee deposits in the quarter, and the proceeds from investment redemptions.

On the financing front, we had a cash outflow mainly resulting from debt repayment. Net net, our FCF in 2Q reached NT$5.82bn, up 7.2% YoY, which translates into an annual FCF yield of 7.3%.

Let me turn the presentation over to James for event updates and key message.

Awards and Recognition

James: Next page lists the recognitions we've received in the 2nd quarter of 2018 for your reference.

Key Message

To wrap up our presentation, this slide summarizes the key message that we would like to deliver:

The $499 unlimited SIM-only offering led to a customer spending pattern change in 2Q. Enhancing distribution efficiency and continuous rationalization of customer retention & acquisition costs remain our areas of focus.

Our significant progress in cloud, AI and IoT businesses provides enterprise revenue growth potential. A faster customer migration to unlimited 4G data also paves the way for our future revenue expansion in OTT-related services. Making all-out efforts to generate steady streams of cash flows and stringent cost control against a lower ARPU are our main aims.

Now I would like to open the floor for the Q&A section.

Q&A

Gary Yu, Morgan Stanley: ***First, related to the NT$499 unlimited data plan, can you share what kind of impact regarding the one-off penalty and, secondly, the potential reduction in the recurring revenue when people take up these lower rate unlimited data?***

Second, it appears the market and the company is struggling to generate growth from the organic business because of competition as well as the rate of reduction in the pricing plans. Is there anything else other than continued cost control and capex reduction that can further enhance the profitability or cash flow of the business?

Lastly, any view on how we should view dividends going forward?

James: I think the NT$499 tariff plan does generate some impact in the top line, particularly in ARPU. However, we also saw upside as the handset subsidy and channel commission had significant reduction in terms of a QoQ decline of more than 50% in handset subsidy and channel commission. And that's in addition to the higher penalty income. So, in terms of the bottom line, we didn't see a significant impact this year.

Regarding your second question, the mobile business has become very competitive as the price of the tariff plans are going down, but it's not going to be worse than now, particularly with the new iPhone coming out in the 2H. It's been our experience that in the past few years, the launch of a new iPhone results in an increase in ARPU. Recently, we noticed an interesting phenomenon, which is those who applied for the recent NT$499 unlimited rate plan were mostly Android users. Thus, given that information, when the new iPhone comes out in the 4Q, we are optimistic this will resume the growth momentum of the ARPU as well as overall revenue.

Meanwhile, we have been working on the enterprise sector for a long time, including re-structuring and creating new business models. Thus, I can foresee starting in the 4Q and into next year significant progress in terms of revenue and EBITDA in the cloud business and the AI business. In the meantime, in the IoT business, next year the government will have a lot of tenders available for the smart city project as well as smart home. Thus, we see the IoT business picking up in the 1Q of next year. So, overall, the mobile revenue will remain resilient. However, our fixed broadband, value-added services and the enterprise sector will have significant growth starting in the 4Q. Thus, these factors will generate growth momentum for TWM.

Regarding dividends, I'll pass that to Rosie.

Rosie: Gary, we will still be very committal to a stable dividend policy.

Jack Hsu, Sinopac: ***First, you mentioned you expect growth momentum starting in the 4Q due to the launch of the new iPhone and the enterprise sector. I'm a bit uncertain about the expected iPhone sales given the recent NT$499 tariff plan. Thus, I'm wondering what percentage of the customers switched to the recent NT$499 tariff plan and how many did not change plans.***

Is the enterprise growth highly related to government plans or businesses from other individual companies?

James: I cannot disclose how many customers switched to the NT$499, but in terms of percentage, I can say that there were fewer iPhone users that switched to the NT$499 plan. And, this is mainly due to the iPhone users being very loyal to the brand. We used to have an insurance program for the iPhone as well as a big subsidy for the iPhone. For those customers, if they downgrade to the NT$499, they have to pay a lot of money upfront without the subsidy for the iPhone handset. The iPhone insurance and annual upgrade program has been very successful for Taiwan Mobile, which make those customers quite loyal to the program. Thus, that's why in 4Q we might have a chance of seeing more iPhone subscribers choosing a higher tariff plan, which will boost our ARPU in 4Q.

Regarding your second question, I think, especially in the IoT business and the smart city, this will be driven by the government. In 4Q, we will see a lot of tenders coming up, especially in gas, water, and electric pole for the smart city and smart metering. TWM has already gained a decent portion of initial small tenders in 4Q. Next year, in terms of IoT and smart city, I am quite optimistic about these businesses.

However, the cloud and AI businesses are not related to the government sector. It is all from the private sector. The cloud business through our IDC has done quite well in 1Q and 2Q this year mainly due to the gaming industry as well as live broadcasting and some value-added video streaming services. Our IDC service has been performing well, and is likely to be even better in 3Q and 4Q.

Varun Aruja, Credit Suisse: ***First, regarding the NT$499 plan, are you happy with the competitive landscape? It seems you are suggesting the NT$499 plan has lower cost, so it has a very limited impact; but it definitely is not an optimal pricing. Do you think mobile pricing has to go up for the earnings to start showing some improvement?***

Second, are you currently generating any revenues from myvideo, OTT services? Just want to understand the current pricing of this service.

Third, how do you see the competitive landscape from the two smaller operators, especially Taiwan Star? It seems from industry data they have been consistently gaining monthly net adds. They seem to be gaining some decent market share.

Fourth, how do you perceive yourself on this IDC business, IoT, cloud, AI compared to CHT who has made a sizeable fixed-line investment? How do you compete with them on that front, especially when bidding for the government initiatives?

Lastly, regarding these AI and cloud initiatives, even if it grows significantly in the next 2-3 years, its contribution towards revenue and profitability will be miniscule. Will they be able to arrest any decline in mobile service revenue, which will come from competition?

James: The NT$499 plan does hurt the top line in terms of revenue and ARPU. However, the subsidy and channel commission also decreased a lot. Mobile revenue will remain resilient or slightly down in the 2H. But, in terms of EBITDA, I don't see any significant impact. Thus, I am confident that we will be able to meet our full-year EPS projection.

Regarding video streaming, since the mobile business has become very competitive, we will concentrate more on fixed broadband. We believe fixed broadband will be a key factor to our EBITDA margin, revenue, and also our video streaming business. In fact, in 2Q, our fixed broadband penetration rate reached 39% of the pay TV installed base.

In comparison with Chunghwa (CHT), we have a HFC network, which uses fiber. And our fiber nodes have already pushed into residential areas. Our coaxial cable can deliver higher bandwidth than CHT's twisted pair. So, in many areas, particularly the rural areas, we are able to deliver higher bandwidth at a very competitive pricing, and gained quite a market share. Thus, we are confident in the fixed broadband business line, which bundles our video streaming and cable TV services, going into 2H and next year.

For the cloud business, we have a good visibility because we already have a lot of customers who have committed to our IDC center. I can't disclose too much right now, but there will be significant growth in our IDC business line.

Regarding Taiwan Star, as far as I can see with the NT$499, which started in May, it has hurt the Big 3, but it has also hurt the two smaller operators. With the tariff dropping to NT$499, customers now have another choice in addition to the NT$299 and NT$199. And many will choose the NT$499 because of the speed and coverage. And our figures have shown that of course many customers have moved down from a higher tariff to NT$499, but also many customers have moved up from the lower tariffs. Thus, the NT$499 plan has impacted the smaller operators' competitiveness in the lower tariff plans.

Varun: ***With the NT$499, are you happy with the NT$499 plan? Do you think this is profitable for you? Or, in the longer term, would you want to increase pricing?***

James: Nobody is happy about the NT$499 tariff. As I said before, it hurts the whole industry, not just the operators. It also hurts the handset industry and the distribution channel, because NT$499 plan is SIM-only. The ones who are hurt the most are those on the channel side with handset sales and commissions reducing to almost zero. So, it's going to be tough for those smaller handset stores on the channel side. So, as you can see, the NT$499 has impacted the whole industry and the value chain, including operators, channels, and handset vendors. But, for us, as an operator, there are other growth potential that can help our bottom line pick up.

Varun: ***Can we expect some improvement in pricing? Because I see the NT$499 is still available online. Any plans to withdraw it online?***

James: Well, since NT$499 sale was merely a flash sale, the big 3 operators understood the NT$499 tariff will hurt. So, we have already stopped selling the NT$499 plan in the physical channel. Thus, for the coming 1 and 2 years, the impact of the NT$499 tariff will remain. But after that, two years from now, my hope is the ARPU and the top line will resume some growth momentum. In addition, as I mentioned, in 4Q when the new handsets come out, I hope it will bring up the tariff plans to NT$999 and above.

Jack Hsu, Sinopac: ***First, can you give us the numbers of the one-time penalty income related to the NT$499 tariff plan?***

James: That information is confidential. Thus, I have no intention to disclose those figures.

Jack: ***Can you inform us what the effect of NT$499 tariff plan is on the EPS, give us a range –***

James: I don't think there will be a big effect on the EPS. I think we are quite confident with EPS we projected this year.

Jack: ***So, does that mean you will not be changing your financial forecast?***

James: No, not all.

Jack: ***What's your strategy for the following year? Because with the NT$499 plan, so many subscribers whether from 3G or 4G have switched to the NT$499 plan. So, what's the strategy with the mobile subscribers?***

James: As I just mentioned, we are not only a mobile operator, we also have fixed-line, cable and e-commerce businesses. We are quite a diversified company. Our telecom revenues only contribute 60% of our total revenue. So, any impact to mobile does not affect the whole revenue in terms of the bottom line or top line because we are doing quite well in e-commerce in terms of the top line and EBITDA level. And, while cable TV has been hurt a little bit, the fixed broadband business has picked up. The EBITDA margin for the fixed broadband has been good. So, for next year, I can see good growth potential in the fixed broadband and e-commerce businesses. Also, the enterprise and fixed-line businesses will also have good growth potential next year.

Jack: ***What's your strategy in terms of competing with Shopee?***

James: Shopee never announces its Taiwan financial results. Based on the 1H financial results, momo has performed well compared with its peers such as PCHome. I don't see Shopee at this point as a threat to momo.

Jack: ***So can we say the future of momo is more positive than Shopee's?***

James: I would say yes. I'm quite sure because momo not only has online business but also TV shopping. This year, we see good growth in EBITDA, especially the TV shopping has been doing well. So, for both top line and bottom line performance for momo, I am very confident. This is the rising star for Taiwan Mobile.

Jack: ***What has changed in TV shopping? Because we have seen TV shopping decline for many seasons, many years.***

James: We have a good strategy. Also, channel leasing cost has declined. So, that profitability has grown. Another factor with TV shopping is that they have changed the product line.

Jack: ***How long do you see this type of good situation going until, 2019 or the end of this year?***

James: I can see its momentum growing. I can see long-term growth momentum for TV shopping.

Jack: ***What kind of products have been selling well for TV shopping?***

James: I cannot disclose that information, but they are doing well.

Jack: ***But is it the 3C components?***

James: I cannot disclose.