

08-Aug-2013

Deutsche Telekom AG (DTE.DE)

Q2 2013 Earnings Call

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MANAGEMENT DISCUSSION SECTION

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Operator: Thank you for your attention. May I now hand you over to Mr. Stephan Eger?

Stephan Eger

Head of Investor Relations, Senior Executive Vice President, Deutsche Telekom AG

Yeah, good afternoon and good morning to our listeners in the U.S., and welcome to the presentation of our Q2 and H1 results.

As always, I've got with me our CEO, René Obermann; and our CFO, Tim Höttges, to discuss the results.

And as always we start with a quick presentation from our side followed by a Q&A session. Given the fact that we have to end sharply at 3 o'clock our time, I would urge you to restrict yourself to one or two questions per analyst. And specifically on the – on U.S. you've got today two opportunities to discuss the U.S. results with us and later on with John Legere, and our CFO Braxton Carter in the U.S. in about three hours. So that is plenty of opportunity to discuss the T-Mobile U.S. results.

Having said that, I would like to hand over to René for the presentation.

René Obermann

CEO & Chairman-Management Board, Deutsche Telekom AG

Thanks, Stephan.

Good afternoon, ladies and gentlemen. Good morning. The second quarter of 2013 at DTE was marked by some significant and some encouraging developments. First of all, we are very satisfied with our operational performance and our customer numbers in the second quarter.

Overall, we won almost 1.4 million new postpaid customers, 121,000 new TV customers, and 44,000 broadband net adds in our group in the second quarter. Our group revenue grew organically, i.e. without the impact of the new consolidation of PCS for two months and without currency effects, by 2%. Let me repeat this, organic revenue growth on a group level at 2%.

The group EBITDA reflected the significant investment level into higher than expected customer growth in the United States, and I will come to this in a second, at €4.4 billion.

In Germany, we delivered rock solid results. Operationally, we kept a good traction in mobile winning over 434,000 new contract customers, of which 157,000 were own branded, and in fixed line with winning 126,000 fiber customers in retail and wholesale combined.

Revenues for the segment Germany were down only by 0.8%. Underlying revenues excluding regulation and changes in consolidation was at minus 0.1%, so almost zero. This was mainly driven by a better performance in our mobile service revenues, where we returned, as promised, to an underlying growth of 1% and that is well in contrast to our competition if you compare the recent results, well in contrast to Vodafone, who we overtook in the market leadership again and let me – let there be no mistake, we will continue to work on this market leadership. On the profitability side, we saw another solid quarter with EBITDA margin close to 41%.

United States. The biggest turnaround here. After 16 consecutive quarters of branded contract customer losses, we are now proud to see the strength turned around significantly in the second quarter. Overall, we grew our customer base at T-Mobile U.S. and excluding the impact of the MetroPCS consolidation in Q2 by over €1.1 million of which 688,000 were branded postpaid net adds, this is the result of great marketing, of our very successful launch of our Un-carrier strategy, of the iPhone in the U.S., and of course the better available network.

The branded contract churn was reduced to a record low level of 1.6%. Revenues grew organically, i.e. without the impact of MetroPCS consolidation, by 12.5% in the quarter and service revenue trends at T-Mobile U.S. have also improved sequentially. This significantly stronger than expected customer intake, as well as the launch of our Un-carrier strategy, and the iPhone launch led to higher investments and an EBITDA decline of 10% in the quarter.

Coming to Europe. In Europe in a still tough economic environment, we again delivered very good customer numbers for our main growth areas. Almost 80,000 TV and 58,000 broadband net adds. And we improved significantly the mobile contract net adds performance from 72,000 in Q1 to 258,000 in Q2. Financials for the quarter were again heavily impacted by two times higher regulatory effect year-on-year, by a very tough economic and competitive environment, and wonderful special taxes.

Nonetheless, trends, especially in revenues improved versus Q1. And please remember that we deconsolidated HellasSat as of April 1. Globul and Germanos Bulgaria will be deconsolidated as of August 1.

Systems Solutions. Operationally, our order entry was satisfying with a growth of more than 3% to €2 billion, almost on the same absolute level as in Q1. Total revenues declined predominantly due to lower internal revenues at Telekom IT, which declined by 30%. That's good on the one side because it saves us costs – IT costs.

The market unit revenues, so this unit where we, you know, deal with external customers were slightly down by 2.3%, mostly due to deconsolidation of businesses, which we sold like T-Systems in Italy and parts of the French business, as well as forex effect.

As in Q1, the financial performance was very positive with a 24% increase in EBITDA and an increase of the EBIT margin from a low 1.1% last year to an improved 2.6% this year in Q2.

A few brief remarks on our headline financials. Revenues and reported net profit grew again both for Q2 as for H1 for the whole half year 2013. Let me stress this again, revenue growth at a group level for European telco, EBITDA and free cash flow were down year-on-year, mostly due to the significantly higher subscriber growth in the U.S. and the launch of our Un-carrier strategy and the iPhone in Q2. And our net debt was basically stable year-on-year in Q2 despite the consolidation of the MetroPCS net debt.

With that – that was my initial part and I hand it over to Tim and I look forward to discussing things in more detail with you. Tim?

Timotheus Höttges

Chief Financial Officer, Deutsche Telekom AG

Thank you, René and good morning, good afternoon to everybody.

Let's start with Germany. As you could imagine, we are quite pleased with the operational and financial performance in the second quarter. Our revenues declined by just 0.8% year-on-year, that is half the rate of the first quarter.

The underlying revenue decline adjusting for the impact of regulation, changes in consolidation, and a negative one-time effect in our wholesale business actually was only minus 0.1%. Main drivers of the revenue improvements were mobile revenues growing at a rate of almost 4%, driven by an improvement in underlying service revenues and strong equipment revenues. The core fixed line revenues declined by 3.1% in line with the trend of the previous quarter.

Wholesale revenues at minus 8% year-on-year worsened versus Q1 mainly due to one-timers related to historical ULL fees billed to other operators of around €50 million and revenues related to previous quarters of €50 million. Adjusted for those, the operational revenue was down 4.5%. Adjusted furthermore for regulation, the underlying revenues were down by 2.9% year-on-year in that quarter.

The adjusted EBITDA declined by 2.9% year-over-year, resulting in a strong margin of 40.6%. Main driver here was the deliberate market invest of €122 million mainly into our mobile business in Germany.

In German fixed we saw a satisfying quarter in line with previous quarter. I would like to highlight the following things. A sequentially improved trend in line losses despite 34,000 DT LTE wireless broadband customers added in Q2. Continued growth in the average revenue per access line driven by the continued migration to double play and triple play. And a very strong growth of 126,000 new fiber customers of which 45,000 came from wholesale driven by our contingent model.

Broadband net adds were slightly negative at minus 14,000, a trend which we will counter with more marketing and more promotional activity around our Entertain product like the new feature Entertain to go or the enlargement of our product offer through the cooperation with Sky. Moreover, we intend to improve our customer win back process. So therefore, this is an area of activity we are going to focus on [indiscernible] (15:01).

Turning to mobile, the German mobile market service revenues decreased by 3.4%, the overall market was under pressure. As promised and projected, and despite a challenging market environment, we delivered a return to underlying service revenue growth of 1% year-over-year excluding the MTR effect driven by the continued improving trend in voice revenues and good mobile data growth of 18%. And importantly, we again showed a strong commercial performance with 434,000 mobile contract net adds of which 157,000 were owned branded net adds.

Continued smartphone momentum with almost 1 million sales, including strong sales of Android and iOS devices, a continued strong growth in double-play customers now accounting for 65% of branded contract customers, and a best-in-class contract churn of only 1.2%.

Coming to the U.S. This is the first quarter of integrating MetroPCS into our numbers from May 1 onwards. As a result, we saw a significant year-over-year increase in the customer base as well as in revenues and service revenues. I'll come to the underlying numbers excluding PCS on the next slide.

We are very proud to report after 16 consecutive quarters of losing contract customers in the U.S. that we have turned around this trend in Q2 with winning 688,000 branded postpaid net adds in one quarter alone. Excluding the impact of qualified upgrades to branded postpaid Simple Choice, the underlying growth in our prepaid customer base, excluding the impact of the MetroPCS consolidation, would have been positive as well.

Another highlight of this exceptional quarter is the record low branded postpaid churn of 1.6%, down 30 basis points sequentially and 50 basis points year-over-year, the lowest branded postpaid churn at T-Mobile U.S. ever.

As forecasted, Q2 was a quarter of significant investments due to the launch of the Un-carrier strategy as well as the launch of the iPhone. This was reflected in the development of the adjusted EBITDA, which declined by 10% year-over-year resulting in an adjusted EBITDA margin of 19.3%.

Branded postpaid ARPU decreased by 6.5% due to the customer shift to Simple Choice and the Value plans, which now account for 50% of the branded postpaid base, up from 36% at the end of Q1. The sequential decline in branded postpaid ARPU improved to minus 0.9%, compared to a decline of 2.5% from Q4 to Q1. Branded prepaid ARPU grew by 30% and 23% sequentially, mainly driven by the inclusion of the MetroPCS customers who have a higher ARPU.

Let me provide you with a bit of detail on the underlying development ex -MetroPCS. Underlying T-Mobile U.S. revenues excluding the impact of the first-time consolidation of MetroPCS for two months increased by 12.5%, mostly driven by stronger handset sales. In the second quarter alone, we sold 4.3 million smartphones or 86% of all devices sold, ending the quarter with 15 million smartphone users in our branded postpaid base or 72% of the total branded postpaid base.

However, also the underlying service revenues saw a slight improving trend, declining by 8.3% versus 9.3% in Q1. This is a reflection of the better customer growth offsetting the impact from the continuing migration to Simple Choice and Value plans. Underlying EBITDA excluding the impact of the MetroPCS first-time consolidation was down 27%. Again driven by the launch of the Un-carrier strategy, the iPhone launch, and the stellar branded postpaid net add number.

We took good quality subscribers on board. I think a very important question. The applications from so-called prime customers more than tripled since Q2 2012. 52% of our equipment installment plans receivables are regarded as prime, up from 43% at yearend 2012. And our bad debt expenses decreased 48% year-over-year in Q2.

Importantly, the porting ratios against all major competitors in the market improved significantly in that quarter. We are also making very good progress on the network front with already 116 metropolitan areas or 157 million POPs covered by our 4GLTE network, way beyond our initial 100 million POP coverage guidance for the first half year.

Going to Europe, revenues in our European segment declined by 4.5%, quite some improvement from the minus 6.9% in Q1. The underlying decline ex-regulatory effects, foreign exchange, special taxes, consolidation, and one-timers improved to minus 1.4%. Main positive contributors to the segment underlying revenues were Poland and Slovakia where we returned to positive underlying revenue growth.

And in Hungary – Hungary is an operational highlight in this quarter. In fixed, the TV revenues, equipment sales, together with energy are still on the growth path. Additionally, the annual fixed access churn is now below 3%, which validates the Hungarian bundling and retention strategy.

In mobile, reported service revenues are almost flat. Revenues are also supported by sales of smartphones and tablets. Bundling of equipment with Magyar Telekom, core telecommunication service is clearly having a positive effect on customer retention and on the ARPU.

Consequently, due to a favorable evolution of energy and equipment sales, Magyar Telekom increased its full-year revenue guidance. MT expects increasing revenues year-on-year instead of previously target flat performance.

Still the biggest negative impact for the European segment, underlying revenues came from Greece with declines in the fixed and mobile voice business. It is however worth mentioning that underlying trends slightly improved in Greece supported by our successful TV business, we gained 100,000 TV customers within a year.

Adjusted EBITDA in the segment fell less than in Q1 as there was a full-year booking of the Hungarian utility tax in the previous quarter. Indirect cost savings in the quarter were partially reinvested into a higher market invest in countries like the Netherlands or in Austria.

The underlying EBITDA ex-foreign exchange consolidation special effects regulation and one-off was down minus 5.8%, resulting in an underlying 1.5% margin decline for the segment. The biggest negative impact for the contribution margin again came from Greece due to negative revenue impact. At the same time, Greece is also the biggest contributor to indirect cost savings and actually increased its underlying EBIT margin by 1.5%.

In the Netherlands and in Austria, the underlying EBITDA declined significantly due to higher market invest in the quarter driven by accelerated commercial momentum. The main positive contribution to underlying EBITDA came from Poland due to rationalized market invest, driven by more move to split contract, and from Hungary due to already described positive revenue effect supported by lower market invest.

From the commercial perspective, we continue to demonstrate good momentum particularly in our growth areas. We showed again good growth in TV with 79,000 net adds, broadband net adds of 58,000, contract net adds of 258,000, up from 72,000 in the first quarter.

In the first half 2013, we reported a double digit mobile data revenue growth of 11% excluding currency effect. The smartphone share of dispatch devices reached 70%, up from 60% a year ago. Let me give you a quick update on the progress made on the strategy for the segment Europe and Technology, presented at our Capital Markets Day in December and the progress being made on the revenues as well as the technology and cost transformation in that segment. We made progress on the revenue transformation. The share of total revenues from our growth areas increased by 2 percentage points year-over-year to 21%. The share of the fixed revenues from connected home grew by 2 percentage points year-over-year to 21% driven by TV revenue growth. And the share of mobile data revenues of overall mobile revenues grew by 2 percentage points to 16%. And the share of B2B/ICT revenues as of total revenues increased by 0.3 percentage points to almost 3%.

We will in the future progress on showing you how the mix towards future revenues is going to look like. Progress on the cost and efficiency side included, the all-IP share of all fixed network access lines grew by 9 percentage points to 23%, driven by Croatia, Slovakia, and Macedonia. LTE sites in service doubled year-over-year to 1,600. We have LTE networks in commercial use in six countries already. Homes connected with fiber to the home grew by 25% year-over-year to around 150,000. And the number of full time employees was reduced by 3% year-over-year to below 57,000.

Highlights of the recently reported EE first half-year numbers in the U.K. clearly show that we are making good progress. A stable underlying service revenue performance; a significant adjusted EBITDA improvement with synergy savings on track; the 4G adaptation rate has doubled and is driving strong high-value postpaid customer additions, we just surpassed the 800,000 customer mark; excellent customer retention with the 9th consecutive quarter of postpaid churn at 1.2% or below; encouraging signs of ARPU growth; and EE was officially ranked by RootMetrics' independent benchmarking as best overall voice, text, and data experience in 16 cities.

Turning to Systems Solutions, Q2 results were quite satisfactory. The revenue decline of 8.6% was mainly driven by a 30% revenue decrease at Telekom IT. Again, partially related to seasonal effects and project delays, the market unit revenue declined by 2.3%, with the big drivers being the deconsolidation of the sold businesses, Italy and parts of France as well as foreign exchange.

The underlying revenues of the market unit declined only by 0.4%. At Telekom IT, we expect an uptick in revenues again in the coming quarters. Order entry in Q2 was almost on the absolute level of Q1 and up 3% year-over-year with deals like KONE and SBB contributing.

Adjusted EBITDA and adjusted EBIT showed a significant improvement with the EBIT margin increasing to 2.6% in the quarter. Main drivers were here efficiency measures as well as the conclusion of the cost-intensive transition and transformation phase for some of our big deals and at the EBIT level, a lower depreciation as a result of a more efficient CapEx strategy. There is even a huge improvement from the cash flow contribution of this entity.

Going to the free cash flow and the net income of the group. Starting with our financials and turning to free cash flow, actual free cash flow at €1.1 billion is down by 30% compared to last year's very strong second quarter. Main drivers here very clear, cash generated from operation declined by €276 million in line with the EBITDA as the working capital impact from the value plans in the U.S. was offset by other working capital items.

A CapEx, excluding spectrum, increase of €443 million as expected and highlighted at our Q1 results driven by T-Mobile U.S. and seasonalities which led to a lower Q1 CapEx. The adjusted net income decreased by only 1.5% year-over-year despite the lower EBITDA driven by lower depreciation due to a lower asset base in the U.S. and the anticipated depreciation, the expiration of older parts of our infrastructure in Germany. Lower P&L taxes in the quarter were as well contributing.

Compared to first half year 2012, we saw an encouraging 60 basis points increase in our group return on capital employed to 4.9% driven by a €143 million improvement in our net operation profit after taxes, with the main driver being lower depreciation amortization; net operating assets decreasing by €9.2 billion to €99.5 billion. The €150 million year-over-year reduction in D&A was also the major driver for the increase of our adjusted earnings per share by almost 12% points – 12%, sorry, year-over-year.

Our net debt increased by 11.5% versus Q1 but only marginally compared to Q2 2012 mainly as a result of the first-time consolidation of MetroPCS and its €3.4 billion net debt as indicated at the Q1 results. The non-seasonal increase versus Q1 is mainly a reflection of the dividend payment in Q2. Due to the high, 38%, acceptance rate for our dividend in kind offer, the cash and thereby net debt impact of the dividend was reduced to only €2 billion this year. Let me be clear, this level will mark the peak in net debt this year. The free cash flow of the next two quarters and the €700 million contribution from the sale of Globul on 31st of August will drive net debt down again.

Turning to our balance sheet ratios; net debt to adjusted EBITDA rose to 2.4 times as a result of the consolidation of the MetroPCS net debt. The equity ratio reduction to 26.9% is predominantly the result from the increased asset base as a consequence of the MetroPCS consolidation.

With regard to our comfort zone ratios, we are in the green with regards to all ratios. And our ratings remain stable at BBB+ with the major agency and stable outlooks. As a result, we continue to get excellent funding conditions in the debt capital market.

As you know, we gave full year 2013 guidance under the theoretical assumption of including MetroPCS for the full year 2013 and promised at the Q1 results to update you on this today with MetroPCS included for eight months. The outlook, with respect to the EBITDA and operating free cash flow contribution of all segments, except T-Mobile U.S. remains completely unchanged. To say that again, there is no change to any business except the U.S.

The full year 2013 guidance adjustment therefore is solely the result of the active and entrepreneurial decision of the T-Mobile U.S. board to invest into significant and valuable subscriber growth for the rest of the year, as shown on the charts on T-Mobile U.S.

Contrary to our initial expectation at the beginning of the year, our T-Mobile U.S. management now expects between 1 million to 1.2 million branded postpaid net adds for the full year. This is a tremendous opportunity to create value for our T-Mobile U.S. and DT shareholders, which is why T-Mobile U.S. is investing significant resources into the organic Un-carrier strategy and winning new branded postpaid customers and the rapid expansion of the Metro brand in now 15 T-Mobile markets in the U.S.

As a result, the new guidance of T-Mobile U.S. for full-year 2013 including MetroPCS for eight months under U.S. GAAP is an EBITDA of \$4.7 billion to \$4.9 billion, this is under U.S. GAAP, translating into \$4.8 billion to \$5 billion under IFRS. A cash CapEx of \$4 billion to \$4.2 billion under U.S. GAAP.

The new resulting group guidance including MetroPCS for eight months is EBITDA of around €17.5 billion, roughly in line with the current analyst consensus. EBITDA for the group ex-T-Mobile U.S. of around €13.7 billion and for T-Mobile U.S. under IFRS, \$4.8 billion to \$5 billion which translates into €3.7 billion to €3.8 billion. Free cash flow of around €4.5 billion being in line with the current analyst consensus. Worth noting is that guidance of today is based on \$1.30 exchange rate versus U.S. dollar – €1.30 exchange rate versus U.S. dollar rather than €1.27 as before.

With this, René and I are now ready for your questions.

QUESTION AND ANSWER SESSION

Stephan Eger

Head of Investor Relations, Senior Executive Vice President, Deutsche Telekom AG

A

Thank you very much, Tim, and we'll start now with the Q&A part. [Operator Instructions] With that, I think we'll start with the first question and please restrict yourself to one or two questions in order to get a couple of people through the line.

Operator: Our first questioner is Mr. Polo Tang at UBS. Mr. Tang, your question, please?

Polo Tang

Analyst, UBS Ltd. (Broker)

Q

Yes, thanks for taking the questions. Just first of all on the U.S., you've guided towards 1 million to 1.2 million postpaid net adds for this year. Do you think that this level of net adds is sustainable, going forward, and is there a risk that AT&T and Sprint start fighting back? Just related to the U.S., can you quantify how many prepaid subscribers were upgraded to postpaid in the quarter? That's the first question. The second question is can you maybe just give us your thoughts on the TEF Deutschland and E-Plus merger and were there implications for Deutsche Telekom, and how do you see the German mobile market developing over the coming quarters? Thanks.

René Obermann

CEO & Chairman-Management Board, Deutsche Telekom AG

A

All right. Let me try and answer the first one. I think our forecast is clear, we are – or the management team in the U.S. is now targeting another 500,000 to 700,000 net adds in the second half of the year. The second quarter, the iPhone launch was – gave quite an extra boost and therefore the 500,000 to 700,000 seem a realistic forecast for the second half.

Your question as to what the competitors will do, that's always a hypothetical question. Look our Un-carrier strategy is very well received in the market. To me personally, it seems it's not so easy to copy that for an established large competitor but let's see what they do. I think the fact that AT&T recently launched something, which seemed to copy our JUMP initiatives, I consider that positive to be honest. I think it underpins that we have developed momentum and that they are somewhat concerned. But that's good and I – personally I am optimistic that we have a very good competitive dynamic and we are very well-positioned in the U.S. with that Un-carrier launch and Un-carrier strategy. The market has waited for that.

Stephan Eger

Head of Investor Relations, Senior Executive Vice President, Deutsche Telekom AG

A

And for the second question, with respect to the upgrades, postpaid in the U.S. is – well, a question which you may direct personally to John and Braxton later on but what we can say is the minus 10,000 reported prepaid customers would have been underlying slightly positive if we would include the upgrade to postpaid.

Timotheus Höttges

Chief Financial Officer, Deutsche Telekom AG

A

The third question, with regard to the German mobile market, we saw the German mobile market shrinking in the second quarter by 3.5% and we saw our competitors with shrinkages of minus 5% and even more. Deutsche Telekom was significantly doing better in this environment it was minus 1% overall and – including the foreign exchange effect so therefore we had a better run in that quarter both on net adds and as well on the service revenue side.

That said, we have clearly stated that we believe that we're going to see for the remainder of the year, an almost flattish market environment for us in this mobile segment and we still believe that this is possible to achieve despite the fact that we are facing a tough competition from our carriers not only today but even in the future with the consolidation of the operators around E-Plus and O2.

Stephan Eger

Head of Investor Relations, Senior Executive Vice President, Deutsche Telekom AG

A

Next question, please.

Operator: Next is Mr. Hannes Wittig at JPMorgan. Mr. Wittig, your question please?

Hannes C. Wittig
Analyst, JPMorgan Securities Plc

Q

Yes, good afternoon. First congratulations on a good turnaround in the United States. And my question relates to the ways you have managed the working capital impact. You have talked about mitigating the negative working capital in the U.S. in this quarter. And truly that's something you will also have to do in the second half of the year. So I just wondered if the cash flow guidance of €4.5 billion implies that there are certain, let's say compensating cash movements in 2014, certain levels of deferrals in cash – working capital or CapEx spending. Thank you.

Timotheus Höttges
Chief Financial Officer, Deutsche Telekom AG

A

Hannes, let me ask – answer that question. Let me start to translate what the impact on the EBITDA is into the free cash flow first.

Our new guidance is reducing the EBITDA by \$600 million. Where the \$600 million are coming from? I would say \$350 million is coming from additional growth, which we foresee for the second half of the year; \$150 million is retentions, which are in this market environment; and the remainder is for our [ph] Apollo 15 (42:44) program, which is let's say the extension of our [ph] Metros brand (42:48) into new markets throughout the year in the prepaid growth.

This \$600 million translates into the free cash flow statement. From this \$600 million, we have on the other side a compensating effect, which is \$600 million less CapEx into the integration of MetroPCS and T-Mobile, which is coming at a lower cost than originally expected, and into the investment into the infrastructure of which we have already seen more of – investments in the first half of the year.

So there is a compensation effect of \$600 million on the CapEx side. And the €600 million negative deviation to our original guidance is coming from working capital effects, which are due to the EIPs or the Value plans on our growth side.

Stephan Eger
Head of Investor Relations, Senior Executive Vice President, Deutsche Telekom AG

A

Hannes, does that answer your question?

Hannes C. Wittig
Analyst, JPMorgan Securities Plc

Q

Well, I would be just quickly, interested how you mitigated – for instance, in this quarter where you had a €400 million working capital drag in the United States but it didn't show in your free cash flow. So maybe you can just say how you're doing it?

Timotheus Höttges
Chief Financial Officer, Deutsche Telekom AG

A

Okay. The impact on the second quarter 2013, we had on the working capital side, on the asset side, a min us €500 million. And on the working capital, on the liability side, we had an increase of €650 million.

So the negative impact predominantly is due to receivables driven by Equipment Installment Plans in the U.S. and an increase in the inventories, mainly smartphone driven, of this – of something around €500 million. So I think this is, let's say, the compensating effect in the second quarter.

Stephan Eger

Head of Investor Relations, Senior Executive Vice President, Deutsche Telekom AG

A

Thanks, Tim. And we'll follow up with the next question.

Operator: Next is Mr. Jonathan Dann of Barclays. Mr. Dann may we have your question, please?

Jonathan R. Dann

Analyst, Barclays Capital Securities Ltd.

Q

Just one question. Looking at the sort of margin pressure starting in the fourth quarter last year. Do you envisage the year-on-year margin pressure sort of abating later this year? Or annualizing, I guess?

Stephan Eger

Head of Investor Relations, Senior Executive Vice President, Deutsche Telekom AG

A

Segment – are you specifically refer -

Jonathan R. Dann

Analyst, Barclays Capital Securities Ltd.

Q

Sorry. Sorry. In Germany.

Stephan Eger

Head of Investor Relations, Senior Executive Vice President, Deutsche Telekom AG

A

Well, I think we don't see any margin pressure to be honest. We always said we'll be around 40% with Germany, but also the capital markets guidance.

Obviously, year-over-year, if you compare Q2 2012 with Q2 2013, we've got a slight dip of 1 percentage point in margin. But however, let's be crystal clear, that is a deliberate decision on our side to invest into the market, which is the market invest of €122 million we just talked about, and we saw the results of that.

So we had way more contract net adds than our competition. I think we're taking market share. We're winning valuable customers. And that is reflected in a superior service revenue growth. So I would not talk about German margin pressure, to be honest.

Timotheus Höttges

Chief Financial Officer, Deutsche Telekom AG

A

By the way, [indiscernible] (46:12) is we have seen a price competition on our double-play offers in the mobile market, and that was maybe the topic of the second – of the fourth quarter last year.

Yes, we had to react on the markets. There were even aggressive attempts from Vodafone with their price reductions on the [ph] red side (46:31). We have reacted on that one. We had a new tariff [ph] cut (46:36), which we launched at the beginning of this year in Germany.

When it comes to margin, as in EBITDA margin, it was always mentioned that we are going to reduce our indirect costs. We have a huge program, which is called Lean Admin, which we have laid out in the second quarter here in the German operation, which is supporting that. We have reduced our head count by almost 1,000 people already until now in Germany.

So therefore I think we always have to react on the cost side on competitive offers from competitors. And therefore, so far, we were able to compensate on this, and you have seen that even in the margins of the German business throughout the last quarter, it was 41.9%. It was 41%. It was one quarter 37%, 45%, 40.6%.

So we are doing everything over the last quarters to keep the margin around 40%, and that is even our commitment, which we have laid out at our Markets Capital Day.

Stephan Eger

Head of Investor Relations, Senior Executive Vice President, Deutsche Telekom AG

A

Thanks, Tim. We'll continue with the next Q&A.

Operator: Next is Mr. Frederic Boulan from Nomura. Mr. Boulan, your question please?

Frederic Boulan

Analyst, Nomura International Plc

Q

Hi there. My question is around the guidance. So first of all, in the U.S., if you could talk a little bit about the mid to long term outlook? Do you present this investment in growth in 2013 as a one-off or a more kind of – more structural rebasing of the margin level? And how – and what does this mean for the 7% to 10% five-year EBITDA CAGR that you presented when you acquired PCS?

And then the extension of that question, at the group level, if you could comment on your 2014 EBITDA targets? Should we just look at that from a lower base or from the initial starting point?

And likewise, do you confirm the free cash flow guidance of €6 billion for 2015 or is this something you will need to rebase after today? Thank you very much.

Timotheus Höttges

Chief Financial Officer, Deutsche Telekom AG

A

Fred, thanks for the question, but we are not rebasing anything as of today. We are, right now, starting with our planning process for the years 2014 and beyond.

We have updated you now due to a significant growth opportunity in the U.S. for the year 2013. We'll not be updating you on the five years CAGRs at T-Mobile U.S. nor will the U.S. management do. I think it's not to be expected anyhow. And if anything, I guess the conviction into our growth opportunities at T-Mobile U.S. is stronger than it has been. And first of all, I would like to mention as well you guys didn't even believe the growth rates that we set out. So if you would digest those over time, then we can speak about an update on that.

And on the group target levels with respect to free cash flow 2015, please bear in mind we'll be entering now in our planning period. We'll be updating you on the years 2014 with our Q4 results, as always, end of February.

Next question, please?

Operator: Next is Ulrich Rathe at Jefferies. Mr. Rathe, your question please.

Ulrich W. Rathe

Analyst, Jefferies International Ltd.

Q

Yeah, thanks very much. First, a slightly more technical one on the Telekom IT sort of volatility. I mean you're highlighting on the one hand that lower revenues are sort of welcome because they represent lower costs, but on the other hand, I think it's pretty clear that the current sort of revenue base there is sort of determined by delayed project bookings.

So I was just wondering, what's the underlying growth? And how does this volatility on the T-Systems side, manifest itself in the margins of the other units? I mean, does this ultimately mean if I understand this correctly that maybe the margins in the other units are a bit quote/unquote too high?

The other question I had is on the fiber intake, which slowed down sequentially a bit. I understand there's a bit of seasonality in this, but on the other hand, particularly on the wholesale side, you really have a ramping now from, I suppose, three wholesale partners instead of just one not long ago, which I would have thought could create a bit of secular growth overlay over the seasonality.

So could you just comment on the sort of momentum you're seeing on the contingent model intake side, and what your opinion on that is? Not necessarily with guidance but sort of just how you look at this at this stage? Thank you.

René Obermann

CEO & Chairman-Management Board, Deutsche Telekom AG

A

Ulrich, this is René speaking. Telekom IT, first and foremost, is the internal company, which provides IT services for Deutsche Telekom for our group. And we have separated these two entities, the Market Unit and Telekom IT, for very good reasons because Telekom IT is managed according to efficiency and internal delivery rather than going out to the market.

External market margin, has improved and the lower revenue simply is a result of the deconsolidation of activities, which we sold in France and in Italy because they were non-profitable, so we decided to get rid of them, and we deconsolidated them.

So that – and then the overall margin has increased by 23%, and the EBIT margin now is 2.6%, and the EBITDA margin is slightly below 10%, so 9 point something or so.

So overall, T-Systems has significantly improved its financial performance. The order entry is somewhat better than in previous quarters. I think it's a plus of 3%. But more importantly, the cloud services at T-Systems where we have pioneered the industry – the cloud services are receiving very good responses from customers.

So our strategic intent is to continue to foster the cloud services. Overall, revenues are impacted by deconsolidation. Margins have improved.

Fiber intake – okay, Tim has got the numbers. I'll just hand it over back to him.

Timotheus Höttges

Chief Financial Officer, Deutsche Telekom AG

A

So Ulrich, the – we have increased our [ph] CDS (52:56) or fiber coverage in Germany now to 37%. On the fiber to the home, we have increased our coverage by almost 410,000 homes, connected now. So this €6 billion additional program, which we have flagged in our Capital Markets Day, is up and running and is moving forward. And to compensate for shortfalls in our wholesale revenue, which was quite challenging on the fixed line side, in the past, we are making big success on the contingent model.

In this quarter, we have seen 126,000 fiber net adds only in that quarter here in Germany, of which 80,000 are retail and 45,000 are wholesale, mainly coming from the contingent model. And we even know and we even believe, we even have the contract for that, that even in the consolidated environment of Vodafone with Kabel or even the Telefónica deal now, that these contracts will generate wholesale revenues for us in the contingent model in the upcoming future.

Stephan Eger

Head of Investor Relations, Senior Executive Vice President, Deutsche Telekom AG

A

Thanks, Tim. Let's continue with the next question please?

Operator: Next is David Wright at Deutsche Bank. Mr. Wright, your question, please?

David A. Wright

Analyst, Deutsche Bank AG (Prime Brokerage)

Q

Yes, thanks very much. Hi, guys. So just on Germany, you mentioned you've taken your market share back above that of Vodafone. It does sound like you've kind of maybe taking a little bit of a tougher stance now and say that – in saying that you're not really willing to let that happen again. So if you could just sort of comment on a little bit more defiance there?

And then we have had these two major events since I think we last spoke on a results call, which is the Telefónica, Deutschland and KPN deal, and Vodafone and Kabel Deutschland deal. Maybe just one or two quick words on how you think, if they were to go ahead, they could possibly change the way the market operates. Thanks.

René Obermann

CEO & Chairman-Management Board, Deutsche Telekom AG

A

Okay. It's nothing new, actually David, because we had always had a small lead over Vodafone and we always wanted to defend that lead and then Vodafone two years ago or so got ahead of us in terms of revenue market share slightly.

And I always believe that we should pursue a strategy based on network and on service quality and based on strong brand and customer trust. And, so slightly somewhat conservative approach to it. And as a result of this, very quality driven strategy, we should defend our premium position in the market as the market leader. That is a position we've obtained now or re-obtained and we are willing to defend. Of course, we are rational people so we are willing to defend that position. We will continue on the service quality, on the network quality while we have a significant lead.

If you read all the reports in Germany from critical consumer surveys to the media and drive tests and so forth, you will get a very clear picture. And that is Deutsche Telekom has by far the best network. That is a big asset for us.

So we are not going to throw money in the market and waste money. We are basing our service quality leader – sorry, our leadership based on service quality, our network quality on a strong brand and so forth. It's very much substantiated I believe and we will continue that approach. Nothing new.

Timotheus Höttges

Chief Financial Officer, Deutsche Telekom AG

A

With regard to the question on the combination of Vodafone and KDG, I think first, we always said and we are saying that for years that the consolidation in the German broadband market has to happen. There is, let's say, [ph] new, higher (56:48) need of CapEx, there is tough regulation, there is a high competition here. So they have to earn capital cost in this industry, the consolidation makes a lot of sense. Now the fact with respect to the potential increase in competition as you've said, is for me, first the combination covers only one-third of Germany on the broadband side. For the rest, Vodafone still has to use our infrastructure or search at least for alternatives. Vodafone stated itself in its investor presentation that they intend to cover the areas not addressable by KDG through our VDSL agreement with us. So we hope that we could even take some revenues out of this combination.

Second, the combination offers, so far, pure mobile and an almost exclusive consumer-focused cable operator, I would say is a very complex undertaking. So they have to deliver on that one. And in this transition and integration phase, this may even provide us with some opportunities in that market. So, yes, it is very good that we have a good starting position. We are not in a defensive mode at that point in time. We have a clearly laid out strategy, and we will now do everything to anticipate how the competition looks like in a few years from now. And we will get prepared for that one. And this is a market issue. It's a marketing issue. It's a cost issue. But trust us, we will do everything to be – we are ready to compete.

Stephan Eger

Head of Investor Relations, Senior Executive Vice President, Deutsche Telekom AG

A

Thanks, Tim. I think there is time for two more questions. Let's go with the first one.

Operator: Next is Mr. Simon Weeden at Citigroup. Mr. Weeden, your question, please?

Simon H. Weeden

Analyst, Citigroup Global Markets Ltd.

Q

Yes, thank you very much. Just one question. Just looking at the free cash flow profile across the year, you delivered I think a little bit more than €2.1 billion in the first half, so you've got a certain amount additional to generate in the second to meet the €4.5 billion target, and I just wondered given the iPhone arrived in the U.S. more than halfway through first half, consequently you're likely to see continued high rate of subsidy commitment in the state for the whole of the second half, what other big moving items are there to enable us to complete that bridge between the first and second half free cash flow? Thanks.

Stephan Eger

Head of Investor Relations, Senior Executive Vice President, Deutsche Telekom AG

A

I'll start and then Tim maybe joining in on this. First of all, as you're rightly saying, we're around about the €2.24 billion for the first half. The guidance is around €4.5 billion, so there's another €2.3 billion to go. Secondly, I would say second half was always pretty strong in our case, and we'll be having another €2.3 billion for the second half. The big moving part if you take the year guidance, starting point of EBITDA, €17.5 billion, if you now take into account the €9.2 billion roundabout CapEx, which includes a CapEx reduction in the U.S., you take into account roundabout €2.25 billion of interest payments, and roundabout €550 million of cash taxes. And the overall impact of roundabout €1.7 billion, which includes restructuring costs on the personnel side, also the working capital impact including, by the way, the €500 million impact, which comes on top due to the large growth we are projecting in the U.S. The normal regular asset sales that we've got throughout the year of about €400 million and the dividends received, for example, by Everything Everywhere of €300 million, you exactly get towards the €4.5 billion.

Tim, anything to add there? That's fine, I think we will have the last question for today which is Paul Marsch, I think.

Operator: Right, Mr. Paul Marsch [Joh. Berenberg, Gossler & Co. KG], your question please?

Paul A. Marsch

Analyst, Joh. Berenberg, Gossler & Co. KG (United Kingdom)

Q

Yes, hi, thank you very much. I have two questions on German consolidation, the O2, Deutschland and E-Plus, just interested in your thoughts as to how likely do you think we are to see a package of remedies that's structured to attract a new entrant in the market. Or are you anticipating that remedies will be more focused on divestment of spectrum to existing network players?

And then on the second question just where are you now in terms of thoughts on the U.S. asset in the portfolio? In the past, you've indicated a desire to exit the U.S. And AT&T is obviously out of the picture. Sprint is occupied. Are you – how are you actually looking at that U.S. asset now given the turnaround that's obviously starting to come through quite nicely now? Could we see Deutsche Telekom remaining here as a major shareholder into the long term?

René Obermann

CEO & Chairman-Management Board, Deutsche Telekom AG

A

Paul, it's René speaking. Consolidation in Germany, E-Plus and O2, first of all, I think it's fair to say it has merits for the market, but it also has some difficult questions related to spectrum. So I cannot speculate on what the remedies will look like and whether or not the regulator dreams of establishing yet another player. I personally would think that would be stupid, but that's my only very personal opinion, and I, to be honest, cannot – I shouldn't assume that, that would happen. But anyway, you'll never know.

I think it should be more spectrum orientated because the spectrum situation as a result of that merger would look rather asymmetrical. There is an amassment of spectrum beyond 1,000, so beyond 1 giga – 1 -no, not 1 megahertz. I'm sorry, I now have a blackout. There's a spectrum beyond 1,000 megahertz and – sorry, 1.8. Sorry, the spectrum beyond the gigahertz – now I'm back – which is there's too much spectrum then in their hands, so there should be some reallocation of the spectrum. And we would demand a level playing field for all players in the industry. But whatever the outcome is, I think it will be related to spectrum.

U.S., in our portfolio, very clear. We are very happy to have regained the momentum. We have established a great marketing strategy that is well received in the market, and our focus really is on winning and on making the company successful. And other than that, I will not nourish any speculation as you can imagine.

Stephan Eger

Head of Investor Relations, Senior Executive Vice President, Deutsche Telekom AG

Thanks, René. The conference call is about to end. Should you still have further questions, we kindly ask you to contact me or my colleagues at the IR Department. With that, thanks very much for listening in. Have fun with John and the team on the T-Mobile U.S. call and speak to you the latest in November. Cheers. Bye.

Operator: We like to thank you for participating at this conference. The recording of this conference will be available for the next seven days by dialing Germany, 49-1805-2043-089 via reference number 444926#. I repeat Germany, 49-1805-2043-089 via reference number 444926#. We are looking forward to hear you – from you again. Thank you and goodbye.

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