

# BT Group Plc

## Q2 Results

11 November 2004

### Opening Comments

**Sir Christopher Bland**

**Chairman, BT Group**

#### **I. Preamble**

Good morning, and welcome to BT's results presentation for our second quarter and half-year. This morning, I will focus on the half year results, and Ben and Ian will take you through the second quarter in more detail. BT Group continues to make good progress in transforming the business and delivering improved financial results. We are very encouraged by our first half performance and by our very strong second quarter. In the first six months of this financial year, new wave revenue continued to more than offset the declines in traditional revenues. This growth is driven by the rapid take-up of Broadband and our success as a premier supplier of global IT and networking services to a wide range of customers. Our global capabilities will be enhanced further, through the acquisition of Infonet and the successful conclusion to our exclusive negotiations with Reuters.

#### **II. Financial Headlines**

Group turnover was 1.5% higher than last year, excluding the impact of mobile termination rate reductions. As a result of continued operational efficiencies, earnings per share (EPS), before leaver costs, rose by 7%, to 9.4 pence. These positive achievements enabled us to pay an interim dividend of 3.9 pence per share, 22% higher than last year. Half year free cash flow remains strong, at £750 million, less than last year's exceptionally high level, but the £594 million generated in the second quarter is 2% higher than the prior year. We have also reduced our debt by a further 6% in the last 12 months.

#### **III. Turnover Transformation**

BT's ongoing transformation is most apparent in the group's turnover mix. The 1.5% rise in underlying turnover was driven by a 34% increase in our new wave turnover, and I am particularly pleased that new wave turnover in the half year represented just over one fifth of group turnover, at nearly £2 billion. Almost 50% of our turnover from major corporates is now new wave, driven by ICT

solutions. At the same time, Broadband take-up contributed to our consumer customers doubling the proportion they spent on new wave services.

#### **IV. Earnings per Share**

To meet the changing demands of our customers, we are transforming our network and cost base. Continued operational efficiencies in traditional areas have enabled us to reinvest and innovate. These efficiencies, together with keen financial discipline, including lower interest and tax charges, have helped deliver EPS growth of 7%, pre-leavers. The BT transformation is one in which we are reinvesting in new businesses and delivering growth in both earnings and dividends.

#### **V. Dividends**

I am pleased to report that the interim dividend we are paying is 3.9 pence, an increase year on year of 22%. This payment is in line with our progressive dividend policy. As you know, we have targeted a 60% payout ratio next year. In addition, we are still proceeding with our share buyback programme. We repurchased a further 54 million shares, at a cost of £99 million, in the last six months.

#### **VI. Three Years of Transformation**

##### **1. Benefits for Customers**

###### *a. Broadband*

Telecoms remains a competitive industry. However, BT has consistently been able to adapt through investment, innovation and transformation. Over the last three years, this transformation has been dramatic; it has delivered a lot of positive benefits to our customers. Three years ago, the UK lagged most of the G7 countries in rolling out broadband. BT Wholesale had less than 100,000 ADSL end-users. Today, more than 3.3 million of our customers now have Broadband, and the UK leads the G7 in terms of ADSL availability. By next summer, ADSL will be available to 99.6% of the UK population.

###### *b. Product and service innovation*

This achievement has not occurred by chance. We are one of the largest investors in R&D in the UK, and spent around £200 million on R&D in the last six months. Product and service innovations now available to customers include Voice over IP, using BT Communicator or BT Broadband Voice, and 'on the pause' working at BT Openzone Wi-Fi hotspots around the world.

*c. Competitively priced services*

Customers have not only benefited from a technological revolution, but a very competitive telecoms market. A 30-minute national evening call now costs 5.5 pence, compared with 60 pence just over three years ago.

*d. Customer satisfaction*

Over the last three years, we have reduced customer dissatisfaction by more than 50%.

*e. 21st century network (21CN)*

BT has recognised the long-term benefits of investment and innovation. We are building 21CN nationwide to benefit all our customers, in the belief that the regulatory environment will reward such investment. This new network will help us bring products to market quicker, and put our customers in control of their own communication needs.

## **2. Benefits for Shareholders**

Our transformation has also delivered excellent financial results. Group turnover is growing, driven by our new wave strategy, which delivers services that enable customers to survive and prosper in the digital networked economy. We continue our drive to become a cost leader amongst telcos, through improved cost efficiency and strong financial discipline. This has delivered strong cash flow, enabled us to pay increasing dividends, reduce debt levels and carry out a share buyback programme. In the last six months alone, we will have returned over half a billion pounds to shareholders.

## **VII. Conclusion**

Our results demonstrate that the transformation of our business has gained momentum. BT is well-placed to lead the next stage of investment and innovation in a digital networked economy.

## **Business Overview**

**Ben Verwaayen**

**CEO, BT Group**

### **I. Preamble**

Thank you, and good morning. The secret formula of BT's success is about how we are doing in ICT, Broadband and Mobility, and how well we are defending our traditional business and driving cost leadership

### **II. Turnover Transformation**

This has been a very strong quarter. If you look at our new wave business, Christopher reported 34% for the first half year; it was 36% in the quarter. If you look at our traditional business, it is minus 5%, and you will see that the decline in traditional business is slowing. We have said all along that this is a business in transformation. For 10 quarters in a row, or almost three years, from a revenue perspective, this has been the best quarter, which tells you how well the formula is starting to work.

### **III. New Wave – Dramatic Growth**

New wave business is growing dramatically. Rolling 12-month revenue figures show that it has grown from £2.5 billion 18 months ago, to £4 billion currently. In terms of the composition of new wave, we are making progress on each and every of the element of the business. ICT business is growing by 20%, in a market where we are really gaining a pole position. Broadband has grown by 88%. In terms of lines, it has grown by 146%. Mobility is growing by 188%.

#### **1. Others**

BT has 171 phone books, each of which now has a classified section, which are now generating more than £1 million each week. We never talk about it, but, by itself, it is a very sound, fundamental business.

#### **2. ICT – Building for the Future**

##### *a. Global deals*

ICT, in the build-up to the future, is really gaining momentum, not just in the headlines of 'big deals', but even more encouraging, I think, is the fact that we had 54 orders of £1-5 million during the quarter. These are significant orders in this market, and 54 orders mean that our ICT business has a much better breadth and spread. Internationally, we are also doing very well; there are

examples, in Korea and Europe, of small and big companies and institutions, and governments, demonstrating the variety of the nature of the business. The contracts are about managing mobile solutions, or a nine-year contract to supply MPLS. This spread of orders tells you that BT is gaining real momentum in the ICT market, not just here in the UK and Europe, but around the world. We are being helped, of course, by building that momentum while building our capabilities.

*b. Infonet acquisition*

We have done that organically so far, but sometimes there is an opportunity to make an acquisition. This one was spot on and right at the heart of our strategy, helping us with a customer base of 1800 blue chip companies that want exactly the type of service and capabilities that we call the heart of our ICT business. Infonet will bring us very good skills and spread for building our momentum in the future. The rationale behind the business case presented to us was not about future business; it was about cost synergies that made it a very good deal, even by itself. The rest is a bonus.

*c. Reuters negotiations*

Another case of momentum is the potential Reuters deal that we are now negotiating. We are confident that this will be another great springboard for new activities, in terms of what Radianz will bring to us, which is the prime product in the financial services business. They have the depth and capability which, combined with ours, will make us absolutely unique in this marketplace. In terms of its size, it involves 18,000 MPLS sites around the world.

### **3. Broadband**

*a. BT Wholesale*

As of 30 September, we had exactly 3,293,772 lines. Every 15 seconds, we add another customer to Broadband. To date, we have enabled 3,529 exchanges, and we have 1,503 exchanges left in order to extend the 93.9% coverage that we have today to 99.6%. It also gives you a feel of how many smaller exchanges you have to convert in order to reach the target of 99.6%, which represents better coverage than analogue TV or mains gas; it is almost at the level of running water.

*b. BT Retail*

We gained 1% market share, in a market that was stronger than ever before. We are now at 30% in the quarter, or 39% in the year to date. BT Retail now has 1.3 million customers, and a service organisation capable of giving a better performance to those customers every quarter.

## **4. Mobility**

### *a. Creating scale*

Mobility is about an MVNO activity that gives us firm feet in the high street, and about a convergence story. In the last quarter, there was a 30% growth of 90,000 customers, and we only have post-pay subscribers. It is very important to see that it is not just in business or consumers, but in both. This is an impressive performance by Mobility in the quarter.

### *b. Project Bluephone*

The real prize, of course, is being able to translate that performance into the convergence play. I am thrilled with the progress we are making on Project Bluephone. From a technology viewpoint, there have been many questions raised around how we are doing and whether we are still confident that we will be able to launch in spring 2005. I think we have seen good, solid progress on the technology side, based also on the fact that this is gaining worldwide momentum. We have that fixed/mobile convergence association. Every day, we have people interested in joining us. Last night, we issued a press release mentioning companies such as AT&T, Cegetel, KPN and Bezeq joining forces. If you are a technology player, you want to play in this field; look to your customer base.

### *c. BT Openzone*

The same maturity can be seen in Openzone. We now have, through international roaming agreements, the ability to tell our customers that they can go to over 20,000 hotspots in 12 countries around the world and use their laptop. This really becomes an attractive addition to the way people use communications while they travel.

## **IV. Traditional Business**

### **1. Calls**

The rate of decline is slowing. I am very happy to report that the figures on private circuits are the same. However, the decline relates totally to calls. The decline is £180 million every year. Half of it is of our own making; it is either rebalancing or the consequences of the phenomenal growth in Broadband. Dial IP, of course, will go down. Market share is a function of the competitiveness of the market, in terms of whether you choose to decide on price or on functionality. We are down by 0.5% in Business, and by 1% in Consumers. The other part is the market, which is about price and volume, and the market is down by about 2%.

## **2. BT Together**

Important for us is the percentage of revenue from consumers under contract. I am happy to report that, every quarter, this increases by another 1%, and we now have 60% of consumers under contract. The higher the number, the better it is. Growth is taking place both in Option 2 and Option 3.

## **V. 21st Century Network**

### **1. Offerings**

This started off as a vision. I would like to remind you that 21CN is not an end in itself; it is a means to an end. We are trying to give our customers more flexibility and competitiveness when it comes to business; telecoms becomes an input to competitiveness for many companies around the world, and we want to give our consumer business more flexibility and personalised services.

### **2. Trials**

We have two trials that I would like to highlight here. One is around taking voice business and putting it on end-to-end IP. This is not Voice over IP by doing it on the Internet. It is about a controlled environment where the performance of the network in a full IP environment has to be equal to or better than the requirements we have on voice on an analogue network, which is far better than what can be obtained on the Internet. We have a trial between Cambridge and Woolwich, and we have 38 other parented exchanges that we will link to that. It is a real-life trial. From January, 100 homes, growing to 1,500 homes in March, will have fibre to the home, in order to see what kind of flexibility and service levels can be achieved that cannot be achieved using highly intelligent copper. These trials have to be undertaken to see where you will put what, in order to make the right decisions about investments in what you intend to offer your customers, because that is the endgame. Whether we are able to introduce better competitiveness and service, and more personalised service, into the market.

### **3. Local Loop Unbundling (LLU)**

First, BT Retail needs to have a level playing field in the downstream business. Second, 21CN needs major customers to make it viable. For example, our shareholders require us to have an economic model if we are to invest a lot of money in creating 21CN. Therefore, the consequence is that, although LLU is not BT Retail's preferred route, unless we have an alternative that offers the same benefits, we cannot afford to disregard the LLU option. This is not a debate between BT and BT, but an industry debate.

## **VI. Delivering Results while Transforming the Business**

In terms of EPS, quarter after quarter, a company in transformation has delivered a better performance. All along, we have said that we will transform

this company while improving our returns to shareholders, which we are now doing quarter after quarter. We are accelerating our turnover and the growth in our turnover. We are very solid in our cost savings; we have very good discipline around our financials, not just in terms of EPS, but also in terms of free cash flow; and I think that we have an accelerating transformation capability. We have enhanced our capabilities to compete in the UK and abroad and, at the same time, we have positioned ourselves to take maximum advantage of what is called the digital networked economy.

## **Financial Review**

**Ian Livingston**

**Finance Director, BT Group**

### **I. Financial Headlines**

Group turnover, at £4.6 billion in the quarter, was 0.7% higher, as new wave growth more than offset the decline in traditional turnover. Taking into account the cuts in mobile termination rates, the underlying revenue actually rose by 2.1%. It is worth repeating that this is the best top line performance in almost three years. Underlying profits before tax rose by 4%. The cost efficiencies achieved offset a large part of the effects on margin of the decline in traditional revenues, and the cost of new wave investment.

Interest and depreciation were also lower. The increase in profit before tax, coupled with lower tax charges, meant that EPS increased by 9%, to 4.8 pence. Leaver costs had a relatively minor effect on this quarter's numbers, so I will not attempt to separate them out as we go through the presentation. During the quarter, we generated nearly £600 million of free cash flow, which is an increase of 2% on the prior year. Despite the increased dividends and the share buyback programme, net debt has reduced by about half a billion pounds over the last year, to just under £8.3 billion.

### **II. BT Retail**

#### **1. Turnover**

After adjusting for the impact of the cuts in mobile termination rates, BT Retail revenues declined by 2%. The mix of revenue continues to evolve. Strong new wave growth of 33% largely offset an 8% decline in traditional products and services. This decline reflects the competitive environment in the UK, and the migration to new wave services that we are encouraging.



## **2. Gross Margin**

The gross margin fell by 1.8 percentage points, to 26.2%. This reflects a substantial investment in customer acquisition costs in Broadband and Mobility, and an increase of new wave business in the mix.

## **3. SG&A and Operating Profit**

The transformation in the cost base delivered £74 million of SG&A savings from traditional areas. We have, of course, reinvested some of this in new wave activities, resulting in a net reduction in SG&A of 8%. This offset some of the gross margin decline, but operating profit was still down by 9%.

# **III. BT Wholesale**

## **1. External Turnover**

Excluding the cuts in fixed to mobile termination rates, BT Wholesale's external revenue rose by some 17%. There was an underlying increase of 9% in traditional revenue, driven by increased interconnect volumes, growth in carrier pre-selection, the take-up of wholesale line rental products, and an increase in private circuits sold, particularly to mobile operators. New wave turnover doubled, with Broadband, of course, being the key driver. In addition, we have seen a growth in new wave activities, such as facilities and network management services that we offer to other operators.

## **2. Internal Turnover**

Internal turnover of £1.3 billion declined by 5%, reflecting lower internal volumes. For Wholesale, in total, volumes were higher. Despite this, costs were reduced by £7 million as a result of productivity improvements and reductions in network and SG&A expenses. These efficiencies have contributed to an increase in both EBITDA and operating profit.

# **IV. BT Global Services**

## **1. Turnover**

Turnover rose by 9%, which was well ahead of the market. Turnover in Consulting and System Integration, previously known as BT Syntegra, rose by 18% and, in Global Solutions, by 19%.

## **2. EBITDA and Operating Loss**

Despite the upfront investment and costs associated with contract wins, EBITDA rose by 10%. This reflects strong revenue growth and ongoing efficiency programmes. The increase in EBITDA, coupled with the reduction in depreciation, delivered a 67% reduction in operating losses.

### **3. Operating Free Cash Flow**

As expected, operating free cash flow is lower, due to investment in capital expenditure on the new contracts. Overall, this was yet another good quarter for Global Services.

## **V. Group P&L**

### **1. Gross Margin**

Gross margins fell by 1.8 percentage points. SG&A reduced by 1%, partially offsetting this. In addition, depreciation was lower, with the result being a small decline in profit margins. Despite making over £100 million of efficiency savings in the quarter, operating costs actually rose by £50 million. The big element was cost of sales, which rose by £160 million. This reflects, in part, the cost of servicing ICT contracts; it also reflects the increased expenditure on customer acquisition in both Broadband and Mobility businesses. This factor alone more than accounted for the deterioration in operating margins. We talked about this at the beginning of the year and said that this would be our strategy for the year.

### **2. Non-Pay SG&A Costs**

Non-pay SG&A costs have risen in areas such as marketing; you cannot have failed to see the adverts raising awareness of BT's position in the digital networked economy. We have also increased our investment in new wave R&D, as we seek to bring truly innovative services to the market. The clearest area that shows our efficiency gains is in SG&A pay, which has fallen by 14%, despite an increase in pay rates. Payments to other telecommunications operators were 6% lower, mainly reflecting the impact of the reduction in mobile termination rates. This also reflected better management of our international network costs.

### **3. Others**

There was a small improvement in associates. There were a couple of one-off events, and we would expect a small loss from associates in each of the next two quarters. There was also a £15 million profit on the sale of a central London property. Net interest payable was £207 million, an improvement of £9 million against last year. That reflects a reduction in the level of net debt. The effective tax rate for the year to date is around 26%. EPS increased by 9%, to 4.8 pence for the quarter.

## **VI. Group Capital Expenditure (Capex)**

Capex in the quarter amounted to just over £800 million. We now have a much flatter quarterly capex profile than in previous years. The increase in capex reflects, on the one hand, our expenditure on 21CN, but also the rapid growth of Broadband, higher wholesale volumes, and the development of new services, particularly in delivering the ICT contracts. This quarter, we spent £45 million

implementing the NHS contract, which is very much in line with the previous guidance we gave you. I will reiterate what I said at the first quarter results: you should expect capex for the year to be at the top end of the £2.6-3 billion range, having been at the low end of that range for the last two years.

## **VII. Cash Flow**

Despite slightly lower EBITDA, and an increase in capex of over £200 million, cash flow improved. This reflects more favourable working capital management and lower interest paid compared to the previous year. Net interest paid in the quarter was £95 million. The year-on-year improvement was mainly driven by the timing of interest payments on some debt that we repaid during the past year. Therefore, the total free cash flow generated in the second quarter was £594 million, which is a £9 million improvement on this quarter last year.

## **VIII. International Accounting Standards**

### **1. Timeframe and Process**

You will be aware that all EU listed companies have to comply with international financial reporting standards from next year. This will, therefore, apply to BT for our 2005-06 financial year. The key changes in BT's financial results are in four areas: financial instruments, leases, pensions and share-based payments (share options).

### **2. Key Accounting Changes**

#### *a. Financial Instruments*

Financial instruments, derivatives and certain financial assets and liabilities will need to be recognised on balance sheet at their fair value. This may add some volatility to the net interest charge and, frankly, could go one way or another.

#### *b. Leases*

Property sold on leaseback will come back on balance sheet as a finance lease under IAS 17.

#### *c. Pension standard*

IAS 19 is pretty similar to FRS 17, whereby the pension scheme deficit is recognised on balance sheet. The P&L charge includes an operating service charge and an interest charge, which is volatile due to changes in asset values and interest rates.

#### *d. Share-based payments*

The fair value of share options must be charged to the P&L, going forward.

It is important to understand there will be no changes to our core operational accounting policies for revenue, cost recognition or depreciation. Some of the changes will be positive for the P&L, and some will be negative. The exact effect that will occur next year will depend on future factors such as interest rates. We will arrange a separate session later in the financial year to give you more detail on this subject.

## **IX. Conclusion**

I would like to leave you with a few key conclusions. The trends in this quarter are very similar to those of recent quarters. The transformation of our business has gained notable momentum in a number of areas. Our strategy to grow new wave business has allowed us to more than offset the declines in traditional revenue and deliver overall growth for three-quarters now. Margins have changed, as we migrate customers to new wave products and services, and invest in our future business. Our continued focus on the cost base and financial discipline has delivered savings to enable us to grow EPS quarter after quarter. That, in turn, has underpinned strong free cash flow generation to facilitate our progressive dividend policy, reduce debt, and operate an ongoing buyback programme. In essence, we continue to deliver improving financial results during the transformation of our business. The success of this strategy will enable BT to take full advantage of the developing opportunities in the digital networked economy.